GLOBAL FIXED INCOME: BREAKING NEW GROUND?

Wisdomtree EU
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It was an incredibly volatile week in the bond market on both sides of the Atlantic, as the month of October got underway. The overarching theme come week's end was higher yields in both the US and the Euro Zone. Was this renewed move to the upside in rates caused by any groundbreaking developments, and what could it mean going forward? Here's some key takeaways:

US Treasuries (UST)

- The UST 10-year yield broke above its May 2018 high point of 3.11%[1] and posted its highest level since 2011, coming in just under 3.25%. While some of the key catalysts may have been economic-related and a reversal of the 'Italian flight-to-quality trade', perhaps most important were comments the market deemed 'hawkish' from Federal Reserve (Fed) chairman Jerome Powell.
- While Powell's comments on the surface didn't seem to represent any shift in Fed policy thinking, he did state that "we may go past neutral" when referring to future fed funds rate hikes, a more aggressive stance than the market had been priced for[2].
- Headlines from the September jobs report were mixed, with the attention grabber being the unemployment rate dropping to 3.7%, the lowest level since 1969[3].
- In our view, and most likely the Fed's as well, the most noteworthy aspect continues to be average hourly earnings (AHE), which rose at a +2.8% annual rate, or -0.1 percent below last month. If AHE breaks above the +3.0% threshold, inflation expectations could get re-ignited.

EUR Government Bonds

- The recent sell-off in treasuries is rippling through Euro bond markets as well. This factor only added to the reversal of the Italian flight-to-quality trade.
- 10-year German bunds stand at 0.56% as of this writing, or up 14 basis points from last week's low; 10-year UK gilts were at 1.69%, up 17 basis points from last week's low while 10-yr Italian government bonds (BTPs) are at 3.39%, up 56 basis points from levels prior to the heightened downgrade fears.
- The 10-year Bund/BTP spread had widened out 70 basis points to +303 basis points (downgrade fears) and has since come in 19basis points from this peak.
- Back to Italy: Reports that deficit targets for 2020 and 2021 were lowered to 2.1% and 1.8% of GDP, respectively, provided some relief to investors initially, but skepticism abounds. The 2019 target remained at 2.4%. Downgrade-anxiety may have been pushed off the front-burner as compared to a few days ago, but the risk of an actual move down a notch still exists. S&P has Italy's credit rating as 'BBB-stable', but the rating at Moody's is already at 'Baa2-negative', so stay tuned.
- An additional concern is referred to as the "doom-loop", or the connection between the amount of Italian debt owned by Italian banks and how the recent sell-off could adversely impact capital cushions. The increase in Italian debt ownership by Italian banks is in contrast to the experience in other countries within the Euro Zone.

Conclusion

US Bottom Line: Some perspective to consider: the Fibonacci technical analysis for the UST 10-year dating back to prior to the financial crisis places 3.32% as a 50% retracement level. Utilizing a strictly ten-year period, the next level would be 3.45%, a 76.4% retracement. We expect the Fed will more than likely raise rates in December, and at least twice in 2019. On the other side of the trade, any downward economic/inflation surprise and/or negative news out of Italy, UST 10-year yields could reverse course.

EUR Bottom Line: Volatility seems to be here to stay for the next few weeks as the markets await any potential credit ratings action. S&P is 'on the clock', with a new report expected towards the end of this month. Given the 'stable' outlook currently in place, S&P would have a choice between lowering the outlook to 'negative' and/or an actual downgrade in the rating itself. Perhaps, once they weigh in, an important area of uncertainty will have been removed, but unfortunately Moody's still looms out there and the Italian budget and banks saga seem destined to re-emerge as well.

Unless otherwise noted, data source is Bloomberg as of 5 October 2018.

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Source

1 Bloomberg, with level of 3.11% observed 17 May 2018.

2 Cox, Jeff. "Powell Says we're a long way from neutral on interest rates, indicating more hikes are coming." CNBC. 4 October 2018.

3 Badkar, Mamta, et al. "US Unemployment Rate Hits Lowest Level Since 1969." FT. 5 October 2018.

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