Rates Spark: Treasuries on Powell-demeanor-watch

US Treasuries got unusually excited about the 20yr auction on Tuesday; usually a tenor that few pay attention to. The bigger impulse is ongoing angst in US risk assets. Yet, Treasury yields continue to reject the nod to go materialy lower. We still see 4% as a firm floor. The FOMC is up next. This one is all about Powell's mood, the dots, and maybe QT wind-down

The Federal Reserve is widely expected to keep rates on hold tomorrow and signal two 25bp rate cuts later this year

Treasuries will have a keen focus on the path for quantitative tightening

Following the last FOMC meeting, Chair Powell was asked one question on quantitative tightening (QT). He read out what seemed like a prepared statement, basically saying nothing of any materiality. But then the subsequent minutes showed that the path for QT was in fact a talking point among the committee members. And so it should be, as on our numbers, continued QT at the current pace would likely see bank reserves converge on US$3tn by mid-year 2025.

That US$3tn area approximates 10% of GDP and is deemed to be something of a floor that the Fed would prefer not to get too much through. The last time the Fed did QT they took bank reserves down to 7.5% of GDP, and had market liquidity issues then, as they had gone too far. There is an argument that say 9% of GDP might do, but either way we'd see the move into single-digit territory as a % of GDP as the point at which the Fed would be minded to wind down QT, completely.

For Treasuries this is important, as once QT comes to an end, the Fed would be a regular buyer of Treasuries. With US$50bn to US$100bn rolling off the curve on a monthly basis, the Federal Reserve would be buying that amount on the marketplace in order to keep their current holdings of Treasuries unchanged. At the last FOMC meeting they broadly agreed to invest according to the capitalisation distribution of debt outstanding. This means they will be buying right along the curve.

While impactful, we should not get too carried away. It won't be determinative for direction. Rather, it returns us to the 'norm' where the Fed is a constant 'market participant' as it manages its reserves obligations on an ongoing basis. This, the dots and Chair Powell's tone are the big issues for Treasuries. Keeping the two dots, plus a projected QT unwind, would be supportive. But likely balanced out by tariff projections on inflation.

Away from that, we expect the Fed to largely retain their forecasts from December and signal that their base case remains two 25bp rate cuts this year. There is no pressing need for additional rate cuts given that unemployment is low and inflation is still tracking hot and is likely to remain above target through the rest of the year given the impetus from tariffs. See more here.

Markets remain cool in light of a historic German vote, but start fretting over tensions

The German fiscal package and debt brake reform passed their first hurdle with the Bundestag vote on Tuesday. A final vote waits in the Bundesrat representing the states on Friday, but also here a positive vote looks very likely after the coalition in Bavaria agreed on a consenting vote.

Market reaction to the historic moment was muted with only a small dip – rather than rise – in yields and even less of a move in Bund ASWs. The German fiscal package remains key to our longer run outlook, where we see 10y yields drifting towards 3% and slightly above eventually.

But more near-term the market is facing elevated uncertainty around the looming US tariffs. We think this has already kept the front end from pricing in the fiscal stimulus story to a larger degree and the confidence still reflected in riskier assets might still be tested, too. That should also help Bund valuations versus swaps to at least consolidate, with the actual issuance impact of the political decisions still some time away.

Wednesday’s events and market view

The highlight of the day is the FOMC meeting. While no one expects a policy change, the updated projection will provide more clues about the Fed’s thinking amid the political changes in the US. Apart from the final eurozone CPI release, the calendar for Wednesday is otherwise light on data with the main focus on European Central Bank speakers. Here we will hear from Centeno, de Guindos, Villeroy and Elderson.

In primary markets Germany will be tapping two 30y Bunds for a total of €2.5bn.

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