
GLOBAL FIXED INCOME: BREAKING NEW GROUND?

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10/10/2018

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 at week's end was higher [yields](#) in both the U.S. and the [eurozone](#). Was this renewed move to the upside in rates caused by any groundbreaking developments? And what could this mean going forward? Here are some key takeaways:

U.S. Treasuries (UST)

- The [UST 10-Year yield](#) broke above its May high point of 3.11% and posted its highest level since 2011, coming in just under 3.25%. While some of the key catalysts may have been economy-related and a reversal of the "Italian flight-to-quality trade," perhaps most important were comments the market deemed "[hawkish](#)" from the [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 Federal Funds [Rate hikes](#), a more aggressive stance than the market had been priced for.
- 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!
- In my 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 pp below last month. If AHE breaks above the +3.0% threshold, inflation expectations could get reignited.

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 previously mentioned "Italian flight-to-quality trade."
- [Ten-year German bunds](#) stand at 0.56% as of this writing, or up 14 [basis points \(bps\)](#) from last week's low; 10-year U.K. gilts were at 1.69%, up 17 bps from last week's low, while 10-year Italian BTPs are at 3.39%, up 56 bps from levels before the heightened downgrade fears.
- The 10-year bund/BTP spread had widened out 70 bps to +303bps (downgrade fears) and has since come in 19 bps from this peak.

- Back to Italy: Reports that deficit targets for 2020 and 2021 were lowered to 2.1% and 1.8% of gross domestic product, 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 compared with 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," 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 eurozone.

Conclusion

U.S. Bottom Line: Some perspective to consider—the [Fibonacci](#) technical analysis for the UST 10-Year dating back to before the financial crisis places 3.32% as a 50% retracement level. Utilizing a strictly 10-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 toward 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 seems destined to re-emerge as well.

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DEFINITIONS

Volatility: A measure of the dispersion of actual returns around a particular average level.

Yield: The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Eurozone (EZ): Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

Treasury: Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

10-Year Treasury: a debt obligation of the U.S. government with an original maturity of ten years.

Hawkish: Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

Federal Reserve: The Federal Reserve System is the central banking system of the United States.

Rate Hike: refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

German 10-year bund: a debt instrument issued by the German government with an original maturity of 10 years.

Basis point: 1/100th of 1 percent.

Fibonacci retracement: A technical analysis tool displaying percentage lines which look at support and resistance levels, potentially signaling short-term price/yield reversals. The concept of retracement suggests that after a period of market movement, prices/yields can retrace a portion of their prior pattern before returning to their original trend.