The Secret Reason That Rates Bounced This Week

There's a lot for financial markets to digest at the moment. Over the past few weeks, the net effect of that digestion has been good for bonds/rates and bad for stocks. But the prevailing correlation broke down this week and few people in the U.S. truly understand why.

That's forgivable, considering there has been a lot to react to in terms of economic data and fiscal updates. Monday's weaker manufacturing data helped keep the good times rolling for rates, which thrive on economic negativity. By Friday, however, rates were back up to last week's levels.

The last big bump came courtesy of a speech from Fed Chair Powell in which he said "the economy is fine. It doesn't need us to do anything, really." If traders had instead seen a bit more concern, rates may have held steadier on Friday as opposed to hitting the highs of the week.

People in the U.S. who are focused on U.S. economic data, U.S. monetary policy speeches, and U.S. politics might mistakenly head into the weekend without appreciating the week's actual x factor. It wasn't that the other stuff didn't matter... just that the x factor caused a breakdown in the prevailing trend for bonds.

The following chart shows that trend with stock prices and bond yields (aka "rates") moving lower together, as well as the amount of weakness attributable to Powell. It also shows the disconnect and forces curious market watchers to dig deeper for answers.

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Without further ado, the x factor is Germany.

It's been a while since we've brought Europe into the mix when it comes to U.S. rate considerations, but this week's example was an easy one. In not so many words, here's the backstory on Germany:

- There is a rule in Germany's constitution that acts very much like the U.S. debt ceiling, but in a more conservative way
- Germany has a history of being fiscally conservative in general
- That has caused disagreements in government, and even the collapse of the most recent governing coalition
- The frontrunner in the upcoming election announced big plans for big spending and a change to the debt limit rule
- Taking on more debt means issuing more German Bunds (akin to Treasuries in the U.S.)
- More debt issuance means higher yields/rates, all other things being equal
- Last but not least, there is a longstanding, fairly well-behaved correlation between German and US debt. The yields themselves may be different, but the movement is often in the same direction.

With all that in mind, here's how the week looks if we replace stocks with Germany's 10yr yield in the same chart:

Long story short, the entirety of that "disconnect" time frame coincided with an explosion in German Bund yields. Very very simple stuff.

Again, there's a history of correlation. Here's a longer-term chart of Germany vs US 10yr yields.

Contrast that to a longer term chart of stocks and US 10yr yields--far less correlated.

What does this mean going forward? Nothing too huge at the moment. Rates are still lower than they've been for most of the past few months, and this week wasn't a huge bounce in the bigger picture. If Germany successfully changes its constitution to allow the new spending/debt, there could be another similar shockwave, but timing is uncertain, but analysts believe it will be hard to push such a change through unless it can be done within the next 3 weeks.

Next week brings more critical economic data for the U.S. with next Consumer Price Index (CPI) being released on Wednesday morning. CPI is the first of the big inflation reports on any given month. The last CPI raised concerns that inflation could once again enter an elevated pattern during the first part of the year--something that would go a long way toward derailing Fed rate cut odds. If CPI instead moves back down, it could help rates hold on to most of the recent gains, or even improve on them.