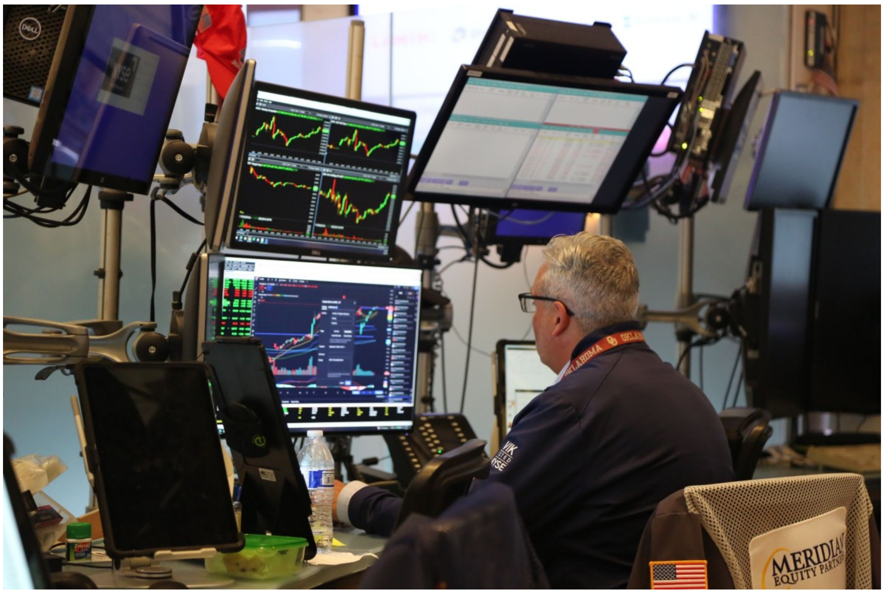
Article | 5 September 2024

Cutting fever is containing long rates, for now

We think the rate-cutting process can coax longer tenor rates lower some more. But there is a limit, and we're close to it. The bigger movement on a three to nine-month outlook is, in fact, higher for longer tenor rates and a steeper curve versus the forward discount



Long-tenor rates can still fall further, but the bigger move will ultimately be to the upside

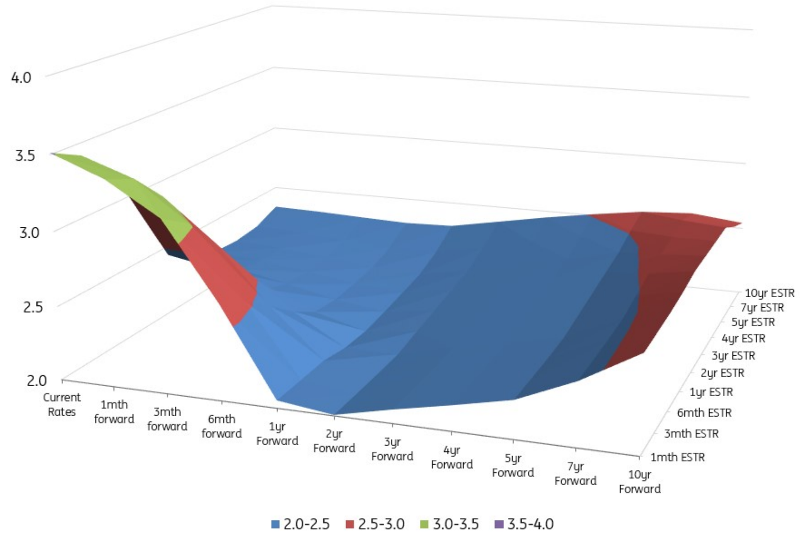
US 10-year SOFR to touch 3% but then backs up to 4% plus

We recently sent out a note on US rates. It's here. In it, we identified the 3% area as neutral for the Fed funds rate. We back this up from previous analysis from the noughties. And that's here. During that decade, US inflation averaged c.2%-2.5%, a rate the Federal Reserve finds acceptable. And over the same time period, the funds rate averaged 3%. The same exercise based on the noughties finds the average 10-year Treasury yield was 4.5%. That translates to around 4% for the 10-year SOFR, and a fair value 100bp curve between the funds rate and the 10-year SOFR.

Based on that, we can see that the current funds rate is high – it's well above the neutrality area of around 3%. The Fed is about to cut, with 3% the ultimate target. But what about the 10-year SOFR rate? It's at 3.4%. That's some 60bp below its neutral area of around 4%. There is no great mystery as to why it's below 4%. The Fed is about to embark on a significant rate-cutting exercise, and history shows that the 10-year rate tends to fall in anticipation - and on delivery of cuts. Hence, 10-year SOFR should still have some room to move lower.

That rate could get down to 3%, a 40bp fall from here. That's the one to three-month target. But getting to 3% would also be an extreme valuation to the downside. We find a 100bp curve from the funds rate to the 10-year yield to be a fair value one. If the funds rate gets pitched at 3%, then 4% is the level we should be thinking about for 10-year SOFR. That's the target on a three- to nine-month view.

The forward profile for ESTR rates shows a structural 2-2.5% tendency from six months out



Source: ING estimates, Macrobond

Eurozone 10-year Euribor to approach 2%, but then backs up towards 3%

Now, what does all of this mean for eurozone rates? In fact, it is something very similar, just with fewer extremes. The forward profile for ESTR is, in fact, very similar to that for SOFR. The entire ESTR curve gets dumped down to the 2% to 2.5% area in the six-month forward space and stays there right out to the four-year forward space. We'd overlay this by asserting that there is a greater probability for the 10-year ESTR rate to claw its way back up towards 3%, especially with 10-year SOFR hitting 4%.

The big adjustment on the ESTR curve in the coming six to twelve months is down on the front end to the 2% area (or slightly above), from 3.5% for one-month ESTR. Out the curve, five-year ESTR also falls to slightly above 2% in the six-month forward space, while 10-year ESTR essentially holds at 2.3%. That results in only a moderately upward-sloping curve in the six to twelve-month forward space. We're OK with this on a one to three-month outlook. But on a three to twelve-month outlook, we'd expect longer rates to be higher. Euribor, of course, trends with ESTR, with a steady c.10bp spread.

If you're interested in an update on the global spreads environment for all tenors - it's here. We expect most spreads to narrow as the Federal Reserve cuts by more than most central banks in the months and quarters ahead.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Disclaimer