Rates: Tactical upside to yields

The brief banking panic is behind us – at least until we get the next one. In front of us is a Fed in a holding pattern, and a May cut is now being questioned. As the Fed strip nudges higher, so too does the US 10yr yield. The 4.25% to 4.5% area is one where it will dawn on the market that it's gone too far. But for now, there is little to object to having that test

Federal Reserve headquarters in Washington, D.C.

US remains pivotal, tactical upside to yields with Fed in holding pattern

The local high for 2024 for the 10yr Treasury yield was just short of 4.2%. It feels right to be back up here, threatening to take out that high and making a path to the 4.25% area. The area between 4.25% and 4.5% is one where it will begin to feel like things have gone a bit too far, and one big catalyst can see us crashing back below 4%. We are just not at that tipping point yet.

The New York Community Bank fall is behind us now, and the big falls in the Regional Bank Index have stalled. Until we get some clear sight of material follow-through angst in this space, we move to a point where we effectively ignore the risks, just like we ignore major geopolitical calamity risks (until they hit us, that is). It leaves us with two items ringing in the ears. First, the payrolls report confirmed the maintenance of a strong labour market. Second, a Federal Reserve cut in March is now a no-go. These are factors forcing yields higher.

In fact, the next question is whether the Fed can cut in May – that's now a toss-up from the market's perspective. The unwind of the May rate cuts discount and the upward drift in the Fed funds strip correlates with the ratchet higher in the 10yr Treasury yield. That can continue at least until something happens to negate it.

Structural dis-inversion still on the cards, to be led by the front end

On the curve, we'd expect it to dis-invert before an actual cut. Once we are a couple of months ahead of an actual cut and it's been effectively endorsed by the market discount and minimal Fed objection, then the 2yr yield will have space to gap lower by 50-100bp. That should be more than the 10yr can do, wiping out the 30bp inversion on the 2/10yr segment. From there, the 2/10yr segment begins a journey toward 100bp. The biggest part of that move will come from the front end, to begin with.

Eurozone rates to echo the US, but are already quite rich versus future policy rates

Eurozone rates reflect a lot of the same pushes and pulls. The nuance is that eurozone rates are already quite low. For example, 5yr to 10yr Euribor rates are in the 2.6% area, and similar ESTER rates are in the 2.4% to 2.5% area. The interest rate strip curves that discount the future for key front-end rates don't push much below these levels, if at all in the coming few years. That suggests that eurozone rates can echo moves in US rates, and in net terms we should see a structural convergence of US to eurozone rates once we get beyond the current tactical upside test to yields in general.

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