Rates: Think normal is boring? Think again

The Fed and ECB are gliding towards what we'd consider to be broadly normal rates. Sounds tranquil. But the deceleration and re-acceleration of these journeys is what impacts longer-dated market rates. In contrast to the smooth policy rate journey, longer tenor rates are susceptible to quite some extremes in the coming months, both high and low

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There may be glide paths mapped out, but they are very susceptible to resets

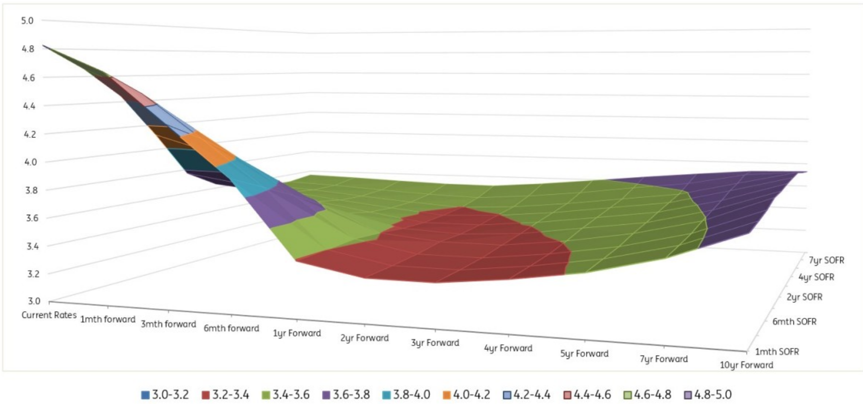
We're in a really interesting period right now. Once the Federal Reserve finally cut by 50bp a couple of weeks back, the rate-cutting cycle was confirmed as well and truly on. Then we've had nuances on both sides of the Atlantic, with a blowout payrolls report curbing the extent of cumulative cuts discounted. And from the eurozone, there's been a decent smattering of disinflation / German vulnerability commentary that has added to discounted rate-cutting needs there. It does appear that both the Fed and the European Central Bank are riding the wave, as opposed to being behind the curve. They have the flexibility to respond in kind to data variations. Neither is on a wholly pre-determined path. A key element is where they are going to end up. And then, of course, what that means for the shape of curves.

Indeed, as strategists, one thing we constantly keep an eye on is the end game. In other words, where rates end up after the rate-cutting cycle. This requires first identifying the likely bottom for policy rates. In the US, there had been a market tendency to view that bottom as mildly sub-3%. But since the recent firm payrolls report, that discounted bottom is now around 3.3%.

For the eurozone, the discounted low for the deposit rate is around 2%, with a marginal tendency to dip mildly below. These levels are not dramatically deviant from where we'd identify "normal" to be. Around 3% (or slightly over) is suitable for the US while around 2% is appropriate for the eurozone. The market discount is broadly on a glide path towards these types of levels, and that's important, as it means a return to normal.

Reality will be far more volatile than suggested here (same for eurozone)

SOFR curve and forward profile



Source: ING estimates, Macrobond

Expect far more variation in the journey for 10yr rates, partly reflecting glide path adjustments

Normal may appear boring, but it's not, as returning to normal on the front end requires more dramatic adjustment for longer tenors. Our 3% equilibrium anchor for the Fed funds rate maps out to a normal 10yr SOFR rate of around 4% (and a 10yr Treasury yield of 4.5%). To see how we get to this, see more here. The current 10yr Treasury yield is around 4%. The normal is 4.5%. We could absolutely head straight to 4.5% unless that is frustrated by a material recession in the labour market. On the assumption that there is such a recession, there is a journey back down to the 3.5-3.75% area. See here for more on this. As the Fed continues its gradual adjustments to the funds rate, 10yr market rates are likely to experience big directional swings. But the end-game is a 100bp one-month to 10yr SOFR curve by this time next year.

For the eurozone, the directional dynamics are similar, just a tad less extreme. But still meaningfully impactful. As the ECB glides to the 2% area, bringing the front end with it, longer tenors are on a different type of journey. The 10yr Ester rate is now at 2.5%. With the deposit rate getting to the 2% area, the normal Ester rate would be in the 2.75-3% area, likely a bit flatter than the SOFR curve. But for simplicity, a 2-3% curve is the probable mythical equilibrium curve from 1mth Ester to 10yr Ester. That implies a 100bp gap between the SOFR curve and the Ester curve from one-month out to the 10yr, again purposely using round numbers. The journey for 10yr Ester is then 2.5%, back down to 2% (on a US employment report wobble, or something similar in the eurozone in the next few months) and then back up towards 3% (more likely in 2025).

> What to watch here is the acceleration or deceleration in the glide path for the Fed and ECB. Recently, the Fed's path has slowed, which is why we've had a severe backup in long-tenor rates. If we get the employment report wobble feared, then the glide path can re-accelerate, likely bringing long rates down with it. If we never get the employment report wobble, then longer tenor rates have seen their lows and the 10yr yield is not going back below 4% (not our base view).
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> It's a similar situation for the ECB. Its glide path re-accelerated on rising macro angst (before the US payrolls report), bringing 10yr rates down with it. The prospect for an earlier ECB cut plus US robustness has since pulled the 10yr rate back up again. Watch this continue to play out like this in the months ahead.

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