Rates Spark: Bulls pushing down the back end

A hawkish ECB press conference helped our bearish case on 10Y swap rates, but markets will face resistance from the bullish momentum in the US. The US 10yr 4% level was breached twice, albeit briefly, on Thursday. It seems to be setting itself up for a break below. All it needs now is a solid excuse. Something like the buildup to a first rate cut in a year – maybe

Even with the glide lower in US rates, we still see euro rates maintaining their current levels or even rising

Thursday's market moves suggest euro rates can disentangle from the US

We rarely see US and euro rates diverge as much as on Thursday, but the bullish move from the US won eventually. Nevertheless we see two very different rates markets, and thus seeing more days with diverging moves is likely. The Fed has many more cuts imminent, whereas the European Central Bank is in a holding pattern. At the same time the growth outlook for the eurozone is one of recovery, while jobs market woes dominate the US narrative. We still think the 10Y euro swap rate can drift higher over the near term and diverging moves like we saw today show that EUR rates may even manage this in a UST bull market. Especially if the eurozone growth recovery

keeps up, the 10Y swap rate could start eyeing 2.8%.

Having said that, the 10Y EUR rate may not continue drifting higher if a further deterioration in US data starts hurting global risk sentiment. But with the S&P 500 hitting new records in response to Thursday's disappointing US data, that doesn't seem to be the case for now. Another risk is a further escalation of the French political turmoil, yet even then the spillovers beyond French government bond yields have so far been contained.

With a view to the EUR front end our economists no longer view a rate cut as the central scenario for the ECB. Nonetheless, the ECB has not fully closed the door to further easing. The market has reduced its prospects for another cut with the easing priced by mid next year pared back to 12.5bp, making it basically a coin toss. The 2y Schatz yield briefly hit the 2% level. As we have stated before, at a level close to 2% we see on balance more reasons for rates to go lower than higher in the coming months.

France faces its first rating test following the latest political upheaval

Rating agency Fitch is scheduled to review France on Friday and any updated will be published after markets close. The risk is obviously for a downgrade as the agency cites "failure to implement a credible medium-term fiscal consolidation plan [..] " as the rationale for a potential downgrade. A downgrade would also show some consistency with the recent lowering of Belgium's rating to A+/Stable in June.

That said, there are also arguments to sit out a politically sensitive decision. Fitch did already say in March that they anticipate new elections in the second half of this year, so we are seeing their assumed base line scenario unfolding.

Also the 2026 consensus GDP growth forecast for France is now in line with Fitch's 0.9%. The consensus had been lower, but has inched up again since bottoming before summer. Fitch itself had lowered French growth prospects in March "mainly due to the risks of rising international protectionism and weaker growth in Germany, France's largest trading partner". While it said "the impact is somewhat mitigated by increased European defence spending [...]", it crucially made no mention yet of Germany's fiscal U-turn where first intentions became public early March, only shortly before the French review.

A downgrade would probably not change the broader picture for French bond markets since a 10y spread of 79bp over Bunds, nearly on par with Italy, already reflects expectations of rating downgrades over the medium term.

US Treasuries maintain a positive gloss on a growing sense of concern on the economy

In the US, the 10yr yield finally decided to make that break for 4%, and scraped through to get below, briefly. Now back above, just about. Not a convincing break, but its been hit and breached, so next time it can get through with some more conviction, when provided with the excuse to do so. The excuse Thursday was in fact not quite as convincing as the excuses offered Wednesday (PPI) and Tuesday (employment revisions). The CPI inflation data released Thursday were if anything a tad firmer than expected, especially the headline 0.4% month-on-month rise, and

we're left with core inflation still running at 3.1%. Jobless claims rose, but continuing claims fell. Bond positive yes, but not glaringly so. The fall in real weekly earnings to 0.4% year-on-year is something to ponder though. That in itself is absolutely not great. Of the data, that's the one that should worry us the most (and cheer the strange bond beasts that love macro pain). The 30yr auction later in the day was absolutely fine, and in fact solid given the firm market that it was auctioned into. A firm market helps from a sentiment perspective, but can risk a tail, which we never got, so all good.

Friday's events and market view

In terms of data we have the final CPI numbers for France and Spain, but usually these don't pose any surprises. Also from the eurozone we have the ECB's Governing Council members Rehn and Kocher talking about monetary policy, possibly of interest after Thursday's meeting. The US will publish the University of Michigan sentiment index, of which consensus sees the headline figure broadly stable at 58.0.

Author

Michiel Tukker
Senior UK & Eurozone Rates Strategist
michiel.tukker@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

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

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("**ING**") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the

Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.