A US rate cut vs a very French affair

A lot is going on. In the eurozone, it's all about spreads, particularly French ones. It comes against an underpinning of mild upward pressure on longer core rates, but without much conviction, partly because there is rate-cut fever at play in the US. We could see long US rates dip down into the cut period and subsequently back up again as inflation bites back

We expect the US 10yr to have a go at gapping lower, but should rebound in subsequent months

The US 10yr yield, now in the 4.1% area, fell to 3.6% when the Federal Reserve commenced its rate-cutting cycle a year ago. Back then, the Fed cut by 50bp as a start and subsequently delivered a further two consecutive 25bp cuts. That 100bp rate-cutting cycle coincided with a remarkable rise in the 10yr yield, from 3.6% all the way up to 4.8%. During the pause phase since then, the 10yr yield has managed to trade around the middle of that range (the 4.25% area, give or take 20bp). It's now shaping up to make a break below 4%, and if it's going to do that, it's most likely in the next week or two. The bond market has rate cutting as a driver, and the first cut of any cycle is always a big event for bonds, typically right out the curve.

That said, we doubt that longer tenor bond yields can simply sail structurally lower from here. One constraint is the inflation readings in the coming months, which are very liable to show an accelerated tariff impact. We anticipate that US inflation, currently at around 3%, rises to the 3.5% area in the third quarter and into the fourth quarter. The 10yr SOFR rate is currently at 3.55% and is liable to find some discomfort should inflation hit that level, resulting in an implied 0% 10yr real rate. While it's true that tariffs are more likely to drive up prices than cause structural inflation, this assumption still needs to be proven.

Also, note that the market is anticipating that the funds rate will fall to the 3% area (maybe a tad below). That sets something of a floor for 10yr SOFR, and really it should not get anywhere near that floor. Right now, there is a degree of rate-cut fever at play that is liable to sustain downward pressure on longer-tenor yields. But we see a limit to that, especially given the inflation dynamic expected in the immediate few months. So a reversal higher is likely, similar to last time. See more here. At the extreme, we can see the 10yr yield bottom ahead at 3.75% before reverting up towards 4.5% over the next few months. SOFR should behave similarly.

Eurozone rates are proving resilient, although spreads are showing more movement. Still eyeing upside (for both)

The eurozone rates story is all about spreads right now, as the French 10yr now sits broadly flat to Italy, and quietly the German yield curve has separated itself from the rest as its debt dynamics revert to its typical solid footing (as has the Dutch curve, and debt dynamics). At the same time, even the German curve continues to sit above the ultra-risk-free curve in the guise of Ester (reflecting the German deficit prognosis). We maintain the view that eurozone rates are more prone to edge higher from here than lower, at least on a multi-month view.

The prognosis of elevated fiscal deficits is an important element across the eurozone, and the need (and indeed, promise) for more spending on defence pushes in the same direction. The German 10yr is now at 2.65%. We maintain a multi-month tendency for that to edge in the direction of 3%, reflecting some of these issues. But also reflecting the fact that the eurozone is no Switzerland, in fact thankfully (from a rates perspective), as negative rates or the threat thereof is not where we want to be heading.

We view the eurozone core rates space as spanning 2% on the front end (Ester / Euribor) to 3% on the 10yr (Germany / Euribor), and above that for longer tenors. Factors that can push the German 10yr yield lower in the more immediate future are twofold: 1. Fallout of any gap lower in the 10yr Treasury yield, and 2. Residual flight to safety should the French story get nasty (probably won't, but needs to be watched).

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