

Rates: Expect the unexpected

With so many crosswinds to deal with, market rates have decided to rise, especially in the US. We find there is more room for this trade. In the eurozone there is resistance to this, and the combination results in wider spreads versus the US. This, too, can continue



US market rates have seen some dramatic moves in recent days

Confronting the US curve to neutral levels results in upward pressure on long rates

The movement in US market rates in recent weeks has been dramatic. Notably, the 80bp increase in the 10-year Treasury yield began just as the Federal Reserve implemented a significant 50bp cut. Historically, rate cut cycles have led to a rise in the 10-year Treasury yield, but typically only by 10-30bp, with 50bp being the previous high. This latest 80bp surge is more than just a reaction to the rate cut; it reflects a substantial reassessment of current macroeconomic conditions. Additionally, it coincided with growing confidence in financial markets for a Donald Trump presidency, which emerged well ahead of the election. It's practically been a one-way trade for higher market rates since that 50bp cut from the Fed.

The picture ahead is interlaced with conflicting issues. At times like this, it's always good to set out key neutral rates against which we can reference current market levels. Starting with the Fed funds rate, our neutral valuation is 3-3.25%. Given that, there is room for the Fed cutting to

continue. Our neutral 10yr SOFR rate is 4%, a 100bp curve. The actuals sit below both of these estimates. As does the 10yr Treasury yield, where we identify neutrality as 4.5%. Then we've got to ask whether we should converge on neutrality or not. For the Fed funds rate we think not; we should settle some 50bp above neutrality. That alone should pressure the 10-year market rate above neutrality, too. And the supply aspect should independently pressure the 10yr Treasury yield above neutrality.

Given that backdrop, we can see the 50bp spread between 10yr SOFR and the 10yr Treasury yield continuing to widen, reflecting supply pressure on Treasuries. And the end game for 10yr SOFR is in the 4% to 4.5% area, with the 10yr Treasury yield concluding in the 4.5% to 5% range. That has also been our end-game hypothesis for this cycle, the caveat being an expectation for a hiccup along the way as the economy slows. And as that coincides with the Fed cutting in the background, there is an impulse for lower rates right along the curve. The latest price action seems to suggest this phase has been skipped. It probably hasn't. We still think there is a decent probability we get such a move lower in market rates, but not until or unless we get a valid excuse to do so. Until then, we stay the course.

Eurozone rates are pulling back as best they can, widening spreads versus US ones

In the eurozone, there are quite different dynamics in play. But let's go through the elements first. Our neutral estimate for the European Central Bank's deposit rate is 2%. We likely need to hit this given the hurt being taken by the growth dynamo that is Germany. That continues to pull the front end lower. In the 10yr, if we talk Ester, we'd have 2.5% to 2.75% as a neutral area. Currently, 10yr Ester is 2.3%. On that measure, there is an upward pressure in play, or at the very least, we'd have to rationalise why 10yr Ester should remain below its neutral valuation. In contrast to the US, we can get there in part on account of the weakness of the economy. We can add to that an ongoing rate-cutting agenda from the ECB. Until that results in some positive macro results, longer tenor rates can be below neutrality.

That said, some sizeable spreads have now opened up between US and eurozone rates, to the tune of 175bp in the 2yr and 150bp in the 10yr. The fair valuation area is around 100bp. Of course, spreads can widen further to the extent that the US rate cut ambitions diverge further from eurozone ones. But if they do, it's likely to come from upward pressure on US market rates. This classic directional trade would place upward pressure on eurozone rates, just as we've seen in recent weeks. A compression tendency is more likely to coincide with a fall in market rates coming from the US, and that requires material macro angst in the US that we are not currently seeing but could well see in due course.

These are testing times

One thing is clear – these are testing times. There are considerable political pushes and pulls that have the capacity to whip markets around. Any sense of a lack of political stewardship can quickly expose elevated deficits to bond market angst. Things can unravel quickly. At the other extreme, the evolution of macro vulnerabilities ahead can work to quicken central bank responses through rate cuts. That can act as a material comfort blanket for bonds. Either way, expect the unexpected.

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