

## Rates: If the system's okay, rates should edge up

The pivot camp thinks market rates have peaked. They may indeed have, but that doesn't mean we can't get back up to that peak. We think it's too early for a precipitous fall, unless the system creaks loud(er). Recession risks are not enough – they may slow down hikes, but that doesn't make them go away. Market rates therefore remain under upward pressure



### Key market rates are thinking about falling, but it's too soon. There's still upward pressure

The US 10yr Treasury yield has settled at around 4% and the Euribor 10yr at 3%. Breaks below these levels have been seen in the past week or so, and are generally premised on market talk of a slowdown in hikes. That has also helped buoy risk assets. Market participants are terming this a pivot, but we'd say it's an adjustment or a modification-type pivot at best, rather than a hard pivot where the direction is materially changed.

The fact remains that central banks are still hiking, and slower hikes can still result in elevated terminal rates. This is especially true given the stickiness of inflation, and we've seen examples of

this from both the US and the eurozone in the past week or so. So, the pressure remains on central banks to do something about inflation, and there is only one thing they can do – ensure financial conditions are tight and constraining on the economy.

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*Any material fall in market rates loosens financial conditions. Not ideal yet*

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A material fall in market rates and/or a precipitous narrowing in credit spreads is not what central banks want to see at this juncture, as it frustrates their purpose. Indeed, if there were to be a material fall in market rates ahead, it would most likely need to be countered by a stronger reaction from central banks. It might be verbal to begin with but will ultimately signal an ambition to target higher terminal rates where necessary.

We are therefore reluctant to join the bandwagon for lower market rates. We will get to that point eventually, but we think it's still too early. Upward yield pressure remains a call for the coming month.

## **There is a mild creaking in the system**

There is one important caveat to this though, and that is a slow uptick in system pressure. One measure of this is where banks print (3-month) commercial paper, and in particular the spread over the risk-free rate. In USD that spread has crept out to the 30bp area, and European banks are printing in the 50-60bp range. That's not awfully wide, but it is much wider than it was.

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*System pressure presents a more credible risk for a hard pivot*

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This type of widening is a more credible reason for a “pivot” than mere recessionary fears. After all, tighter policies from central banks are designed to slow growth, and such policies accept the risk of consequent recession. But what central banks can't accept is any threat to the functioning of the system. There's no need to panic yet, but this is what we really need to be cognisant of.

Any material fall in market rates from here will only make sense if the system is really creaking. Here we've outlined the risks, and note that they are there. But we are not at a point yet where it can cause central banks to abort what they are up to. Therefore, the upward pressure on market rates remains.

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