Rates: Long ends get some personality

We've argued that the US 10yr has been far too correlated with the 2yr. The 10yr yield should be more worried about inflation and the fiscal deficit, but instead has been hypnotised by rate cutting. It's about time for longer tenor rates to become more unhinged. The same goes for eurozone long tenor rates, especially as the ECB is on hold for the time being

If long end rates are going to test materially higher at all, now is as good a time as ever

Here's a question: why is the spread between 2yr SOFR and 10yr SOFR just 30bp?

The 2yr rate is at just under 3.4%. That compares with a 3mth SOFR at 4.0%. On the theory that the Federal Reserve cuts the funds rate by another 75bp in the coming six to nine months, and holds there, that averages 3.35%. So 2yr SOFR at 3.4% looks okay. It *could* dip a tad lower. But no big issue with where it sits. But the 10yr? At just 30bp above the 2yr, this looks quite tight. One rationale is an implied discount for even bigger cuts than the market currently discounts. That could centre on the notion that something breaks, and the Fed is forced to cut deeper. Maybe. Or it could come from manufactured rotations at the Fed that manifest in the emergence of a super-dovish tilt.

But what about the inflation environment? It's currently running at or about 3%. Even the most conservative estimates expect inflation to rise to 3.3%. We think 3.6%. Rounded, we'd not be crazy to assert that the tariff feed-through can push inflation up to the 3.5% area. That's right up against the current 10yr SOFR rate at just under 3.7%. So, even if something *did* break and/or the Fed

becomes doveish, should the 10yr not be more concerned about where inflation is heading to in the next few months? We continue to view the 3.75-4% area as fair value for the 10yr SOFR rate when the Fed bottoms at 3%. And that, in fact, should not theoretically change much, even if the Fed were to shock-cut to 2%.

That is unless the 10yr SOFR rate remains overly enamoured with where the front end *could* get to. The 10yr should get a personality of its own, and think beyond what the Fed is doing, and more about where it's pitched in real terms.

Question two: why does the German 10yr yield love the 2.6% area?

The 2.6% area was hit in the early weeks of January, and since then the German 10yr yield has managed to average there. It's now at 2.65%, and has happily mean-reverted around that level in recent months. German inflation is running at 2.3%, and we expect it to hold in that area, or slightly above 2%. Yet the German 10yr breakeven rate is at under 1.8% (nominal yield minus real yield from inflation-linked bonds). So, either the German real yield is too high or the German nominal yield is too low. The German real yield is about 0.75% (extrapolated from 0.65% on the 8yr), which does not seem high. So can we square the circle by asserting the 10yr Bund yield as too low?

The Bund yield must also take into account issuance pressure. That's something, theoretically, that should not be an issue for ESTR (or SOFR, or indeed Euribor). German debt dynamics have been admirable, at least up until recently, as it has managed to credibly head in the direction of 60%. Ahead, however, fiscal deficits of 3-4% of GDP would not be out of kilter with heightened spending ambition (defence, but also infrastructure). That risks steering the debt/GDP ratio higher, even if just temporarily. That should add pressure from an issuance perspective. The same as US Treasuries can feel relative to SOFR. Long story short, the 2.75% to 3% area is where the 10yr Bund yield should be heading.

Again, the likelihood of this happening is enhanced now that the ECB distraction has been downsized (assuming a dominant on-hold tendency ahead). Time for longer dates to become a bit more deanchored versus the front end.

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