

Rates: Mapping the war to markets

We're in an uncomfortable spot. But it's tolerably better than a spiral out of control. Given what we know, rate markets are dealing with an upward shift in the starting points of curves and an increase in inflation expectations. Both of these maintain pressure for elevated bond yields. There is a tipping point, led by lower real yields. But not quite yet.



Expect market yields to remain elevated

The markets and the war and bond yields

To understand market thinking on the war, one must recognise that markets are cold-hearted. The fact that negotiations broke down last week is important, of course, but it's not the dominant factor for markets; wars between regional powers aren't actually that important to them. What matters is an improved medium-term capacity to get back to a normal flow of stuff generally. While remaining apolitical, the stalemate in the Strait of Hormuz is bizarrely a more market-friendly outcome given that, in theory, the ultimate aim is to reopen the Strait fully and unrestricted.

The impact reaction is more nuanced, as in fact the US intervention mutes flows, certainly from Iran. But the bigger and longer-term picture is more palatable. From a cold market mindset, even if Israel and Iran were to lob munitions at each other, markets wouldn't care that much. Markets will care if the US is in the game and ramping up risk. As it is, it seems the US prefers an off-ramp, as long as it comes with the US taking control of enriched uranium and

the Strait fully reopening. Things could change quickly in the coming days, but based on what we know, a landing has been found in an uncomfortable spot, in an area that averts a super-bad-case outcome.

Expect market yields to remain elevated, though. Oil prices may be off their highs, but nothing's been solved. Inflation breakevens *have* managed to ease lower in short tenors, reflecting that mild ratchet away from extremes. But longer-tenor yields have come off highs mostly from an easing in real yields. The market is beginning to think about a medium-term activity hit. That said, we continue to view the inflation spurt as the immediate issue that will keep long-term yields elevated.

Setting the scene for medium-term rates

Translating this into a view on bond yields requires mapping out the considered neutral valuations, then assessing where we should be relative to them.

In the eurozone, the deposit rate at 2% is considered neutral. The 10yr, then, at 75bp above that, is where the conversation begins about where neutrality is. It's a more opaque conversation for longer tenors. But two key ingredients need to be added. First, the front end is trading in the 2.75% area, which presents us with an elevated base. Second, 1yr inflation breakevens are around 4%. Bottom line, it's fair to argue that the 10yr Euribor rate should have a 3% handle (which it does), and it risks edging higher still.

In the US, the funds rate is considered neutral in the range of 3% to 3.5%. It's currently at 3.64%, and markets expect it to hold there for the coming couple of quarters. That's the base from which the curve needs to be pitched. Front-end inflation breakevens are in the range 3% to 3.5%. Neutrality for the 10yr yield has a 4% handle. Currently, the 10yr real yield is at 1.8%. Lob the latest 2.7% core CPI number on top of that, and we hit 4.5%. Market breakevens in the 10yr area are lower, but printed PCE inflation metrics are higher. There is no perfect model here, but getting to 4.5% should not be a surprise outcome.

There is a tipping point where bond markets start to worry more about collapsing real yields and a recessionary tendency. That would be where the war re-intensifies, and would likely require some loss of control by the US. We don't assume that, so for now, the central impulse is coming from front and centre inflation worries. And for as long as rate hikes are *not* delivered, pressure for higher (consequently unprotected) long yields remains.

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