

Rates: Pressure for higher rates and wider spreads

There is quite a contrast between the US and eurozone's rates narrative. The discount for a rate cut in the US has shifted to September, but in Europe, it's still June and/or July. That means upward pressure on market rates and wider spreads. And it also anticipates a steepening of the eurozone curve from both sides



Varying rate expectations: The ECB's Christine Lagarde and the Fed's Jay Powell

US Treasury yields remain under upward pressure

In previous cycles, the 10yr yield typically managed to fall appreciably once the Fed has peaked. In the current cycle, the 10yr yield has, in fact, risen post the peak. What is clear is market rates have not fallen by anything near what would have been typically expected from a "Fed peak moment". See more [here](#).

Firm labour market data and pops in inflation data have muddied Fed rate cut ambitions. And the latest payrolls and consumer price inflation reports largely contain more of the same. Bottom line: the data since the Fed has peaked has not been consistent with an excuse to cut, which delays confirmation of July 2023 as the peak.

That, in turn, exposes an excuse for the 10-year yield to continue to retest higher for as long as the economy refuses to lie down. We've now hit 4.5%. The next big target is a potential re-visit of 5%. With another run of 0.3% or 0.4% month-on-month readings for March inflation, the pressure is building in that direction.

Eurozone market rates can't ignore the US

In contrast, the eurozone is moving in the opposite direction as the discount for a June and/or July cut remains hard, while it has virtually disappeared for the Fed (a first cut from September is now discounted). This is quite an unusual circumstance but reflective of a US economy that remains more inflation-prone than the eurozone and, indeed, more vulnerable from a growth perspective. This is being echoed on the curve through a widening in the Treasury versus Bund spread, which has now shot above 200bp and is likely to continue to widen.

Progress towards lower longer tenor market rates for the eurozone is being frustrated by upward pressure on Treasury yields. The US 10yr Treasury yield, now at 4.5%, contrasts with a 10yr Euribor rate of c.2.7%. Should the US 10yr head towards 5%, the Euribor 10yr could be dragged towards 3%, even as the ECB prepares to cut. This would allow for steepening as 2yr Euribor moves from 3.2% down to sub-3%, finding it easier to shift clear of the US 2yr.

Bottom line, we see upward pressure on Treasury yields in the months ahead, and eurozone market rates are being dragged a touch higher by the directional impulse coming from the US. Hence, there's a continued widening of the spread from eurozone market rates to US ones. We should also see some steepening from the front end on the eurozone curve for as long as the ECB sticks to its pre-Fed rate cut ambitions.

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