

## Rates: Risk mood to tip the balance ahead

We called for the recent rise in market rates, and when they eventually popped it was in a flash. Thematically, inflation stickiness is a key theme, and heads have turned to 'we told you so' central banks. Logically, upward pressure for market rates remains, which is probable if risk assets perform. If not, duration buying should mute the upside risk



### Front ends are getting priced higher on more hikes and fewer cuts being discounted

Front ends are hitting new extremes as the rate hike narrative from central banks has become more credible. The German 2yr has popped above 3% in the past week for the first time since the Great Financial Crisis. And the 10yr Euribor is also now back above 3%; comfortably in fact, at 3.2%. The marketplace is being bullied by inflation stickiness (see the latest [French](#) and [Spanish](#) readings) and the associated heightened European Central Bank rate hike risks.

## *The front end is being bullied by inflation stickiness*

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It's a similar story on the US curve. A June hike of 25bp is now fully priced (so we have 25bp priced for March, May and June). There is some talk of a 50bp move, although we view this as being quite unlikely, and indeed unnecessary. The Fed needs a degree of underlying stability, so upping the size of hikes here would be counter-productive.

The other big change on the US front end has been the downsizing of the probability attached to interest rate cuts in late 2023. This is the other reason for the US 2yr to hit a new cycle high in recent days. It's off the highs hit in the week but is still only a smidgen below 5%, a level that the 2yr yield collapsed from in 2007 as US banks began to feel a sense of impending doom as the housing market collapsed.

## **Long rates also rising, but still low versus the front end**

The US 10yr has responded to heaping pressure to move higher in yield over the past few weeks but still remains a tad anomalous, as the 3.9% area is still some 150bp below the market's projected peak in the Fed funds rate. Most of the time the 10yr hits the same peak as the front end, only much sooner. Here, the 10yr peaked at around 4.25% back in October. That's a deep discount versus the terminal funds rate now discounted at 5.4%.

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## *Long rates suggest that economies will creak ahead*

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One of the plausible reasons for the remarkable early and deep inversion of the US curve is longer maturities are a tad nervous about the future. Putin's war in Ukraine shows how uncertain geopolitics is, and how impacts from such events become global really quickly. And it's ongoing. The bigger question ahead is whether we can sensibly suggest that the US and eurozone economies are about to successfully weather the cumulative effect of rate hikes delivered. Remember these rate hikes have been quite aggressive, and quick, and they are not yet complete. At a certain point, economies will creak.

The data ahead will of course be pivotal. But we'll also take our cue from the appetite for risk. Stay risk-on, and market rates are pressured up in tandem with recent data. Come off, and they can calm down as future data is projected to take a dip. We think market rates should be calming here after their hectic ride higher, and should be dominated by duration buying and fixed rate receiving, ultimately pulling market rates back down. But the current mood is in fact to go the other way; risk-on, tempting rates to dare to go higher still first.

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