Rates Spark: A hawkish send off

Rates are nudging higher with the 10Y Bund touching 2.35% and Treasuries close to our envisaged 4.15% tactical target. While we had envisaged a hawkish send-off into the ECB's and Fed's pre-meeting black out periods – central bankers pushed back against early cut pricing. But data has been at least as relevant, if not more

US 10yr hits 4.15%. Still a path to 4.25%...

The backup in the rate cuts discount for March continues. It's now a 55% probability. It's approaching a balanced outcome, but we still marvel at how high it is. Watch it dip to 35% in the coming weeks. The latest jobless claims data released on Thursday confirm that the labour market in the early weeks of January continues to motor along. We'd have to have a macro economic capitulation of sorts to have a cut accelerated to March.

Also, the market is pricing out later cuts. The terminal funds rate was discounted in the range 3% to 3.25% towards end-2023. It's now in the 3.25% to 3.5% range. As this ticks higher, it technically places upwards pressure on longer tenor market rates, to the extent that longer tenor rates are a manifestation of the future path for shorter tenor ones.

The residual is the term premium, which is now at -17bp for the 10yr. That was as low as -44bp at the turn of the year, when the 10yr yield was at 3.8%. So the 10yr is not as rich as it was, but it is still rich. It has managed to get back to the 4.15% level we were at before Chair Powell said what he said post the 13 December FOMC meeting. So that's, as we expected, been ticked off.

Based off what we see, and as noted before, there is a path to 4.25% for the US 10yr. We won't get back up to the prior high at 5%. But this edge off recent turn of the year sub-4% extremes makes a lot of sense to us. It plays off the unwind of the rate cut discount. It leaves a bigger bond rally ahead as we continue to target 3.5% around mid-year. But for now, we continue to play the market from the short side.

ECB pushes back against near-term pricing, but bigger shifts are taking place

The European Central Bank has gone into its pre-meeting quiet period with markets still discounting an 80% chance of a first rate cut in April and discounting some 135bp of easing over the current year as a whole. At the end of last week we were still looking at more than 150bp over the year and more than 33bp for the April meeting, so while an improvement, levels still looks rather excessive after a week of almost daily pushback from officials against premature cuts.

But if the ECB ever intended to really push back, it has limited its own impact. While in December the ECB still shied away from spelling out rate cuts, officials are now more openly talking about the possibility of rate cuts in summer, or under certain conditions even earlier as Market News reported on Thursday, citing ECB sources. Whilst the ECB tried to downplay the possibility of near-term cuts over the past days, that other shift has not gone unnoticed allowing the overall distribution of market expectations to remain lower even if tail pricings are pared.

There is, however, one consolation for the ECB amid the recent market moves. While the rally lower in rates at the end of last year was also accompanied by a fall in inflation expectations, the move higher this year has seen inflation swaps trading pretty much sideways. Meaning the rise is entirely happening in real rates. While the nominal 5Y OIS for instance is at its lowest since January last year, in terms of real rates we are at levels prevailing last summer through early September. So the argument that rate cut pricing is creating much easier financial conditions is weakened, at least by this measure.

Of course wider measures still show that risk assets for instance remain more supported. In rates we can point to still relatively tight spreads, the key 10Y Italy-Bund spread stands around 155bp (interpolated), close to its narrowest levels since summer. The geopolitical risks remain there in the background, but market perception of the associated risks in the near term seem muted as also signified by the range bound trading of oil over the past two months and a VIX that remains below historical averages.

Today's events and market view

Friday marks the final day for Fed official to steer market expectations ahead of the pre-meeting black out period. As such there will be a particular focus on the appearances of the Fed's Goolsbee and Daly today. We have seen pushback already over the past days also from the Fed, but better data certainly lent a helping hand. Thursday saw initial jobless claims drop to below 200k for instance and also stronger-than-expected housing starts.

Friday's main focus is the University of Michigan consumer sentiment survey along its inflation expectation measures. With an unchanged 2.9% on the 5-10y measure this would imply expectations remaining in the somewhat elevated range of the past two years. In other data we will get the existing home sales. Ahead of the US releases there are only few events of note in Europe. The main highlights here are the UK retail sales and the PPI figures out of Germany. During the day Lagarde will speak again in Davos alongside the German finance minister.

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