# Rates Spark: A sudden jump to new equilibria

Markets made a dash for higher rates, and the new levels seem justified based on fundamentals. A focus on supply in the eurozone could keep up the bearish mood over the coming weeks. Ahead it's the Fed, with some balance sheet management to do

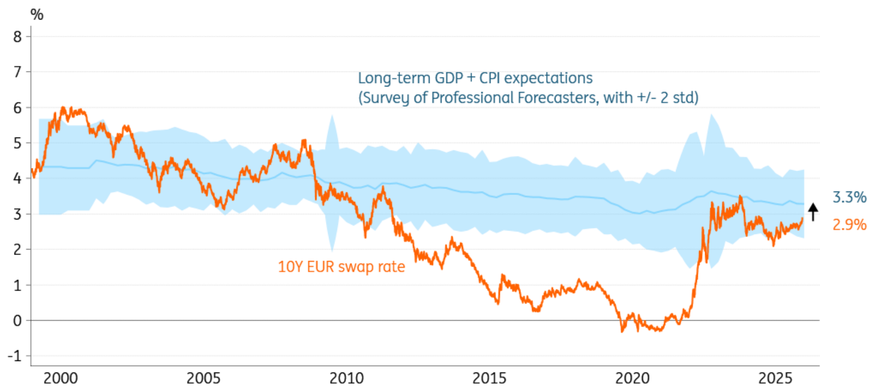

## Higher euro rates are justified, but the speed caught us by surprise

Euro rates started the week in an incredibly bearish mood, catching markets (and ourselves) quite by surprise. Suddenly the possibility of more European Central Bank easing seems gone with money market curves now almost perfectly flat one year out. To be fair, many of the risks we identified earlier as triggers for more cuts seem to have faded. For one, growth continues to pick up, with Monday's data even providing hope for Germany given decent industrial production numbers. Secondly, service price pressures remain more stubborn than hoped, keeping core inflation well above target for now. Add hawkish comments from the ECB's Schnabel to the mix, and markets are quick to jump on higher rates across the curve.

Whilst the move up in rates happened sooner than we anticipated, we do think higher rates are justified from a structural perspective. The growth outlook for 2026 looks decent, whilst from a supply perspective we should also get more upward pressure. Germany's funding announcement is likely next week and in January we expect plenty of frontloading of funding plans, both placing supply in focus for the coming weeks. In between, around €600bn of Dutch pension fund assets will transition to a new system, drastically reducing the amount of longer-dated swaps and bonds needed.

That begs the question, where can the curve move from here? We would continue to argue that the front end has little room to go higher for now, given more inflation data is needed before seriously contemplating a rate hike. The 10Y swap rate, however, could still move higher as a term risk premium builds. The 2s10s is now at 60bp, which is still relatively flat compared to the average of 80bp since 2000. From an economics perspective, one could also look at long-term nominal growth expectations as an anchor for longer rates. In that case, having the 10Y swap rate settle around 3.0-3.5% would be considered fair value.

## Rates can still go higher when taking long-term nominal growth expectations as an anchor



Source: ING, Macrobond

## The Fed will buy bills in excess of the roll-off in MBS bonds

As we look ahead to the FOMC meeting on Wednesday, it's quite possible that the Fed will decide to buy more bills than required from the MBS roll-off, thus acting to increase bank reserves. We don't think the Fed needs to do anything dramatic here, maybe only to announce that they have that flexibility. In fact, repo has tamed in the past day or so (post the month-end turn), which could in fact pull the funds rate back down a tad before the FOMC meeting. These subtle policy changes won't make the headlines, but they are important, as proper market functioning is a key Fed responsibility. The key element to be aware of, if the Fed wants to freeze the balance sheet, but in actual fact, it will ultimately have to re-expand the balance sheet at the same pace as the nominal economy is growing at. So, if nominal GDP is growing at 3-5%, bank reserves too should expand at that rate. This equates to the Fed buying bills to the tune of US$10-15bn per month, over and above the roll-off in MBS bonds (an additional US$10-15bn); which implies a total of some US$20-30bn per month of bill buying.

## Tuesday's events and market views

We won't get any notable data from the eurozone, but from the US we do have the NFIB small business survey and the JOLTS jobs openings data. With the US economy clearly showing signs of cooling, but government data still delayed, such alternative data sources will be closely watched by markets. A Fed cut on Wednesday is practically fully priced in, however, and these data points won't change that.

In terms of supply, we have Austria with a 7Y RAGB for €0.58bn and the UK will tender 7Y Gilts for up to £0.75bn. From the US we have a 10Y Note auction totalling $39bn.

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