

Rates Spark: Back to competing narratives

While the market is clearly eyeing a change in the rate cycle, 10Y UST yields are still fighting a battle along the 4.5% area, with the deficit-induced term premium narrative not off the table. Overall, Bund yields have dropped alongside US yields – even a bit more than purely directional correlation would have suggested



The steepening of the 5s10s of the EUR swap curve has stopped given the uncertainties on the horizon

US yields consolidate amid competing narratives – and looming holidays

The market is clearly eyeing a change in the rate cycle. Futures are pricing a 100bp of rate cuts from the Fed over the course of next year, with the first rate cut possibly coming ahead of the summer. As a result, the UST 2Y yield has been testing the 4.8% level over the past sessions. Yesterday, the market was focused on the weekly initial jobless claims data, which has been signalling a cooling trend, although overall figures are still relatively low.

The Fed does not appear ready to give in yet to somewhat softer data and the markets' speculation for earlier rate cuts. More pushback came yesterday from the Fed's Loretta Mester, who said she hadn't decided yet on the need for a further rate hike and that more evidence was

needed to see inflation on a clear path to 2%. But others, such as Lisa Cook, were also attuned to the risks of a sharper slowdown.

Further out the curve, the 10Y yield continues its fight with the 4.5% area. The potential rate cycle change is still being weighed against the term premium narrative as a 20Y auction next week and greater uncertainty about next year's presidential elections are not helping either the near or long-term perspective. Reuters also cited Fed officials' letter to a Senator that the central bank's balance sheet could shrink considerably further before levels consistent with the ample reserves framework are reached. The spread of 10Y UST yields over SOFR OIS is at 34bp, still closer to its recent wides.

Bund yields fall alongside the US – and a bit more

European markets have seen Bund yields slip below 2.6%. This is largely driven by the dynamics in the US, although we would note that taking the correlation of the 10Y UST-Bund spread with the outright yield over the past couple of months, this spread could have easily been even tighter beyond 180bp instead of the 188bp where it currently stands, i.e., Bund yields have fallen even a tad more than just react to the US.

One factor at play is falling inflation expectations/risks, as implied, for instance, by the 5y5y EUR forward inflation. This indicator has continued to drop and now stands close to 2.35%, its lowest since late March. Its downward dynamic also diverges from its US counterpart, already since the past two months. That is reflective of the weaker macro backdrop in Europe, although oil prices continuing to slide will have helped with the latest leg lower as energy prices have been cited by the European Central Bank as one reason to be cautious, especially against the backdrop of geopolitics.

At the margin, the [decision by the German constitutional court](#) to invalidate the repurposing of pandemic aid may have also helped as it lowers the prospects of Bund issuance. A look at Bund spreads over swaps shows that the recent underperformance of bonds has halted.

Today's events and market view

It will be a bit busier on the speakers front alongside the European Banking Congress in Frankfurt. Watch for the ECB's Christine Lagarde, Joachim Nagel and Pierre Wunsch, but also the Fed's Mary Daly, who delivers the closing keynote. Today's main risk event for the government bond market will come after the European close with the scheduled rating review of Italy by Moody's – here, Italy is only one notch away from losing its investment grade rating and carries a negative outlook. As we have written on [Tuesday morning](#), markets are going into this event with some confidence.

The data calendar, however, does not have too much to offer today apart from final inflation data for the eurozone and in the US the numbers for building permits and housing starts. This allows for a peak into next week, which will give us the flash PMIs and meeting minutes from both the ECB and Fed. But note that the Thanksgiving holiday will effectively shorten the week for the US by two days.

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