Rates Spark: Bear flattening pressure persists, for now

The bear flattening pressure after the payrolls report extended at the start of this week. While in the US the discussion is morphing into whether or not the Fed should cut in November, the repricing on the EUR curve is focussed even more on where the ECB will land. Near-term cut expectations are little changed with 25bp in October still the base case

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Bear flattening pressure persists as near-term Fed cuts and the ECB terminal rate are reevaluated

Friday's payrolls data is still reverberating in markets. The bear flattening continued today with the Treasury 2s10s curve briefly flattening out completely. Less than two weeks ago it had peaked at 22bp.

The discussion in US rates markets is now whether the Fed will cut by 25bp or not at all at the November meeting versus the 25bp or 50bp options on the table before. Another cut in December remains likely, but overall the market discounts only 42bp of additional Fed easing for this year. As such the market is now more in line with the Fed's dot plot, which saw a larger number of FOMC members put in their forecasts at less than the median prediction of 50bp more easing this year.

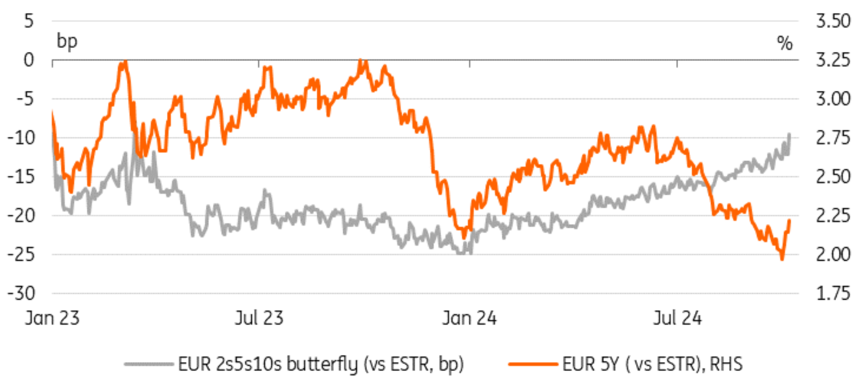
The prospect of further Fed cuts rolling in, even if not at the pace of 50bp, should keep a cap on the front end following Friday's surge. The 2Y UST yield only briefly managed to top 4% on Monday. If we take a view of a soft landing that would put the Fed's terminal rate in the area of 3.25-3.5%, even slightly tight versus neutral estimates, then the upside looks limited. At the moment, the SOFR futures strip already pitches that landing just above 3.3%, up from just below 3% ahead of the payrolls data.

Further out the curve the 10Y SOFR rate now stands at c. 3.55%, which is not far above the floor implied by the terminal rate. The 10Y Treasury trades with a 46bp spread over OIS, which implies that upside pressure even at a 4% yield handle now can persist – more here. That can also morph the current bear flattening towards a steepening. The limiting factors of course are the markets' unease about the official jobs data, which does not tally with many other of the available data, say ISM employment components, or even the Fed's indications from its Beige Book. There is one more jobs release to come ahead of the November meeting. Markets will also be on alert about the ongoing geopolitical tensions.

EUR rates have seen a strong spillover from repricing in the US. 10Y Bund yields are now back above 2.25%, up from close to 2% at the very start of the month. But it has been the 5Y part of the curve that has seen the most cheapening, accelerating its recent trend. This links to the market repricing the ECB's terminal rate to around 2%. That still reflects a gloomier outlook but comes from levels eyeing 1.75%. Interestingly though, the payrolls report had little bearing on near-term expectations. Here the market is still pricing 23bp of easing for the October meeting and a tad over 50bp for the remainder of the year as a whole.

ECB officials did provide some pushback against the market's broader easing expectations. VP De Guindos made a start last week and Austria's Holzmann – arch-hawk of the ECB – declared on Monday that inflation wasn't defeated yet. Overall, however, the hawkish ECB camp has been relatively quiet on the topic of market expectations. Our economists think the case for an October cut is not as straightforward as the market believes.

The 5y ESTR OIS continued to cheapen, buffeted by the terminal rate repricing



Source: Refinitiv, ING

Today's events and market view

Data calendars become quieter again with the only notable releases today being the US NFIB's small business optimism and the US trade balance. Markets will likely pay more attention to Fed speakers after the strong data. Today's slate of speakers includes the Fed's Kugler, Bostic and Collins. We will also see a couple of ECB speakers with Centeno and Nagel.

In European primary markets Germany, the Netherlands and Austria will be active today. Austria will auction 10y and 30y bonds for up to €1.7bn. Germany reopens a 9y green bond for €1bn, while the Netherlands taps its 10y benchmark for up to €2.5bn. Additionally, the EU will tap 3y and 15y bonds via syndication. Over in the US, the Treasury will sell US$58bn in a new 3Y note.

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