Rates Spark: Bearish headwinds

The Moody's move is more a reminder on the de-rating mood on Treasuries. Not directly impactful, but something that will linger as an issue in the coming months. In Europe, Bunds evaded the latest headwinds and we sense that ECB officials are paring back their dovishness. The Dutch parliament will vote on a controversial pension reform amendment

Moody's downgrade of US debt indicates that not all risks are priced into US Treasuries

Moody's acts as a reminder of risks not fully priced into Treasuries

We remain bearish on Treasuries. The Moody's move is more a reminder on the de-rating mood on Treasuries. Not directly impactful, but something that will linger as an issue in the coming months. On the tax bill, if it does get passed, it will be bearish for Treasuries, as in its current guise it has minimal fiscal deficit reducing capacity. The only silver lining is the extension of existing cuts, while optically the most expensive aspect of the bill, it in fact won't add directly to Treasury issuance (as its already catered for in current issuance patterns). As it is some 23% of issuance is financed through bills, which is well above the preferred level of 15%. So far Treasury Secretary Bessent has decided not to push some of this out into coupon issuance, which helps to contain pressure on long dates.

A complicating factor to consider is the debt ceiling. This was automatically reinstated on 2 January 2025, and the biggest implication of this for liquidity circumstances comes from the requirement for the US Treasury to spend down its cash balances (as a cushion for the inability to engage in higher net issuance). Currently, the Treasury has a cash balance of around $600bn. As we progress towards late summer and into the autumn/fall season, the US Treasury will be in payout mode, and in that sense will tend to bolster bank reserves. But once the debt ceiling has been successfully negotiated, the Treasury will re-commence net issuance, rebuilding its cash balance and, in turn, depleting reserves from the banking system. It's at this point that issuance pressure will really be felt by the market.

The prognosis remains for a steeper curve as the front end still has a rate cut bias to cling to

US remain rates under upward pressure with the Moody's downgrade probing 10y US Treasury yields beyond 4.5% again. The widening of Treasury yields versus SOFR swaps and the even more pronounced widening versus Bunds – in the 10y from 184bp to up to 193bp – underscore the domestic nature of the driver.

The downgrade last week turned the spotlight back on US fiscal dynamics and the question whether there is any serious intent by politicians to rein in the deficit. The US has now lost it last AAA rating, although it was not really a surprise. S&P had downgraded the US from its highest level already in 2011. Back then, however, the market reaction was quite different – the reaction was a flight to safety which ultimately benefitted Treasuries. But it was very different times.

This time bearish headwinds are more persistent and compounded inflationary concerns even if alleviated somewhat by the latest data. And away from the sentiment indicators, the overall economy and its labour market is still proving relatively resilient. Given the Fed's "slightly restrictive" stance – as stated by Williams on Monday again – there is some room to cut rates. But there is a large degree of uncertainty around the impact of tariffs and the outlook in general. As Williams also again made clear, the Fed is in no hurry to cut rates and it may take months before the FOMC has the confidence to change its policy.

There is little data this week to change the narrative, so markets will likely look more closely at the take-up of the 20y UST auction later this week as a more timely gauge of investor appetite surrounding the US credit.

EUR rates detach from US bearishness – for now

The focus on US fiscals has allowed EUR rates to detach again from US dynamics. The 10y Bund yield has managed to slip back below 2.6% and stay there. However, we do not think that EUR rates will fully evade the bearish trends.

While European Central Bank pricing is also turning slightly more dovish of late – still with a 1.75% deposit rate by year-end as the firm base case – ECB officials themselves seem to be scaling back their own dovishness to some degree over the past days. Executive board member Schnabel called for a "steady hand" in policy setting over the weekend. Kazaks suggested a "couple" of cuts were still possible, but the ECB was already "relatively close" to the terminal rate. Estonia's Muller even remarked it was not obvious to him that the ECB should significantly lower rates.

Dutch pension reform vote may lead to more uncertainty

The long end of the EUR swap curve could show signs of flattening if a controversial vote on Dutch pension reforms finds a majority on Tuesday. The Dutch parliament will decide on a proposal that may push back the pension reforms by years, thereby postponing the anticipated unwind of longer dated swaps and bonds. The legal amendment would give all participants the right to opt-out from transitioning their accrued pensions to the new system. Given the current transition framework took years to develop, any adjustments would make the planned transitions in 2026 seem unrealistic.

Whilst our base case is that the vote does not find a majority, a vote in favour would lead to even more uncertainty ahead. Most importantly, the proposal would struggle to find a majority in the senate. Since more pension funds recently announced that they are pushing their transition date to 2027 instead of 2026, we think that the uncertainty can convince more funds to delay. Market players that have anticipated a curve steepening at tenors of 20Y and longer may therefore reconsider their position.

Tuesday's events and market view

There are only few data points to watch such as the eurozone labour costs for the first quarter or consumer confidence for May. As the June ECB meeting draws closer the number of ECB speakers appears to be picking up with Wunsch, Knot and Cipollone scheduled for today. The US speakers schedule is also busier for the day as we will hear from Bostic, Barkin, Collins and Musalem.

In primary markets Germany will tap two green bonds for a total of €2bn while Finland auctions 7y and 10y bonds for €1.5bn.

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