

Rates Spark: Big divergence trade ongoing

Germany's fiscal plans have hit first stumbling blocks, but markets assume the change in the German fiscal attitude sticks. The front end of the EUR curve is held up by tariff uncertainty, but the path is to a 3% handle for 10y Bunds. US Treasuries are not reacting to this, but to elevated domestic angst on a complex policy prescription laced with uncertainty



US Treasuries remain enamored by 4% as a target for the 10yr

Severe risk-off and elevated volatility characterised a rough day for US markets. No Monday crash here, but certainly a slow-grind move south, extending from preliminary weakness last week. Only one way to go for US Treasuries on the back of this, as the 10yr homed in on the 4.2% area. The dominant driver here is a self-harming process coming from the complex policy prescription being shown to the markets, and the back story is one of a resurgent Europe versus a more isolated United States, or the perception thereof. Whether this sticks remains to be seen, but it's a theme that's likely to persist a bit until or unless negated by events or new information.

For the US 10yr yield, there is a natural tendency for the 4% area to be aimed for, especially given

the latest mood music. Room is gradually being made for a test lower as the Fed funds future strip continues to edge lower. At the beginning of the day the terminal rate was in the 3.5% area. It's now approaching 3.25%. At the same time the 10yr swap spread has been on a re-widening tendency, acting to limit the full feed-through of the deeper rate cut expectation on the 10yr yield. This, plus the new found resilience out of Europe, is dampening the extent of movement in the 10yr yield to the downside.

For the 10yr yield to get and stay through 4%, there would need to be an even deeper rate cut discount, one that verges on outright recession. We're not quite on that wavelength yet, but watching it carefully.

Despite hitting first stumbling blocks, the German fiscal rethink sticks with long-end rates

The 10yr Bund started the week with yields retracing slightly back towards 2.8%, but that is still up 40bp versus the end of February. Where we are still seeing the repercussions of the European defence rethink and Germany's turnaround on fiscal conservatism play out further is in the curve itself and the decoupling of US and EUR long-end rates. The 2s10s EUR swap curve has even managed to slightly extend its steepening from last week to now stand at 37bp. The 10yr US Treasury-Bund spread has now narrowed to below 140bp on Monday coming from 184bp at the end of February.

The EUR short end is still looking at the European Central Bank with a degree of caution, though. A terminal rate at 2% still seems to be the base case – or better the market's middle-ground – in light of uncertainty surrounding especially US tariffs on EU imports even as it seems to be desensitised to tariff headlines given the US administration's back and forth on the topic. Terminal rate pricing is up by about 15bp versus end-February, but was up by more than 20bp briefly over the past few sessions. However, even those levels were not unprecedented this year – one only needs to go back to late January. After listening to Lagarde last week, our economists think the ECB may well stop easing at a deposit facility rate of 2.25%. But this scenario will need more clarity, also on the implementation of German spending plans.

10yr Bund yields – and more relevant here – spreads over swaps have shown a limited reaction to the headlines as Germany's proposed package of a €500bn infrastructure funds and debt brake reform hit the first stumbling block on Monday. While this suggests markets are in a waiting mode, the moment of imminent 'peak supply fear' also seems to have passed. At the same time there is also the sense there is no turning back from the change in German fiscal attitudes in a more general sense, allowing the levels to stick.

But if the market's ECB pricing were to move higher on more clarity that stimulus will pass in the coming two weeks, then the path for 10yr Bund yields to move towards 3% would become much clearer.

Tuesday's events and market view

The data calendar is light on Tuesday with the main event the US JOLTS job openings data for January. On the EUR side, headlines surrounding the passage of the German fiscal package will remain at the centre of attention. We will also be listening to the ECB's Rehn speak on the economic outlook and monetary policy. The EcoFin meeting of EU finance ministers will also be

attended by the ECB's VP de Guindos.

In primary markets the EU syndicated sale of a new 10yr benchmark will be the main event with an anticipated volume of around €7bn. Germany will also auction 2yr bonds for €4.5bn. Outside EURs, the UK sells a new 25yr gilt linker via syndication and the US will auction new 3yr notes (\$58bn).

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