

Rates Spark: Bund yields vulnerable to repricing of ECB endpoint

The EUR swap curve prices in a terminal ECB rate of 1.75% by mid-2025, which seems pessimistic given current data. 10Y Bund yields could edge higher as the terminal rate is repriced closer to the estimated neutral range of 2-2.25%



Bund yields remain vulnerable to repricing of ECB terminal rate

Bund yields bounced back up and undid the decline of the day before, bringing the 10Y Bund above 2.1% again. Such large moves are likely to stick around as markets balance between hard-landing and soft-landing scenarios whilst the risk sentiment is being tested by geopolitical headlines. Markets seem content with the pricing of the front end of the curve for now, which is positioned for back-to-back ECB cuts of 25bp. The endpoint, however, remains in limbo.

Current pricing of 1-year forwards suggests the ECB policy rate will hit 1.75%, below most estimates of the neutral range of around 2-2.25%. In effect, this means markets already attribute a considerable probability to the economy slowing down, be it the general macro gloom or the geopolitical fear factors of late. The ECB would fall behind the curve and have to continue cutting below the neutral rate. Given the data available, such pricing seems presumptuous and could see

some reversal.

With markets positioned for a relatively pessimistic economy, the back end of the curve is left vulnerable to upside surprises. Any disappointments regarding inflation or upside surprises from growth could be enough to reprice the terminal rate by some 25bp and bring the 10Y Bund yield back towards 2.3%. As the unemployment data from the eurozone confirmed, the labour market remains resilient and thus immediate recession risks are limited whilst wage growth should not be neglected. Having said that, upcoming US payroll numbers are likely the more important driver to watch, also for longer euro rates.

Today's events and market view

The eurozone opens with Spanish and Italian PMIs, which are all still expected to remain in expansionary territory. Eurozone PPI on a month-on-month basis is expected to remain hot at 0.5%, but the year-on-year number should remain well in negative territory at -2.3%. From the US, we have the ISM services and weekly jobless claims numbers. With nonfarm payrolls scheduled for Friday, the job numbers will get extra scrutiny, and given services make up the largest part of the economy, the ISM index and its employment component will likely be market-moving.

France will auction 10Y, 25Y (green) and 31Y OATs totalling €12bn, which should be of interest given the ongoing headlines around deficits. Spreads tightened somewhat over the past day, but this heavy issuance will test markets. Other issuance includes Spain with 3Y, 5Y, 17Y SPGBs and 15Y SPGBi for a total of c.€6bn.

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