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RATES SPARK

Rates Spark: Differences brought into sharper relief

Markets are once again eying the possibility of a deal in the Middle East. The reactions underscored the difference in macro backdrops, and European rates have more potential to rally than their US counterparts, where the more recent leg higher had been driven by the real component and not inflation expectations



The spread between 10y US Treasury and Bund yields has widened to over 150bp, its widest level since August 2025

The possibility of a deal drives rates market volatility

Geopolitical headlines continue to drive market volatility. Even if signals remain conflicting at times, there is a suggestion of progress – or at least a narrowing of the gap between the warring parties' positions.

The market reaction in the wake of this latest news has also brought the different macro backdrops across regions into sharper relief. The spread between 10y US Treasury and Bund yields has widened by almost 10bp over the past week alone. At over 150bp, the spread has reached its widest level since August 2025.

EUR rates have managed to largely hold at lower levels on the back of the latest news. For one, Europe is more directly exposed to the energy market disruptions and stands to benefit most from a timely resolution to the blockage of the Strait of Hormuz. More importantly, the macro

backdrop is shakier, as a round of disappointing PMIs has just highlighted.

European Central Bank officials have signalled lately that a June hike is likely to materialise. While still tying the decision to the dynamics in the Middle East, the near-term inflation dynamics have moved closer to the adverse scenario. And that said, it is unclear whether by mid-June there will be enough clarity and certainty around any potential deal to call off a rate hike. As the ECB's Olli Rehn has said, hiking in June would be more about protecting the ECB's credibility than anything else.

There is good reason for caution around the need for further tightening. A Reuters insider story late on Wednesday had indeed suggested the ECB might prefer to wait until the September projections to make any decision. The market currently fully prices three hikes over the next 12 months, suggesting a greater potential to drop should the ECB find room to focus more on the growth story again.

Over in the US, risk assets remain largely supported and the macro backdrop resilient, while the FOMC minutes have confirmed the hawkish turn witnessed at the latest Federal Reserve meeting in April. Separately, we have FOMC members such as Austan Goolsbee talking of a "significant inflation problem developing".

The 10y US Treasury yield currently holds at levels around 4.6% while the money market prices more than 20bp of policy tightening by year-end from the Fed. Even if we were to see progress in the Middle East and an easing of energy price pressure, a quick return of the market towards pricing a cutting bias looks unlikely. A material drop in longer end rates also looks unlikely to the extent that the latest leg higher was in large part driven by rising real rates and not inflation expectations.

Friday's events and market view

US data flow is limited to the final University of Michigan consumer confidence and the Kansas Fed services activity indices. In the eurozone, we will get first-quarter negotiated wages and the German Ifo index on the heels of Thursday's PMIs, which in Germany disappointed on the manufacturing side. There will be more talk from central bankers, including ECB President Christine Lagarde. Others are the ECB's Olaf Sleijpen, Boris Vujcic, Peter Kazimir and Madis Muller. From the Fed, Christopher Waller will speak about the economy.

Primary markets are quiet on Friday. We have scheduled rating reviews for Belgium (Fitch: A+/Stable) and Portugal (Moody's: A3/Stable) after the market close.

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