

Rates Spark: Don't look down, yet

Policy rates have practically peaked in the US and eurozone. Even if there is another hike it would be the final one. But market rates are not yielding to this. The US 10yr has re-hit 4%. The issue here is not the peak in policy rates, but the potential for cuts. Basically the market has reined back rate cut expectations, and that's keeping long rates elevated



US 10yr makes the break to 4%. It should stay there for a while

US market rates latched on to the strength in the activity data released on Thursday, rather than the calming in inflation data. Even if lower, the 3.8% on core PCE is still too high for comfort, and remains vulnerable to future upside should the economy continue to bubble as it has been doing. The release of decent consumer spending, a fall in jobless claims and firm durable orders all point to an economy that continues to defy the forces acting against it.

For the 10yr Treasury yield, the issue remains that there is little room for lower yields if the terminal discount for the funds rate is not much below 4% in the medium term. The implied fed funds discount for Jan 2025 has in fact drifted higher, now up at 4.1%. Based off that the 10yr is in fact still arguably too low. We view the push up to the 4% area as perfectly valid, and indeed we anticipate that the 10yr yield remains above 4%, at least for as long as the medium-term discount

for the fed funds rate also remains above 4%.

The ECB moves to 0% on excess reserves; don't worry, it's a move back to normalcy

The European Central Bank (ECB) decision to pay 0% on excess reserves brings things back to where they were before the Great Financial Crisis (GFC). Regulatory reserves always paid zero percent. But since the GFC the ECB has remunerated reserves at the overnight deposit rate. This had to be done as else the banks would simply not hold them.

The move back to 0% applies only to regulatory reserves, and not to excess reserves. It is a mild hit to banks, as they receive less interest income on reserves. But it is not dramatic, as the reserves held over and above the minimum will continue to get remunerated as normal.

Latest data show that excess reserves across the banking system were running at EUR 3.6trn. These continue to get compensated at the deposit rate. Reserve requirements were running at an average of EUR 165bn. These will be compensated at zero percent. That represents about 5% of total reserves. It's not nothing, but it's also not terribly significant. This saves the ECB a few bob, but nothing more to it.

Today's events and market views

Key US data on Friday includes the June PCE deflator. Look for a continuation of the deceleration in inflation, with the headline deflator set to ease down to 3% and the PCE core deflator to ease down in the direction of 4% (but likely to remain above).

The University of Michigan Sentiment indicator for July is set to hold in the low 70's, which is below the average in the 85 area. It's been on a upward recovery, from around 60 in May. We'll also get the 5-10yr inflation expectation, which is expected to ease slightly to 3%.

The eurozone will have a consumer price inflation focus, with the German lander CPI data to be followed by a country-wide one. A mild easing is expected, but still leaving inflation running uncomfortably high. We'll also see EU consumer confidence, which is likely to remain in the mid 90's, and below the benchmark reference of 100, signalling ongoing macro weakness.

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