Rates Spark: Equity optimism not shared by rates

Significantly lower yields in the belly of EUR and USD swap curves suggest rates markets remain pessimistic about the economic outlook further in the future. This contrasts with the rally in equities during the day. A Bloomberg survey shows a dispersion of expectations about near-term eurozone inflation due to tariffs, keeping front-end rates anchored

Rates markets don't share equities' optimism

Whilst equity markets posted decent gains, rates markets reflected less optimism. The belly of the curve, in particular, outperformed in rates markets. For both EUR and USD curves, the 5Y swap rate was down almost 10bp, which voices a somewhat different tone from the bump higher in equities. The fall in 5Y rates suggests that economic concerns are peaking further out the curve, whereby Trump's policies are expected to especially weigh on growth later into his presidency. Perhaps equity markets are taking a more short-sighted view.

The front end of the euro swap curve showed less volatility and remains anchored to the idea that the European Central Bank will cut to around 1.75% by the end of this year. A Bloomberg survey suggests that markets agree on the negative growth impact in the near term from US tariffs but show more dispersion regarding the impact on inflation. Around a quarter of the respondents see higher inflation from Trump's policies in the near term, which would prevent the ECB from accelerating rate cuts. As such, the 2Y swap rate may face some resistance to break lower from current levels.

USTs outperformed the swap curve, which would reflect a risk-off day in normal circumstances. But since the turmoil last week, the UST has not behaved as a typical safe asset. Investors withdrawing from the US, fiscal deficit concerns and technical drivers all contributed to the selling off of USTs during times of market stress. The Bund, on the other hand, did reflect the improved global market sentiment correctly and underperformed versus swaps. Having said that, the 10Y Bund only trades at 2bp above the swap, still significantly smaller than the 9bp pre-liberation day spread.

Today's events and market views

The ECB bank lending survey could be of interest as we are approaching neutral monetary policy. The demand and supply of loans provide an indicator of how restrictive the policy still is. We will also get the ZEW survey outcomes from Germany and the eurozone as a whole. The abundance of headlines circulating these days makes measuring sentiment challenging, but these data points could be the first to capture the impact from Trump's tariffs. The expectations component for Germany is expected to drop from around 50 to just 10, which would bring us back to the levels before the large-scale spending announcements. In the US, the Empire manufacturing index is expected to improve from -20 to -12.

The UK will auction £4bn of 10Y Gilts. From Germany, we have €4.5bn of 5Y Bobls, and from Finland, 6Y and 30Y RFGBs for a total of €1.5bn.

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