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Rates Spark: EUR rates cannot follow a dovish US

Euro rate dynamics remain separated from the US, which is looking more at domestic factors, while oil and gas are primarily driving ECB pricing. Eurozone inflation may take longer to turn, so while both 2y USD and EUR rates look bullish, the US leg could come down first

The rise in Brent oil prices resulted in the 2y euro swap rate approaching 3%, the highest level since the start of the Middle East conflict

Euro rates will need more time to follow a dovish US

Euro rates continue to do their own thing and especially the front end seems relatively isolated from US dynamics. The sharp dovish move in US rates on the back of benign inflation numbers was barely noticeable for the 2y euro swap rate. Oil is clearly the main driver and therefore Brent reaching as high as US$87 per barrel is a more important variable to watch. At these prices, the 2y swap rate almost hit 3%, which marks the highest level since the start of the conflict.

Also, the eurozone inflation data will be pivotal in challenging the hawkish market positioning, but we may have to be patient. July's figures are still weeks away and even then, those numbers will not be enough to comfort markets about second-round risks. Especially with oil prices surging again, the full pass-through of higher energy prices will remain difficult to estimate. An added complexity is the rise in natural gas prices, which are now at the highest levels since March. Meanwhile, European gas reserves still seem relatively low and will have to be filled before winter starts approaching.

All this uncertainty means markets' European Central Bank pricing can continue to diverge from the Fed's. The momentum in US inflation should be downwards, whereas for Europe the peak might not be in sight yet, especially if energy prices continue to drift higher again. So, while we are bullish on both 2y USD and EUR rates, the US leg might find itself coming down earlier.

Wednesday's events and market view

While Europe looks to geopolitics and energy prices, the US looks more towards domestic drivers. Following a cooler-than-anticipated CPI release, markets will now watch the producer prices for June as well as the second day of Fed Chair Warsh's testimony to Congress. Other Fed speakers of the day include Williams, Cook and Musalem. The Fed will also release its Beige Book.

The eurozone releases industrial production data for May. From the ECB, Panetta and Nagel will be speaking.

In primary markets, Germany taps three bonds in the 30y area for a total of €3bn.

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