

Rates Spark: Euro rates eyeing quicker ECB cuts

Markets see more ECB rate cuts in the near term and the back end of euro rates remains well-anchored, adding to the steepening. We saw a change in tone in the US as yields reverted higher, but a decent 7yr auction settled things down. It's all about the PCE deflator now. The risk for bond bulls is a 0.3% on the core reading. We think 0.2%, but there's the risk



Relief trade through US hours Thursday, but underlying risks remain

The US saw a decent 7yr auction on Thursday. There was a strong indirect bid, and it came through the when-issued yield by almost half a basis point. This was a relief for those playing Treasuries from the long side, as it's been a day of reversal for the most part. Thursday's US data was net bearish for Treasuries, and helped to change the narrative on the week, even as it followed another [drop in the German Ifo](#) index. The market also reverted to a more risk-on mode, at least during US hours. Volatility came off the highs too.

We're doubtful that we're about to return to a full risk-on mode. It's far more likely that a risk-off tone persists, and even if not on Friday, likely into the weeks ahead. The rationale for this centres on the notion that macro data is prone to getting away from the Fed to the downside as we start the long wait for the 18 September FOMC meeting, assuming the Fed passes at next week's FOMC meeting. The fact that the market has been playing with the notion of more than a 25bp cut from the September meeting has been part of the narrative too, although that has been tamed by this morning's data.

The front end, which had been on fire in recent days, saw a mild pop higher in yields after the data and moved into some risk buying. The back end also ended up higher in yield. The need for a July cut has been tamed, and the probability for a September cut has moved back to a 25bp one (a lower probability for a 50bp cut). The big one is tomorrow, the PCE priced index for June. The headline should be fine, but watch the core number. It's expected at 0.2%, which is very fine. But, risk case, if it were to touch 0.3% for whatever reason, that would severely tame the rally we've seen on the front end, which increasingly views a rate cut as a done deal.

Markets are frontloading ECB cuts

The back end led the initial move lower for UST yields, whereas for Bund yields, the 2Y point fell the most. The move in the eurozone stemmed from a frontloading of European Central Bank cuts into 2024 instead of 2025. Weaker Ifo survey results from Germany were another addition to the soft data points reflecting fragile growth, and the global risk-off sentiment kept bonds supported, too. Looking further down the curve we see that markets continue to price a terminal ECB rate in the range of 2.25-2.50%. Such a well-anchored terminal rate means that the turning of the business cycle can have a strong steepening impact.

The 10Y Bund yield briefly broke through the 2.4% handle, but ended the day a few basis points above, returning to the 2.4-2.6% range we have been seeing for most of this year. Eurozone growth may be weakening, yet the chance of a severe recession materialising remains contained. Markets are positioning for faster rate cuts, but a broader rotation towards safer assets has not been seen. Only when hard data starts showing a sharp deterioration do we expect a more sustained break below 2.4%. Alternatively the global risk sentiment continues to worsen, in which case Bund yields will have to find a lower equilibrium.

Today's events and market views

The PCE numbers from the US can give further insights into the breakdown of Thursday's higher-than-expected quarter-on-quarter core reading. Based on earlier PPI and CPI figures, the June month-on-month core reading is likely to still come in at 0.2%. Other data from the US includes personal income and spending numbers and the Michigan indices. From the eurozone, we have the 1-year and 3-year CPI expectations from June, but given that inflation expectations are well-anchored, these are unlikely to surprise.

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