

## Rates Spark: Focus on quantitative tightening tweaks from the Fed

The US remains in a steady state along the coupon curve. But there's a lot going on in the money markets pipes as repo tightness persists. As we head into the Federal Reserve meeting, the big call would be to maintain the MBS roll-off and replace it with buying of T-bills, while broadly ending quantitative tightening



### US Treasuries tread water while front end tightness dominates into the Fed

The yield on the US 10-year Treasury is hovering around 4%, while the 2-year is sticking close to 3.5%. There's not much difference between the two, so the yield curve is pretty flat. The drop in the 10-year yield has been helped by a narrowing in the swap spread to the secured overnight financing rate (SOFR). It's shrunk by more than 10 basis points, from the mid-50s to the low 40s. This shift started just before the release of the 2025 fiscal deficit, which came in slightly lower than the 2024 figure. It's still high, but a bit lower -- a small positive. One reason for the improvement is higher tariff revenue, which reached \$120 billion -- more than last year. Even though the overall debt situation is still troubling, the bond market doesn't seem to be reacting negatively for now.

At the same time, the heavy net issuance of bills is affecting money market conditions. The Treasury cash balance continues to grow, while reserves decline. Repo has tightened up, and the funds rate has risen, partly due to competition among the various places where players can place cash. In the end, it's a relative-value trade; upside pressure on repo — and, by extension, SOFR— presents a tempting bucket for liquidity. The Federal Reserve may well have to consider buying bills to build reserves if this continues. That said, the reserves position looks broadly balanced (see more [here](#)). And the Fed is neither providing nor withdrawing liquidity from the system to any great extent. The USD basis premium on cross-currency is up a tad, but not to any material extent. The best solution is a loosening of US big bank supplementary liquidity requirements (see more [here](#)).

At the Federal Open Market Committee meeting, ending 29 October, policymakers will likely craft a plan for quantitative tightening (QT). We know the Fed is uncomfortable having MBS on its balance sheet. So an interesting move could be to leave the MBS roll-off as it is (capped at USD\$35bn), but to offset whatever rolls off on a monthly basis (closer to USD\$15bn) with buying of T-bills (to help keep reserves from falling).

## Fed meeting preview

The market is heading into the Fed meeting with clear expectations for one 25-bp cut, as concerns about the job market outweigh lingering fears of tariff-driven inflation. It does not end there, as the next cut in December is also almost fully priced. Overall, the market is pricing in an easing of more than 100 bp over the next 12 months.

Currently, the government shutdown means there is less data to guide expectations. The Fed finds itself in a similar position, having no clear read on the jobs market beyond anecdotal evidence it collects -- like the Beige Book -- and private-sector surveys and data such as ADP and ISMs. Given remaining inflation concerns, it would thus take a quite deliberate hawkish tilt from the Fed to move rates away from current levels; we have seen some stabilisation in the 10y UST around the 4% level.

Treasuries, and their spread over the SOFR overnight index swap (OIS) rate, might react more to any news that the Fed intends to end quantitative tightening, in particular, the roll-off of Treasuries from its balance sheet. As we mentioned before, the Fed also holds MBS on its balance sheet. But it might be inclined to let these continue to roll off. In that case, replacing them with (shorter-dated) Treasuries or T-bills could prove quite supportive for the market.

## The US is the main driver of EUR rates, maybe too much so

With the European Central Bank clearly on hold, we see very little volatility in euro rates driven by domestic factors. Therefore, they may seek their cues elsewhere. In fact, the only time we saw less volatility for 2Y swap rates was when the ECB was at the zero lower bound. It means daily volatility in euro rates is, for the most part, driven by external factors. And because the front end is so firmly anchored, this is mostly expressed by moves further out the curve.

That also means that any changes to the Fed's forward guidance on its easing path may have little spillover to the eurozone. Spillovers from 10Y UST yields due to risk sentiment leave a clear mark on euro markets, as we have seen in the past weeks. But we doubt the Fed will trigger such a risk-off move. We do think 10Y euro rates may have already followed US rates too low for too long, and thus the balance of risk is more tilted towards a move higher from here.

## Wednesday's events and market view

After Spain's GDP numbers, the highlight will be the Fed meeting. US wholesale inventories data will likely be delayed due to the government shutdown, but pending home sales should still be released.

In terms of issuance, we have the UK auction £3.75bn of 7Y Gilts and Germany has scheduled a 10Y Bund auction for €4.5bn. From the US, we will have 2Y FRNs totalling \$30bn.

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