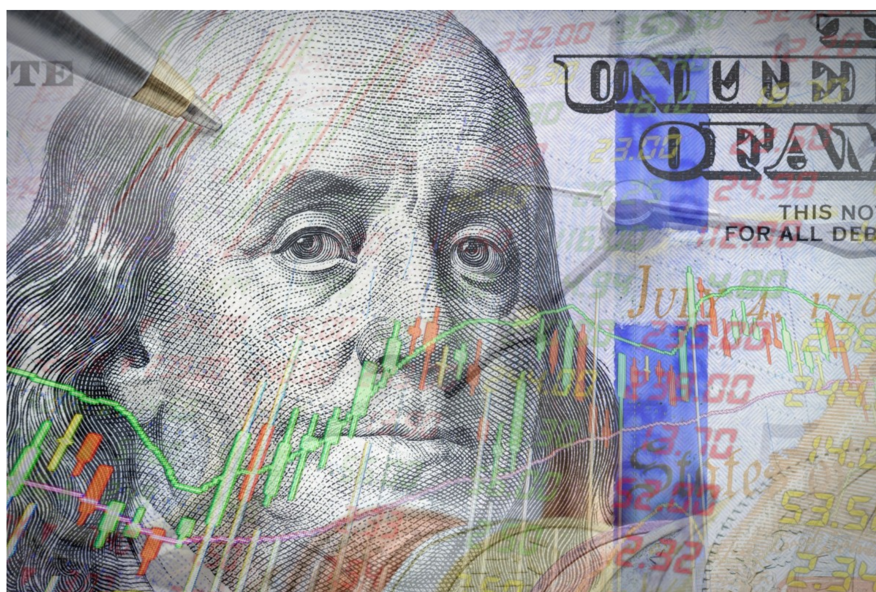
Rates Spark: Front ends are steady but lots going on

The current risks are towards more ECB easing, but because medium-term risks are tilted to the upside, we think markets will remain firmly anchored around a 1.75% landing zone. In the US, the ultra front end has a tight feel to it, while longer tenor yields have a more loose tendency. We identify some technical factors driving this



US rates are taking the lead as EUR rates followed the bullish mood in US Treasuries

Big surprises needed to move the front end of the euro curve

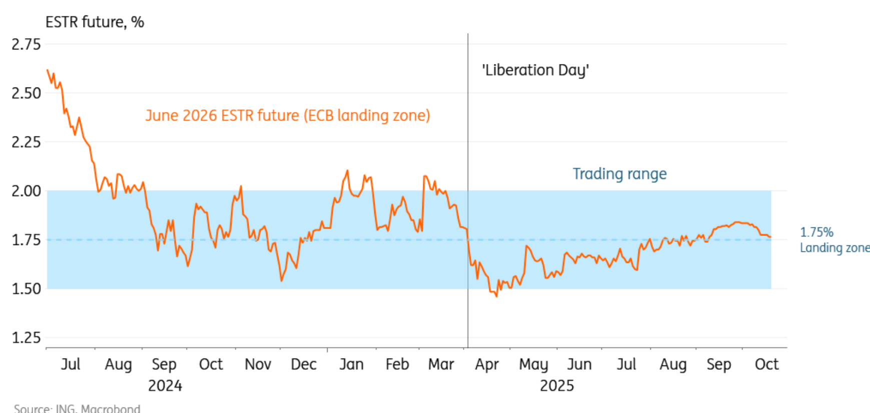
Whilst we do see some movement at the front end of the euro curve, we expect the current pricing to remain relatively sticky until at least mid-2026. Markets imply a probability of around 70% for another cut by summer next year, which seems fair given the balance of risks. The biggest downside risk would be headwinds to the growth outlook, but so far the economy has shown resilience even despite the trade turmoil earlier this year. Bar a big surprise, the PMIs on Friday should confirm a continuation of a slow but gradual recovery in growth.

Disinflation could lead to a pricing in of more easing, but markets are already positioned for an undershoot, which means the bar for downside surprises is high. The two-year inflation swap is at just 1.7% and even the 10Y inflation swap is now 1.9%, both below the European Central Bank's target. Lower oil prices or a stronger euro on the back of Fed cuts could add to the downside

inflation risks. But with the last core inflation reading still at 2.4%, we doubt these risks can persuade markets for more cuts in the near term.

Then there is the German spending story, which adds upside risks to growth and inflation in the medium term, preventing markets from pursuing a fully data-driven approach. Even if growth starts disappointing or inflation drifts below 2%, the uncertainty about the impact of more fiscal spending in Europe cautions the ECB from easing too much too soon. This means that markets cannot blindly follow PMI or inflation surprises, but will need to account for the ECB's projections about future dynamics. As such, the front end has little room to move lower from here.

Moving markets away from a 1.75% landing zone is tough



Source: ING, Macrobond

US back-end rates on the slide while the ultra front end remains tight

In the US, the big unfolding narrative surrounds the move in longer tenor yields. The 30yr yield is heading in the direction of 4.5% while the 10yr is stretching below 4%. The dip lower is being helped by a contemporaneous tightening in swap spreads, by some 10bp in the past six weeks. In our mind, this is a reflection of the fiscal deficit outcome for 2025, which came in lower than for 2024, even if only by a smidgen. That eases the build in supply narrative, even as absolute levels of supply remain very elevated. Bills issuance is now running at 21% of marketable debt, which is high, and also keeping supply pressure away from the longer-term coupon curve.

There is also an anticipatory trade reflecting expectations for a loosening in the supplementary liquidity ratio for large US banks. We covered this here, showing how it can coax more buying of Treasuries. It can also add liquidity to repo. It's needed as SOFR continues to trade at a rate discount. We don't view this as reflective of a reserves' shortage, as we view reserves as broadly in balance right now. Rather, it's a market that could do with more participation. At the margin, the Fed is still engaging in mild quantitative tightening, but is likely to wind this down completely as far as Treasuries are concerned.

Bottom line, it's easier for Treasuries than Repo to anticipate SLR adjustment. That said, we can't ignore that inflation reading we'll get this week, and its likelihood for a further creep higher in the coming months. The big question remains – can 10yr SOFR sit there at 3.5% if inflation trends up to the same level. For now, the 10yr is not showing too much concern. But that can change.

Wednesday's events and market views

After seeing UK CPI numbers this morning, we only have ECB speakers to look forward to. Lagarde will speak at a climate conference and the Austrian Kocher will talk about global trade and tariffs.

Issuance includes a new Italian 7Y retail Valore BTP for an estimated €12-15bn. From Germany we have a 7Y Bund auction for €3bn, and from the US a 20Y Bond for $13bn.

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