

Rates Spark: Growing momentum for a 50bp rate cut

The big question going into the FOMC meeting is whether Treasuries are too overbid. We think that is a risk. The 2yr is so rich to the funds rate that it's as if we were facing a crash, rather than a soft landing. The risk of a sell-the-fact reaction is very much alive



Treasuries are arguably too overbid into the rate cut phase ahead

It's increasingly probable that the Federal Reserve will go into Wednesday's meeting with a market discount directing them towards a 50bp cut. If that's the case, in effect it will make the decision easier. Easier in the sense that delivery of a 50bp cut would then be easier than 25bp, allowing the Fed to get somewhat back on curve. Also, delivery of an impactful 50bp cut would, by definition, be practically discounted.

The build of the 50bp discount is an ongoing bullish process for bonds as anticipation for a series of rate cut events dominates. It's typical for periods like this to be net bullish for bonds. There is more uncertainty concerning the reaction to the cut event itself. It is not unusual to see longer tenor market rates rise on a rate cut. History shows that the reaction is mixed. Sometimes rates react by

moving higher on a sell-the-fact-type-move, and sometimes rates move lower on an ongoing build in the rate cut discount ahead.

If we were to get a 50bp cut, especially if not fully discounted, then logic should suggest some downside for longer tenor yields. If we were to get 25bp, with the market partly discounting a 50bp cut, then a pull-back and higher yields would make sense. That said, regardless of the logic here, we suspect that a sell-the-fact reaction is quite likely. We say that as we feel the market continues to over-discount future cuts.

We are also swayed by the remarkable spread from the 2yr to the funds rate – it has never been wider since the 1980s (2yr yield through the funds rate by 177bp). That suggests things are getting overdone here.

With the ECB behind us, euro rates are awaiting the Fed

With the ECB meeting behind us, the Governing Council members have taken the stage again to comment on the path going forward. Chief Economist Phillip Lane reiterated the data-dependent approach and Peter Kazimir shared his view that the next move will likely be in December. With data dependency the guiding principle, we too think December is more likely. Economic data would have to start showing severe recession risk to convince us that a cut is necessary in October. We tend to think the 30% probability priced in by markets is on the high side.

Until the Fed meeting, we expect euro rates to trade sideways. The spillovers from a 50bp cut would have some bullish spillovers to the Bund curve, including more steepening, and will also likely increase pricing for an October cut. But overall the scope for lower Bund yields is limited.

Tuesday's events and market views

From the eurozone, we have ZEW survey outcomes, which are expected to worsen for Germany from already poor prior readings. The US will publish retail sales, industrial production and capacity utilisation, all figures that could shed more light on the cooling economy. On a more technical note, the ECB will allot its first weekly MRO liquidity operation at the new lower spread of 15bp above the deposit facility rate. At this stage, we do not expect a significant increase in uptake by banks given the overall €3tr of excess reserves still in the system.

For supply, we have the UK with a £2.25bn 30Y Gilt auction. Finland has a 5Y and 10Y RFGB lined up for €1.5bn. Lastly, the US will auction a 20Y bond for a total of \$13bn.

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