Rates Spark: It’s not just US rates exploring new highs

While rates on Monday stabilised, this cannot hide the fact that markets have reassessed their Fed expectations quite noticeably. In fact, the stabilisation was only after touching new post payrolls bond yield highs. Markets are likely to maintain their bearish untertone until data signals otherwise. ECB members are trying to head off spillovers, but likely to little effect as EUR rates have also risen for homemade reasons

US Treasuries comfortable at new local highs for yields

The impact effect of Friday's payrolls report was to push the 10yr yield up to a high of 4.79% on the day. Monday then saw 4.80% nipped at a few times. It's a similar story for the front end as a new high north of 4.42% was touched. Even if now off these highs, this price action suggests a degree of comfort at these new lofty levels post payrolls. Both the 2yr and 10yr yields have seen 5% in the current cycle. The difference is the 2yr is unlikely to see 5% again in this cycle. But the 10yr yield is primed to head in that direction. We don't have a rate hike risk, so the 2yr should remain contained. But we do have a supply / inflation combination to continue to worry about.

To reverse this trend we'd need to see Wednesday's CPI report surprise to the downside. There is a 0.4% month-on-month rate discounted on the headline number, which is not great to say the least, and the core MoM rate is expected at 0.3%. If that is realised, that would be the fifth 0.3% MoM reading in a row. That annualises to over 4% inflation; not good. The realised year-on-year rates are in the 3% area, which in itself is not contained enough for comfort. When the Fed first cut in September 2024, it followed a run of 3-4 months of contained MoM readings in the 0.1% to 0.2% area. We would need to get back there for a few months before another cut is even considered.

The focus for Treasuries on Tuesday is PPI readings, and even there we have 0.3% and 0.4% MoM rates featuring, even if not as impactful as Wednesday's CPI reading(s).

ECB members try to differentiate themselves from the Fed

Fed expectations have repriced higher following Friday's jobs report with the market now not even fully pricing one cut this year. The EUR market's European Central Bank expectations have repriced higher as well with the central bank now seen at most cutting to a depo rate of 2% by the end of the year.

It is important to remember that the upward dynamics seen in EUR rates of late are not just simply US spillovers. The repricing is equally homemade, also illustrated by the fact that even after the payrolls report the 10y UST/BUND still stands tighter compared to late December.

The less dovish than anticipated tone of the December ECB meeting last year paired with the latest sticky inflation prints and rising energy prices have laid the ground for markets to also refocus on the inflation issue this side of the Atlantic. Coming from a low around 1.95% early in December, the 5y5y inflation forward has risen to 2.13% again as of Monday.

The ECB policy still is in restrictive territory and more easing remains the baseline view, but with the question being just how much. Some Governing Council members seem to show some unease about the latest developments given the fragility of the economy. Finland's Rehn was one of the ECB officials who tried to distance the ECB from what is happening in the US, stating the ECB was not the Fed's 13th district.

Such commentary might only slow the bearish dynamic, but to really turn things around we would probably need to see more weakness in the data or inflation readings coming down. Especially the latter is something that could be delayed eyeing what is happening in energy markets.

A more market technical factor that adds to upside pressure in longer EUR rates is the usual wave of new bond supply at the start of the year. Here markets are bracing for the first syndicated deal of the year from the EU, which has yesterday mandated banks for a new 3y bond alongside a 30y tap. The EU has indicated it intends to fund €90bn in the first half of the year alone.

Tuesday's events and market view

Ahead of the US CPI release on Wednesday markets will get the PPI print for December. Expectations are for a 0.3% MoM print in the core categories. Key will be the components that feed into the PCE deflator due at the end of the month. The NFIB's small-business sentiment indicator likely improved further in December, after it already rose with the Trump election. In the eurozone the only data to watch on Tuesday is Italy's industrial production. The ECB's Holzman will speak at the Euromoney conference.

In primary markets all eyes are on the EU's first deal of the year – a new long 3y alongside a 30y tap. Separately, Greece has also mandated banks for a new 10y benchmark. The deal come alongside the already scheduled auction supply, with Germany launching a new 5y bond and the Netherlands tapping a 30y line.

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