

## Rates Spark: Long-end rates look too low post the FOMC

Noteworthy here is the upside shift in the market expectation for the effective fund rate for end-2025. It's essentially flat to the current 10yr SOFR rate. Something is mis-priced here. Most likely, long tenor rates are too low. Compared to the Fed, the ECB has more flexibility to cut rates if needed, posing downside risks to the EUR front-end



### The recalibrated market discount for the funds rate exposes the 10yr rate as still too low here

The 25bp cut from the FOMC was expected, but the big news is the larger-than-expected upward shift in the dot plot. The Fed now pitches the funds rate at 3.875% next year. That's up 50bp from what they had before. In fairness though, the market's discount had changed dramatically too in the past couple of months. Still, the market reaction is higher rates along the curve. Looking at the 2yr now at over 4.3%, it's likely overreacted to the upside. While the 10yr rate is back to the 4.45%, back to where it was just post the Trump re-election. Little reason for this to collapse back lower based on what we know.

Noteworthy here is the upside shift in the market expectation for the effective fund rate for

end-2025. This is now up to almost 4%. In other words the market is questioning whether the Fed delivers a final 25bp cut to get the funds rate below 4%. That pitches the implied “floor” for longer tenor rates at or about 4% (or just under). Contrast against that where the 10yr SOFR rate is now, at 3.95%. That’s essentially flat to the expected landing area for the funds rate. Something is mis-priced here. Either the Fed is going to cut by more than that. Or, and more likely, longer tenor rates are too low. As a call for 2025, we still see 4.5% for 10yr SOFR and 5%+ for the 10yr Treasury yields as viable targets.

The Fed also made an important technical adjustment to the overnight reverse repo rate (cut by 30bp), and now flat to the new Fed funds floor at 4.25% (cut by 25bp). This was broadly anticipated. It reduces the compensation obtainable at the reverse repo window, and should prompt less use of that window at the margin. Having a 5bp cushion made sense when the funds rate floor was a zero (to prevent a zero print). Now there is no cushion, but also no need for one. The effective funds rate should not be impacted in the sense that it should remain c.8bp above the floor. Although there can be a mild bias lower if anything.

## An agile ECB means more room for the EUR front-end to dip lower

Whilst the Fed is more constrained going into 2025, the European Central Bank has plenty of flexibility to accelerate cuts if needed. Or as Chief Economist Lane put it, “maintaining agility on a meeting-by-meeting basis”. This also means the front-end of the EUR swap curve is less anchored compared to the US curve. Markets now see an ECB landing zone around 1.75%, but nothing prevents markets from shaving off another cut in the case of worsening data; inflation is gradually falling whilst the ECB’s focus has moved to growth concerns instead.

The back-end of the euro curve remains sensitive to US rates, and the bear steepening of the past week is a good example of these tied dynamics. As long as eurozone data doesn’t move towards a severe recession scenario, the 10Y swap rate will be kept up by higher UST yields. In effect we see plenty [more steepening potential](#) for the euro curve going forward, both driven by the front-end and back-end of the curve. A risk to our steepening view would be that eurozone growth decides to pick up again, but we don’t see this happening in the near-term, but is more likely a story for around mid-2025.

## Last Rates Spark of the year! Happy holidays everyone!

As we wrap up the final Rates Spark of the year, we want to extend our warmest holiday wishes to all our readers! For those looking for some holiday reading, we highly recommend our [Rates Outlook for 2025](#). If you prefer to dive into A Christmas Carol by Charles Dickens instead, we of course won’t hold it against you. See you all in 2025!

### Thursday’s events and market view

The Bank of England is not expected to adjust policies on Thursday. In the US the focus is on the jobless claims data where the market is looking for slightly lower initial claims. We will also get the third reading of second quarter GDP data, before attention then turns to the PCE deflator on Friday. The important month-on-month core reading is expected to return to 0.2%.

The eurozone calendar holds only few pieces of note. On Thursday we will get French

business and manufacturing confidence indicators as well as a German consumer confidence reading ahead of the eurozone consumer confidence on Friday.

In primary markets the US Treasury sells US\$22bn in 5Y TIPs. We will also be looking to Finnish debt agency which will announce its funding for 2025 on Friday.

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