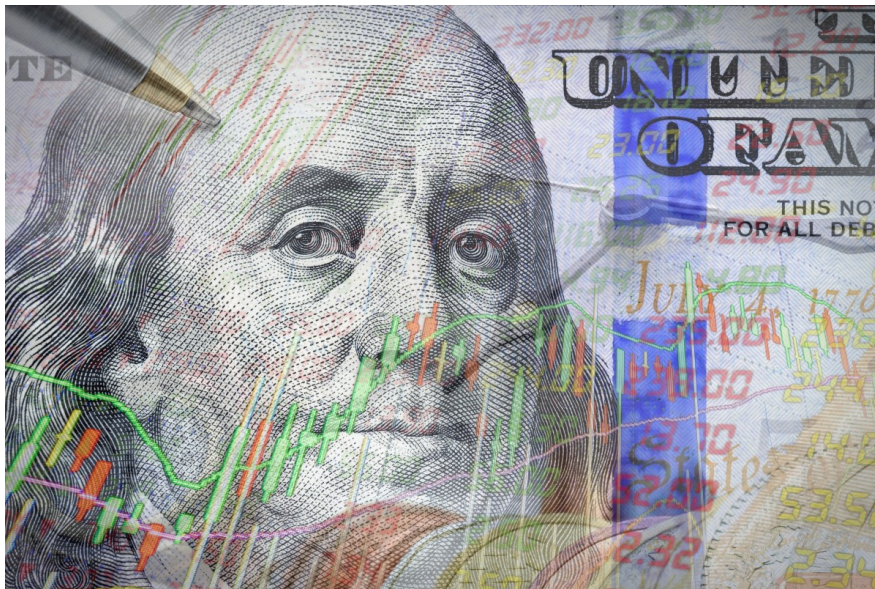


Rates Spark: Long end rates untethered

Last week, US Treasury yields moved in tandem with the rebuild of the discount for a December rate cut. Not this week so far! In the eurozone, rates are testing new highs. If (as expected) inflation does not undershoot the 2% target, we shouldn't dismiss a scenario where the 10Y swap rate breaks 3% a bit sooner



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

Treasury correlation with the rate cut discount is reduced

The US 10yr yield had a few goes at breaking back below 4% last week, but in the end decided that the stars had not aligned for such a move. The tone on Monday was quite different, as it decided to shoot back up towards the 4.1% area that has been something of a haven for some time now, certainly since early September. Even though the data has not been great, it's also not been awful enough to validate a big bull market for bonds. Even the November ISM data were not great, but the PMI number was okay, and ISM prices were elevated (approaching 60). On top of that, five of the last six bond auctions 'tailed'. Not in a catastrophic way, but still, not the type of auction outcomes that bond bulls could find as comfortable.

It is remarkable how quickly the discount for a 10 December rate cut rebuilt from a 25% probability to practically a 100% one. It's true that the data has not been fantastic, certainly in pockets. But there's also been some evidence of resilience (jobless claims). We're okay with the morph to a preferred rate cut, as we've been calling for it. But to be honest, the only solid reason for the

dramatic rebuild in the discount for a cut is that Chair Powell has not come out and objected to it. The thinking is that the Williams comments came with a nod from Chair Powell. That's certainly the way the market is viewing it.

The move in the probability of a December rate cut was in tandem with the 10yr Treasury yield up until Friday of last week. That changed on Monday, with a more hawkish Bank of Japan pushing in that new direction.

Inflation risks in focus for euro rates as new highs are being tested

Markets are still tilted towards downside inflation risks, limiting the upside potential for euro swap rates for now. The 10Y inflation swap is currently priced at 1.94%, which is below the long-term ECB target of 2%. The latest nudge downwards in inflation expectations was in November on the back of a potential peace deal with Russia, which lowered the price of gas futures for 2026. On top of that, a deal may also reduce the sense of urgency for defence spending, thereby pressing down on future price pressure.

The fact that the 10Y swap rate touched the 2.8% handle on Monday despite disinflationary forces does highlight the upside risk to rates too. Euro rates were not immune to the recent global move higher in rates from Japan, the US and the UK, allowing real rates to rise materially. Then we also have the Dutch pension reforms playing in the background, which provide upward pressure from the long end in the form of more payer swaps.

If eurozone inflation does not undershoot the ECB's target in the coming months, as markets are positioned for, then seeing the 10Y swap rate break through 3% is suddenly not an unrealistic scenario. But for this to happen, we first need a series of hotter-than-expected inflation numbers. The 2.4% core CPI reading we expect on Tuesday does, however, underline we're still far from 2%.

Tuesday's events and market views

From the eurozone the highlight will be the core CPI number which consensus sees come in at 2.4%. US data is likely to still face delays due to the government shutdown.

In terms of supply, the UK will auction £1bn of 6Y Gilt linkers and Germany 2Y Schatz for €4.5bn.

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