

Rates Spark: Steepening from the back end – more to come

Markets continue to discount early rate cuts, but central banks are pushing back against premature cuts and stressing the data-dependent approach. Long-end rates continue to drift higher, and curves are steepening. The US 30yr is back to where it was before the Dec FOMC. The 10yr was at 4.15% then, which represents a reasonable tactical target to aim for



The target of the pre 13 December FOMC meeting level for US yields

A key feature of price action has been re-steepening from the back end of late. The US 2/10yr spread is in to the -17bp area now, just a smidgen off the -15bp seen a few months back. Still inverted, but now dis-inverting with some vigor. Part of this has been driven by prior front-end falls in market rates as bets for a March cut built. But this week the dominant driver has been a pull higher in longer tenor rates, right out the curve. The US 10/30yr spread is now knocking on the door of 25bp.

The pressure for higher long-term rates is mostly coming from Treasuries, as swap spreads in 10's

and 30's are relatively contained. In contrast, front-end swap spreads have been widening, as 2yr yields have fallen in a relative sense. From here the 2/10yr will want to hit zero as a target, while the 10/30yr will eye the 35bp level hit last summer. Curve steepening trades are an obvious way to go as we gear up for rate cuts, but they are negative in carry and thus a pain to hold. Decent steepening episodes like we are seeing now help ease that pain.

At the same time there is a clear manoeuvre away from the market discount for a March cut. We've never been believers in a March cut, even though we've been aggressive on our rate cut call for quite some time now. Still, the market has an appreciable expectation for a March cut still priced. It was approaching 80% on Friday. It has since eased in toward 65%. We fully expect it to flip to a 65% discount for no March cut in due course, which should act as a negative driver for bonds.

The move back above 4% for the 10yr Treasury yield reflects many of these factors, and we continue to assess that marks above 4% make sense. There is a route to the 4.15% area as the market looks to get back to where it was just prior to the 13 December FOMC meeting. In fact the 30yr yield is already there. It was in the 4.25% area when Chair Powell stood up at the press conference, and that's where it is now.

Timing of rate cuts remain a focus for markets and central banks

Markets have been tinkering with the idea of having rate cuts as early as March or April this year, whilst central banks are doing their best to push back against premature cuts. The ECB pushback over the weekend and on Monday showed some impact with US rates also rising after returning from a long weekend, as they ingested the views as expressed by Lane, Nagel and Holzmann.

Tuesday's interview with ECB Governing Council member Villeroy was more balanced, assigning a high probability to a rate cut this year but also reiterating that it's too early to declare victory over inflation. Again, the data-dependent approach was stressed, which is the recurring theme in recent central banks' messaging.

Having said that, European data points Tuesday were not convincing enough either way to move markets. The ECB survey of consumer CPI expectations declined noticeably, indicative that inflation expectations remain anchored, a condition for any potential rate cuts to be on the cards. Whilst these consumer surveys may not be the hard data point we are looking for, they may help keeping upcoming wage negotiations contained, a closely followed development by the ECB. For now, the forward-looking data also seems sufficiently strong to dismiss the need for imminent rate cuts, as was reflected by the recovering ZEW data from yesterday. A surprisingly negative reading from the US Empire Manufacturing survey seemed to nudge US rates down by a few basis points at first, but most of the decline was retraced shortly after.

Yet despite the soft data and all the pushbacks from central bankers, markets continue to place a high probability on early rate cuts. An escalation of the conflicts in the Middle East is possible, but especially with a view to the ECB, given the supply chain implications and oil price impact, increased inflation pressures in such a scenario could overtake the central bank's growth priorities – at least initially.

Data events and market views

European markets open Wednesday with a long list of inflation-related data in the UK, which we can expect to trigger some moves in the Gilt market. US retail sales and industrial production numbers come in during US opening, and together with the Beige Book at the end of the day, these should provide a more thorough look into the underlying strength of the US economy.

The Fed's Bowman will speak about bank capital reforms and Williams is set to speak in the evening about equitable growth.

Tuesday saw Finland mandate a 30-year benchmark issuance, which should come to the market on Wednesday. Germany is also slated for a smaller bond tap in the 30Y sector.

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