Rates Spark: Near-term balance of risks still tilted towards higher rates

Markets are geared for dovish outcomes this week, not just in rates where still notable probabilities are discounted for first cuts as early as March, but also across wider risk markets. This sets up markets for disppointments if they don't get exactly what they want. Data is a wild card, but the ECB will have this in mind if it is earnest about pushback

Near-term balance of risks still tilted towards higher rates

The thought of a soft landing actually materialising against all odds are supporting risk assets in all corners of the market. The S&P 500 closed at new record levels on Friday and also on Monday the equities rally pushed on through. In rates the pricing in of a soft landing has pushed down rates along the curve at the start of the week, supported by the idea that inflation is coming down as markets are eyeing this week’s PCE data. But markets are starting to fine-tune their expectations more in line with our thinking, even if we see more scope for correction in this direction: pricing for a March Fed cut is now down to 10bp, even though overall pricing for cuts this year has even deepened somewhat again to 134bp.

Even though we also see inflation coming down steadily, we warrant caution about markets still getting ahead of themselves – especially in EUR rates. The European Central Bank will meet on Thursday and we expect a reiteration of their data-dependent path towards policy normalisation. Last week yields came down the day that Lagarde hinted at rate cuts in the summer. The best that markets can hope for is a reiteration of that comment, but given the guarded fashion of Lagarde's statements we can see a scenario where she does not repeat this dovish message in the context of the policy meeting this week. We therefore see a chance that EUR 2Y rates will recalibrate higher again in response to the press conference when markets don't get exactly what they are looking for.

In the US there is also no guarantee that the nudge lower in rates we saw at the start of this week will extend. Markets have their eyes on a 2.0% core PCE inflation, in line with the Fed's mandate that will be published on Thursday, which, if met, would keep the market pricing of a March rate cut as a realistic scenario. If, on the other hand, the actual number were to exceed 2.0%, even by a bit, we could imagine the market reacting more sensitively to such a disappointment. Similarly, we would expect an asymmetric reaction to the GDP growth figures, which our economist expects to come in firm on Thursday. On balance, if data come in as expected the further downside is moderate, but at least near term the potential could still be larger.

Tuesday's events and market views

Japan will kick-off this week's central bank meetings but no change of the policy rate is expected. In terms of economic data releases Tuesday will be another light day. The EU Commission will publish the consumer confidence index and the ECB will release results of its bank lending survey. In the US we a few business indicators from regional Feds.

It is the rest of the week will be of more interest, with eurozone PMIs on Wednesday, the ECB meeting and US GDP data on Thursday followed by the PCE on Friday.

In primary markets Germany will sell 4Y and 30Y green bonds while the Netherlands taps a 15Y bond. The US Treasury sells new 2Y notes. In SSAs the EU has mandated syndicated taps of existing 7Y and 30Y bonds, which should also be Tuesday's business.

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