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# Rates Spark: Data is soft, but other factors continue to weigh

A large sense of anticipation ahead of data dominates thinking, but so too do technical issues like the ongoing un-wind of the March rate cut in the US and the re-build of the 10yr term premium.

Market rates have moved higher as the ECB meeting and US GDP data release loom large on Thursday



The European Central Bank meeting and US GDP data loom large on Thursday

## The macro impulse from the US is bond positive this week, but we continue to see some cracks in the narrative

The US 2yr auction was fine Tuesday. Pricing was tidy, and overall auction statistics were decent, including an important and decent indirect bid from central banks. The 5yr is up next, but overall these auctions should not prove determinative of direction. That said, the 5yr part of the curve trades rich in absolute terms, given the ongoing inversion of the 2/5yr segment.

In fact, the 5yr continues to trade at a net 21bp give-up to an interpolated line between the 2yr and the 10yr. Indeed this richness attached to the 5yr is indicative of a bond market that is not taking an imminent rate cut seriously. The March rate cut discount continues to fade in the background too, now down to a 45% probability for a cut. That should drift down to the 35% area,

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leaving some room for upward pressure to build on longer tenor rates, given that they are an extrapolation of the front end.

We are running the gauntlet through what is expected to be some decent US inflation data on Thursday. If that is better than expected we might need to revise things. But if its purely in line, it still deserves a positive reaction, but the subsequent path can still head towards the 4.25% area for the 10yr, as the 5bp negative term premium there also needs to at least turn positive.

### Supply has helped steepen a curve that is still priced for very dovish outcomes

Markets did not have much to trade on over the past session but did nudge somewhat higher with curves steepening from the ultra-long end. Some of that may have been related to the primary market activity, where the EU issued 7Y and 30Y bonds on Tuesday. On the face of it though broader markets have absorbed the wave of new issuance at the start of the year quite well, noting that Bloomberg has actually reported that this month has already been the busiest January in history with €293bn in bond sales.

Markets are still eyeing the European Central Bank meeting on Thursday and whether there will be more guidance on the possibility of cuts, following up on the hints with regards to cuts by summer that were dropped last week. And indeed the bank lending survey published yesterday showed that the ECB's transmission is working, dampening loan demand from businesses and households.

The markets take on inflation remains pretty benign. Near-term traded inflation fixes have headline inflation dipping to basically 2% by April and then also well below the ECB target in the third quarter down to 1.6%. Longer-term pricing is also very benign with the EUR 2Y inflation swap at 1.87% and even a 10Y measure at 2.14% where it has been relatively stable since mid-December.

More importantly, that means there are effectively no traces that the frictions we are seeing along trade routes through the Strait of Hormuz are having any bearing on the bigger picture yet. We still have the feeling that the ECB could be more sensitive to such risks.

To be fair, the market rates must reflect tail risks and should come closer to reflecting a probability-weighted average of possible rate outcomes rather than just the baseline we look at in our forecasts. But even then we find that the probability attached to early cuts is still looking somewhat high given the ECB's inclination to err on the side of caution with regards to inflation.

To note, the dynamic in market inflation expectations basically moving sideways in EUR space is slightly different from what we have seen over the past weeks in the US. Here inflation swaps have moved a tad higher, which was at least partly supported by a number of better-than-expected economic data releases.

### Wednesday's events and market view

The PMI releases should give markets more to trade on, although we do not think that the survey outcomes will change the overall picture. In the eurozone they are likely to remain in contractionary territory but should signal a more generally bottoming out of the economy. The US S&P PMIs are usually less influential than their ISM counterparts, but large swings have seen markets react in the past. That said, for the upcoming releases consensus is

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looking for marginal changes only.

Primary markets will stay a little busier on Wednesday. Germany taps 15Y and 23Y bonds. In the eurozone periphery Portgual is active in 5Y to 20Y area. The UK sells 5Y gilts and over in the US the Treasury will sell new 5Y notes as well as new 2Y floating rate notes.

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