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RATES SPARK

Rates Spark: Rates are seeking new levels to settle

Markets have a pile of macro data and central bank speak to digest from last week, and with US payrolls scheduled for Friday, expect more volatility ahead. Meanwhile, oil remains the wildcard and could be the deciding factor in whether we're looking at lower or higher rates by the end of this week

We expect volatility to continue in rates markets, with oil prices potentially being the deciding factor on whether we have lower or higher rates this week

Bearish rates bias but oil will be the judge

Euro rates seem happy to drift higher as growth surprises have turned significantly more positive of late. Last week's inflation reading was also slightly on the bearish side, with core CPI unexpectedly ticking up. While we think inflation risks are less than feared, in the near term we would not push against markets' hawkish ECB positioning. Structurally, we still think 2Y euro swap rates should find themselves lower, but this might be more of a 2027 story. As we get more inflation data, limited second-round effects should allow for a more dovish ECB outlook.

For US rates, we continue to see potential for a steepening from both sides in the near term. After last week's FOMC meeting, markets have turned more dovish on the Fed, but the long end is clearly vulnerable to higher rates. The expectations for Friday's payroll numbers are just 88k, but still in positive territory. In a scenario of easing inflation and a relatively steady jobs market, longer rates can stay anchored at higher levels even if the front end comes down.

Only when the economic outlook starts deteriorating should we start seeing a more noticeable bullish move in US rates. With the US consumer increasingly struggling, we expect growth headwinds to start mounting in 2027. Therefore, structurally, we still eye lower US rates across the curve.

Meanwhile, the correlation between oil and rates remains strong, and even though the latest signs have turned more positive, we'll have to see concrete steps to open the Strait to prevent oil prices from rising again. The relationship does not show any signs of easing. If anything, the longer oil prices remain elevated, the higher the risk of second-round inflation effects. Based on a simple linear model, a $10 rise in Brent oil translates to around a 10bp higher 2Y EUR swap rate, 15bp for the 2Y GBP swap rate and 6bp for 2Y USD swap rates.

Monday's events and market views

The data highlight will be the US ISM manufacturing from July. Consensus sees an improvement of the headline number from 53.3 to 54.0. Earlier from Europe, we also have Italian and French manufacturing PMIs. So far, the manufacturing indicators have shown resilience amid higher energy prices, and consensus expects another tick higher.

No notable supply is scheduled.

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