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RATES

Rates Spark: Resumed steepening impulse

Thursday's payrolls number prompted some steepening. We think there is more to come, as longer dated yields hold up while shorter dated yields ease lower. Longer dated yields are supported by a tendency for real yields to rise, partly as inflation gets sold. Shorter dated yields should fall as that selling of inflation means less inflation/rate-hike risk



After Thursday's payroll number we see more steepening potential in both US and eurozone rates

US employment data leaves the curve net steeper, from the front end

The US payrolls report saw employment growth for June (57k), clearly a miss versus expectations, and there was a downward revision to the previous month – hence the impact down-move yields. But the unemployment rate is down to 4.2%. That was enough to prevent this report from being an outright bull story for Treasuries.

In many ways, the unemployment rate is the more important number for the markets. It historically wasn't. But the debate on where the replacement rate is on the employment change has downsized its importance relative to where it was. The three-month moving average is now at 111k, which is okay. At the same time, and being data selective, the jobs

number takes imminent rate hike pressure away. The 2yr yield was lower post the number, and showed a tendency to stay lower on the day.

The curve ended the day net steeper. Ahead, we note that the 10yr has shown a tendency to hug the 4.45% to 4,5% area. It got there partly on some big duration squaring (selling) into month end (June into July), but also got there quite efficiently. We stick to the view that the long end remains heavy (yields holding up), while the front end should richen (yields fall). The richness of the 5yr area of the curve suggests the same.

The juxtaposition between the calming of inflation expectations versus the resilience to the rate hike narrative is tough to square, but we think the rate hike discount is mispriced.

Dovish trend can continue in near term until oil backs up again

With US markets closed, we should already start thinking about the week ahead. The week is light in terms of data, with eurozone retail sales and US weekly jobless claims likely the highlights. That means markets will have time to evaluate central bank reaction functions while also keeping an eye on oil prices. For the ECB, markets still see a 50% chance of a rate hike in September, but notably, a July hike is fully priced out. The softer-than-expected inflation data from this week would clearly not justify another round of tightening in the near term.

So, unless oil makes another move higher, or next month's inflation numbers come in hotter, we should see a continuation of the dovish trend in euro rates. ECB speakers have thus far been careful not to come across as too dovish, but oil stabilising around current levels could convince more governing council members to take a more balanced view. On the other hand, the situation in the Middle East remains unresolved, and the risk of oil prices ticking higher therefore remains likely. The 60-day ceasefire still has plenty of time to run, and even thereafter the geopolitical situation will likely stay fragile. While for now we take a dovish view on shorter EUR rates, the move lower is more likely to be a slow grind than a sudden fall.

Friday's events and market view

A relatively quiet day with US markets closed. In terms of eurozone data, we have PMIs from Spain and Italy. ECB speakers include Joachim Nagel and Gabriel Makhoul, and from the Bank of England, we have Governor Andrew Bailey scheduled to speak.

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