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RATES SPARK

Rates Spark: Still exposed to more upside

It is hard to shake off the bearish dynamic without a solution in the Middle East. That means 10y yields are left eyeing further upside after marching through key levels. EUR rates are probably more vulnerable to a shift in sentiment as the backdrop looks shakier than in the US, but sentiment is holding and EUR rates remain caught in the global up drift

EUR rates seem more vulnerable to a sudden shift in sentiment than US rates

Hard to shake off the bearish dynamic without a solution in the Middle East

Rates markets are struggling to shake off the bearish dynamic with the Middle East situation showing little progress. US Treasury yields on the belly of the curve led the way higher and 10y yields have now topped 4.65%. In Europe, the 10y Bund yield was dragged above 3.15% while gilts displayed a slightly more moderate rise after Andy Burnham, a contender for Keir Starmer's premiership, vowed to stick to the fiscal rules. This eased some of the prior fiscal concerns that had rattled the gilts market.

Overall market sentiment remains relatively immune to the geopolitical uncertainty. In the US, equity markets remain closer to all-time highs, even if only driven by a narrower set of tech names. Macro data such as the weekly ADP employment change also continue to signal resilience and add to the bearish rates sentiment by the day. Although the informative value

of that particular data point is likely limited, the argument is that this overall resilience gives the Federal Reserve greater leeway to focus on the inflation issue. The latter is lifting front-end rates as the market has now swung to pricing in Fed rate hikes. But the rise in long-end rates, largely driven by the real component in the recent leg higher, is probably more a reflection of the macro resilience.

EUR rates are caught in this mix, though the backdrop does look shakier here. The upcoming PMIs tomorrow are anticipated to show the growing economic struggle and could thus counterbalance the inflation narrative. In terms of sentiment, high and rising rates themselves could bring us closer to a tipping point, but for now, market sentiment is holding on here, too. Not just in the broader equity markets, but also in bond and credit markets where widening pressures remain muted. Even Italian government bond spreads over German Bunds, regarded as more sensitive to the higher energy prices, are well below the peaks of March and late April even as oil prices closed in on recent highs.

Primary markets also remain open and very active, though some of the recent flurry is likely also down to issuers wanting to get ahead of the summer break and also the upcoming round of central bank meetings. The European Central Bank is priced to deliver a rate hike already in June (about 22bp discounted), and while the Fed and Bank of England are seen to move only at a later stage, their June meetings could see greater market volatility as investors parse communications for any signals regarding the next steps.

Wednesday's events and market view

UK CPI data this morning was not as hot as feared, offering some relief to the market. The few data releases following the UK numbers will mean that the FOMC minutes tonight will likely take the spotlight. It was the meeting where three members thought the Fed language was too dovish in implying an easing bias. Data releases for the day are US mortgage application numbers and from the eurozone, the final inflation figures for April.

Central bank speakers for the day are the ECB's Olaf Sleijpen and, ahead of the FOMC meeting minutes, the Fed's Michael Barr. BoE Governor Andrew Bailey will testify to lawmakers.

In primary markets, Germany reopens the 10y benchmark for €5bn. Later, the US Treasury will then auction a new 20y bond for US$16bn.

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