

## Rates Spark: The ratchet lower in yields is far from done

US Treasuries continue to drift lower, and we continue to eye 4% as both a target and a floor. The 2yr could go through. The 10yr could too, but shouldn't. In the eurozone, markets are refraining from pricing in more near-term ECB cuts and are instead focusing increasingly on the landing point, potentially bull flattening the money market curve further



### US 2yr finally manages a second leg lower

The US 2yr has finally managed to break below the 4.15% area (now at 4.11%), following three failed attempts in the past week. In the past couple of weeks, it has had a tendency on a few occasions to test lower through the US afternoon, only to be pulled higher again in the European morning. We suspect this time it might be different.

There is an element of path of least resistance to the move lower, with the fall of the French government not deterministic, but at the very least symptomatic of a host of mad political manoeuvres in the past few weeks, and factors like eurozone macro malaise pushes in the same direction.

The US 2yr yield averaged 3.3% during the noughties, effectively at a 30bp spread over the funds rate. We reference the noughties as we view it as something of a neutral reference when averaged

over the full decade. Currently, the 2yr trades some 40bp through the effective funds rate. If, as we expect, the Fed cuts by 100bp and nothing else happens, that would pitch the funds rate at 60bp through the 2yr yield. Based off that there is some room for the 2yr yield to test lower, likely to the 4% area. And there is scope to dip below 4%.

For the 10yr the floor should really be 4%. It can go as low as it wants to of course, but below 4% would look stretched from a relative value perspective, as it would push 10yr SOFR towards 3.5%. That's a stretch versus a market expectation for the funds rate not to get to 3.5% at all. Still tactically bullish though.

## Euro rates markets are seeing risks further in the future

Markets have now almost completely removed the chance of a 50bp European Central Bank cut in December and we too think the data does not warrant the central bank to speed up its easing. PMIs are disappointing, yes, but not enough to deviate from the gradual path already set in motion. The October cut was already an extra gift, in a way frontloading the extra 25bp which would otherwise be needed in December. Since then ECB speakers have also put in little effort to move market expectations from the current stance.

But while markets are seemingly reducing the probability of 50bp ECB cuts in the very near term, the back end of the curve exhibits more bullish momentum. The landing point of the ECB is now well below our own 1.75% forecast, and the 10Y ESTR swap rate has this week symbolically broken the 2% handle, for the first time since 2022.

The focus in euro rates is shifting from the very front end of the curve to further outwards, potentially leading to more bull flattening of the money market curve. The reason is that many of the risks ahead of us are unlikely to justify the ECB to cut faster. And indeed the list of risks is extensive, think of the escalation in the Ukraine, French politics gone wild again, while Trump has continued his trade threats, along with weak eurozone growth – notably Germany. But all these risks won't show up in the data in the near term, and although the ECB intends to be less data dependent, growth and inflation numbers will still be leading for the time being.

### Thursday's events and market views

From the eurozone we have retail sales numbers, which are expected to fall by -0.3% month-on-month and thus expectations are already low. The US will publish initial jobless claims, which could warm up markets for the more important payrolls numbers on Friday.

France will auction €5bn of OATs with relatively long-dated maturities including 14Y, 15Y, 25Y and 47Y OATs, which could be of interest to watch, although likely well-absorbed by markets. From Spain we have €3bn of 5Y and 10Y SPGBs.

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