

## Rates Spark: The rate cut discount hardens

The hardening of interest rate cut discounts and their ultimate delivery typically correlate with falls in market rates right out the curve. We see this being a feature for both eurozone and US market rates. This remains the path of least resistance unless the data negates it



### Perfect soft landing would limit 10-year EUR rates from going much lower

Treasuries are in a good mood. The strong US 30-year auction followed a strong 10-year auction, as the CPI outcome of 0.2% month-on-month continues to dominate thinking. A subdued PPI report helped too. Treasuries are on a rate-cut-build path unless negated by data/events. Treasuries have been re-cobbling together the string of weaker observations seen in the past few weeks, and downsizing the importance of the firmer ones. We're back to the build of a rate-cut bias, as had been seen in the couple of weeks prior to the firm payrolls report. The 10-year is now in the 4.25% area, and the 2-year at 4.7%. The target for both would be 4% provided the rate cut discount continues to build.

The US data also helped the 10-year euro short-term rate (ESTR) overnight indexed swap rate back to 2.6% again, after briefly touching 2.8% at the beginning of June. Much of the volatility is being driven by UST yields and will continue to do so going forward. At the same time, we should recognise that 2.5% is also the level we eye as a reasonable terminal rate for the European Central Bank. This imposes a bit of a lower bound for the 10-year rate in the medium-long term, given that we foresee a return of the term risk premium once the European Central Bank cutting cycle starts materialising.

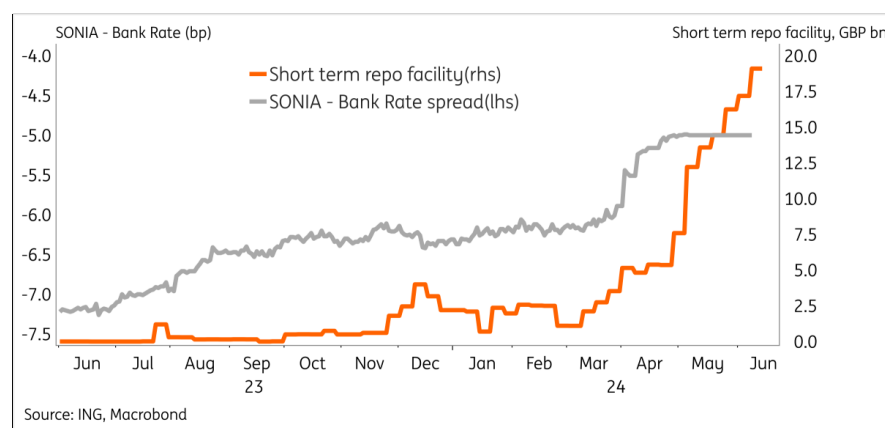
Important to note is that if the Federal Reserve and ECB manage to engineer a perfect soft landing, then 10-year swap rates can end higher from here, despite a fall in yields of short-dated maturities. A soft landing would convey a resilient eurozone economy, even under the pressure of policy rates then not coming down as far. And as the policy rate still settles lower, history shows us that the term risk premium tends to increase. Add quantitative tightening in the background and you could be eyeing a higher back end of the yield curve.

In the eurozone sovereign bonds' space, French spreads widened again on Thursday, showing that the uncertainty and worries about this week's election news are still being digested. Other eurozone government bond spreads and the Bund ASW spread widened too, an indication of a broader flight to quality. But overall the euro market impact from heightened political risk remains fairly contained, helped probably by the favourable US data this week. Having said that, we do expect volatility and consequentially spreads of French bond yields to remain higher until the elections.

## Tighter GBP liquidity contains warning for EUR rates

Over the past few weeks, banks have [started paying more](#) to attract sterling liquidity, according to data underlying the Bank of England's SONIA benchmark rate. Also, the short-term repo facility use rose sharply and given the steepness of the increase this trend will likely continue (see chart below). The sudden tightening of liquidity conditions is a warning for the eurozone, where such a tightening could have a more profound impact on rates as the ESTR can rise by relatively more.

## SONIA rate reaching 5.20% coincides with higher repo facility uptake



## Today's events and market views

From the US we finish the week with the Michigan indicators, which showed a bit of a slowdown last month, so a second weak reading will be noted. Given the focus on price dynamics, the import price index will also be of interest. In the eurozone, we have various ECB speakers but given the lack of forward guidance given by ECB speeches this week, we don't expect to see much price action around these events.

No notable issuance is scheduled.

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