Rates Spark: There's resistance to the push lower in rates

Looking for lower market rates is the simplest interpretation of the wider backdrop. However, an upward creep in US inflation and a slow firming of Eurozone purchasing managers' indexes argue against. Something would need to break for this narrative to change

Customers remain bullish on EUR/USD

The US 10yr wants to dip lower, but knows inflation readings are a risk ahead

In the US, a mean reversion of around 4% for 10-year yields is the ongoing central tendency. And the 2yr yield is not deviating too much from the 3.5% area, with the market continuing to discount a floor for the funds rate at or about 3%. There has also been a slow ratcheting tighter in the 10yr swap spread in recent weeks, correlating with some better news on the fiscal story (2025 fiscal deficit confirmed as below that of 2024).

We stick with the directional sentiment as laid out here at the beginning of September. The idea is that there's a vulnerability for a break below 4% in the near term. But on a multi-month basis, it's tough to argue that US inflation will fall given the persistence of tariffs and the likelihood that they will eventually result in higher prices for the consumer. We anticipate that US inflation, now at 3%,

will head to the 3.5% range. That's where 10yr secured overnight financing rate (SOFR) is currently at -- in the 3.5% area and at a mere 25bp spread to 2yr SOFR. We think that a 3.5% valuation will be tough to sustain if inflation creeps up and affects it.

We also feel the curve has room to steepen some more. The rate-cutting theme helps. Only a deep recessionary tendency is at risk of flattening the curve from the back end. Ahead of that, we will get a consumer price inflation report this week despite the government shutdown. We'll see inflation creeping higher to the 3%-3.1% year-on-year range. It's a slow creep, but edging higher for the coming months at least.

EUR rates more sensitive to global factors than local political risks and fiscal concerns

Risk sentiment in the EUR rates space has proven resilient in the face of the latest unscheduled downgrade of France by S&P. Even the mild widening of the 10y spread of French bonds over Bunds was fleeting as it quickly returned to below 80bp. Observers will argue that this second downgrade into single-A territory was bound to happen, given the developments over recent weeks. With Moody's scheduled to review France at the end of the week, another negative rating action is lurking.

Similarly, 10y Bund yields inched back toward the swaps rate, although even the almost flat level to swaps now still denotes a stickier safe haven premium. We attribute this more to a global sense of uncertainty amid trade tensions and US regional banks. We have seen long-term inflation swaps sliding at a somewhat faster pace over the past week or so – 5y5y coming from 2.09% to 2.05%. This is partly a response to declining oil prices. It might also indicate slightly lower confidence in the overall outlook.

Considering the European economic sentiment, we believe that the PMIs at the end of the week should still support the notion of a weak but ongoing economic recovery, which would help limit the downside to rates.

Tuesday’s events and market view

The risk of headlines remains prevalent for now on the front of trade and US banks. There is no US data nor any Federal Reserve speakers to follow on Tuesday, given the shutdown and also the pre-Federal Open Market Committee meeting communications blackout. EUR rates will have to look to a busy slate of central bank speakers, including chief European Central Bank economist Lane and ECB President Lagarde, for any impulses.

In primary markets, Finland is reopening 6y and 10y bonds for a total of €1.5bn. Germany is tapping two green bonds also for €1.5bn, while tapping its 28y green gilt for £1.5bn.

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