

## Rates Spark: Tight yield correlations are inconsistent with soft-landing narrative

The correlation between UST and Bund yields is significantly elevated, which usually points to a hard-landing narrative, as seen during the SVB crisis. The pricing in of rate cuts, however, points to a soft-landing scenario and is inconsistent with these high correlations. We expect the correlation between US and eurozone rates to weaken.



### UST-Bund correlations are as high as during the SVB crisis

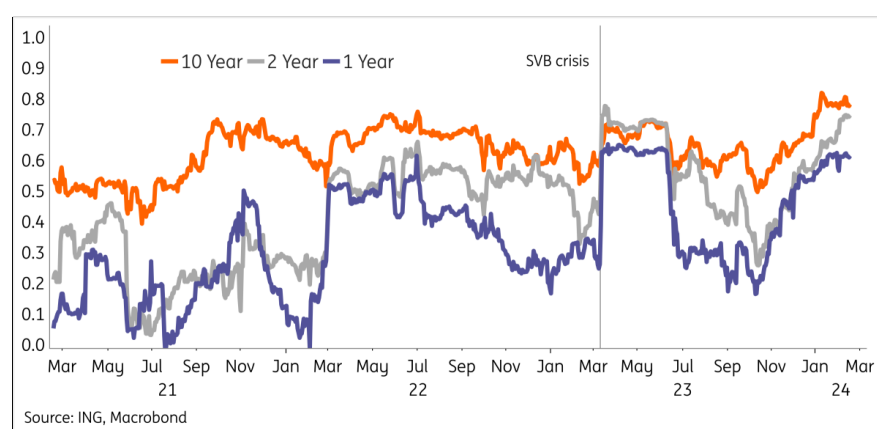
Ahead of the US markets reopening later after a holiday, we've seen some movement in euro rates after a flat day yesterday. The ECB wage indicator showed a small nudge down from 4.7% to 4.5%, leaving markets unimpressed and leading to little change in the immediate trading after that. But by the end of the day, both US and eurozone rates declined, with the UST 2y point leading the decline by around -7bp. This steering of euro rates by the US has been a recurring theme, and when we plot the rolling correlations between UST and Bund yields, we indeed see a correlation of over 0.5 for both the short end and long end of the curve.

Usually, global asset price correlations are driven by risk premia, but the strong correlation at the shorter end of the curve suggests that the anticipation of rate cuts is a more likely driver. In the case of a US hard landing, such as a severe recession or something "breaking", the ECB would also be inclined to react with short notice, leading to a synchronised policy reaction. This effect is

clearly seen on the chart during the Silicon Valley Bank crisis in March 2023 – when markets were preparing for global insurance cuts. If, on the other hand, a US soft landing is achieved with steadily declining inflation, other central banks should not be pressured into cuts to the same extent, and thus, the correlation should be lower.

The high correlation of short-end yields is more consistent with a hard landing, but this would be inconsistent with the current pricing in of gradual rate cuts. As such, we would expect the tight correlation to weaken going forward, allowing euro markets to increase their focus on the ECB's narrative as opposed to the Fed's. If, for instance, the narrative were to shift to the easing of the Fed again, and correlations indeed weaken going forward, then the 2y UST-Schatz spread could see a fair bit of narrowing.

## Correlations between UST and Bund yields are elevated (3-month rolling)



## Wednesday's events and market view

In the eurozone, we have preliminary consumer confidence figures for February. The momentum is up, and given the gradual recovery pencilled in by our economists, we expect this trend to continue.

From the Fed, we'll receive the FOMC meeting minutes from 31 January. Since then, the US payroll and CPI numbers have brought some new data to the table, so we don't expect the minutes to have much market impact.

In terms of supply, the US will auction \$16 billion of new 20-year bonds, which will be watched. Germany will auction €4.5 billion of 10-year Bunds, and the UK will conduct an auction for £4 billion of 4-year Gilts.

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