Rates Spark: US election risk may limit EUR rates upside

Higher 10Y UST yields are pushing up euro rates. The upcoming US elections add to the upward pressure for UST yields, but the spillover to EUR rates could be capped. A Trump victory would likely trigger risk-off episodes outside the US, which would prevent EUR rates from joining UST yields higher

US election caps potential for higher EUR rates

The 10Y EUR swap rate edged above 2.3% again, thereby joining the push higher with UST yields. Part of the move up may be related to Trump's increased polling performance, but that also begs the question of how far 10Y EUR rates can follow the US. The outcome of a Trump victory could have diverging rate implications. Increasing US tariffs would result in US inflationary pressure, but outside the US, a global risk-off episode would likely push bond yields down.

Should 10Y UST yields rise further on the back of improving US growth expectations, the EUR curve may follow for longer. Yet also here there is a limit to how far euro rates can follow. Eurozone growth numbers have been disappointing of late and this week’s PMIs might add to the fire. Add the looming US election risk and the back-end of the EUR curve may be limited in terms of upside potential. Whilst we think eventually 10Y euro swap rates can make a move higher, this may have to wait till past the elections.

The front end of the EUR curve is less reliant on the US and is currently driven more by central bank guidance. Comments from the Austrian Holzmann at the IMF show that even the fervent hawks within the European Central Bank now see rate cuts “not too far” in the future. This seems to confirm the market's view that the ECB is satisfied with the progress on inflation and is keen to stay ahead of the curve. We are broadly aligned with the market's view on frontloaded consecutive cuts, although we think a probability of 30% for a 50bp cut in December is overstated.

The Bund ASW is at its tightest levels in 20 years

One of the key dynamics taking place over the past few sessions was the acceleration in Bund ASW tightening. 10Y German government bonds have now cheapened more than 10bp versus swaps over the past two weeks, 4bp just over the past two sessions, taking it to a spread level of 14bp below swaps. To find levels where Bunds have traded at levels this cheap more structurally and consistently, one has to go back to around 2003-05.

The structural drivers weighing on Bunds all remain in place – the high issuance volumes on top of the ECB rolling off bonds it had previously bought. Repo markets are showing diminished scarcity premiums. At the same time, the situation in the wider eurozone seems to be consolidating. France has fiscal problems and is trading at elevated spreads still, but prospects for Spain and Italy are actually brightening.

What we do observe at the moment is that bearish sentiment in US rates is spilling over to longer EUR rates. In connection with an ECB that has turned more dovish, this may have encouraged some investors to seize the opportunity of receiving fixed rates – that would provide a technical explanation for the swap outperformance. Rising odds of a Trump win as the elections close in might add another layer. The prospective impact of tariffs and trade on ECB rates might be more clear-cut than on Bunds, where the fiscal dynamics of the export-orientated German economy have to be considered. Unless paired with a clear risk-off scenario and a flight-to-quality, Bunds might not necessarily outperform.

Wednesday's events and market views

The main focus remains on central bank speakers today. There are ECB speakers including President Lagarde, Lane and Knot, but we will also hear from the Bank of England's Breeden and later Governor Bailey. Bowman and Barkin are the Fed speakers to watch before the central bank releases the Beige Book, which likely swayed the decision towards a larger cut the last time around.

Data releases for the day are eurozone consumer confidence and US mortgage applications as well as existing home sales. We will also get a rate decision from the Bank of Canada with expectations geared towards a 50bp cut.

In primary markets, Germany will sell €4bn in 10y Bunds while the UK sells £4bn 2y gilts. The US Treasury will later sell US$13bn in 20y bonds.

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