

Rates Spark: US 2's and 10's touch 3.75%

US market rates continue to pressure core rates lower. US 2's and 10's have settled at 3.75%. Both are some 1.6% through the funds rate. That's quite a discount. The Bund curve is still some 10bp from disinverting and may need more time as the eurozone faces sticky inflation and limited recession risk. Plenty of EUR issuance scheduled Thursday



Rates are eyeing the 3% floor, but prepare for some surprises

The US 2yr and 10yr have coalesced in the 3.75% area, a flat curve. And still looking down. The 5yr is showing the way, in the 3.55% area. And the 30yr is homing in on a re-visit of 4%. The ultimate floor is set by the bottom of the Fed funds strip at around 3%. That's the latest scene.

As the market continues to build into a first Fed rate cutting event there is material interest rate positivity being pre-priced, which can actually present difficulty when the Fed actually does execute its first rate cut. We're getting to the point where the impact reaction of a cut could well be for market rates to ratchet higher for a bit. We still think market rates will be drawn lower as the Fed actually gets into the rate cutting groove. But we're also questioning the degree of manoeuvre for market rates to dip materially lower.

It's also remarkable that the Fed is on the eve of a rate cut against a backdrop where the Dow Jones is just off its all-time high. Yes there have been some wobbles this week in risk space, but not enough for it to look in any way systemic. Something in the bones of the Fed will make it a tad

uncomfortable to deliver a rate cut should we remain in a risk-on mode into the rate cutting event. It's still a couple of weeks away, and we still need to get through Friday's payrolls report, but there is a complex square to circle here for the Fed.

A cut is coming. It will be at least 25bp. Rates are all bulled up ahead of it. Risk could be too. We'd need quite a weak payrolls report to make it 50bp. And even a 25bp cut is enough to validate all of these prior moves, likely pushing for more. But a straight extrapolation is unlikely. Something must give. We think ultimately that longer tenor rates will rise well in excess of where the forwards pitch them. Maybe this week or next. But certainly likely at some point during the few months following the first Fed hike.

US labour market jitters keep bonds supported

Market sentiment improved but remained subdued after yesterday's equity sell-off and bonds continued to make gains throughout the day. Eurozone PMIs and PPI data did little to give a clear direction, but disappointing US JOLTS data dragged global yields lower again. The number of job openings declined to 7673k, well below the consensus expectation of 8100k. With US payrolls data on the agenda for Friday, markets are particularly sensitive to labour market jitters; the JOLTS data triggered a 7bp drop in the 2Y UST yield.

As a result we witnessed the disinversion of the UST 2y10y curve for the first time since 2022 (if we ignore the brief disinversion during last month's turmoil). The 2-year and 10-year UST yields are now both at 3.8% and the curve will likely continue to steepen as we move into Fed cuts. At first the 2Y point will lead the steepening as markets add additional cuts on the back of recession woes. Once the novelty of cuts wears off, it will be the return of the term premium that will drive the steepness of the curve.

The 2y10y Bund curve is now some 10bp away from disinverting and also here the path of least resistance is towards steeper curves. Given that inflation is still stickier and recession risks seemingly limited, the European Central Bank is less pressed for aggressive cuts. For 2024 we project 50bp more ECB cuts, whilst this is 100bp for the US. As lower policy rates are a key driver of steeper curves, euro rates may need more time to follow the US trajectory.

Thursday's events and market views

From the eurozone we have retail sales in the morning, which is expected to have grown by a low 0.2% year-on-year. From the US we have ADP employment data, together with jobless claims. Given the focus on jobs data, these two will be watched. Also US ISM services should draw attention, as this index is still expected to come in above 50, in contrast to the contractionary number of ISM manufacturing yesterday.

Plenty of EUR issuance is scheduled which could put upward pressure on the backend of the curve. Spain has scheduled 3Y, 5Y and 10Y SPGBs together with a 6Y SPGBi, together totaling €6.75bn. From France we have 10Y, 12Y, 16Y and 31Y OATs for a total of €12bn. The UK will auction £4bn of 5Y Gilts.

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