Rates Spark: Weak PMIs help build the case for rate cuts

We continue to view the environment as prone to more risk-off, higher volatility and lower market rates. The macro data is pointing in that direction, as are US politics. Weaker eurozone PMIs have helped markets price in two more ECB rate cuts for 2024, helping the 2s10s steeper by 5bp. The question for the Fed is if it's a 25bp or 50bp cut for September

US 5yr auction was not great, but underlying impulses still point to downward pressure on market rates

Yesterday's US 5yr auction was not as dramatically successful as the previous day's 2yr auction. The 5yr tailed by about a basis point, while the 2yr came through by a couple of basis points (negative tail). The 5yr area is a rich part of the curve, as it's a give-up in yield versus the 2yr and 10yr interpolated combination, by some 19bp. We should also not forget the huge sizes the market is being asked to take down. Both were in the region of US$70bn, and the 5yr is also a higher duration product (versus the 2yr). It's providing the market an opportunity to do some retracing on a day when the pressure has been for lower yields. It's been a day of risk-off, higher volatility and widening pressure on credit spreads. We think this continues, as it feels like the path of least resistance as we continue to digest the US political backdrop, interlaced by predominately weak or weakening macro data.

Earlier yesterday, the manufacturing PMI slipped back below 50 (indicating contraction) and new home sales weakened, although the services PMI did manage to edge higher and is indicating a mild expansion. The 7yr auction is up next today.

The spread from the 2yr yield to the effective funds rate has hit a new low at -93bp as we build up to a first rate cut in the cycle ahead. The magic level is -100bp, as traditionally once we hit that level the market is fully primed for a first cut and the beginning of a sequence of cuts. The 2yr yield is now in the 4.4% area, and tracking towards 4% as a call in the coming couple of months. Getting to 4% can be fast. The only reason for a longer-term call is the Federal Reserve not being expected to cut at the upcoming meeting and looking more inclined to cut at the 18 September meeting. It is possible, however, for the Fed to give the move a push should it use the July meeting as an opportunity to nod towards the likelihood of a cut at the September meeting. The 10yr yield is also tracking towards 4%. Now in the 4.2% area, the inversion of the curve is under 20bp. As the 2yr yield and the 10yr yield head towards 4%, the curve completely flattens out; and from there we build an upward-sloping curve as the Fed continues along the rate-cutting process over subsequent months.

Weak eurozone PMIs resonate with ECB growth concerns

Euro rates steepened considerably on the back of disappointing PMI data from both Europe and the US. The 2s10s swap curve steepened by some 5bp, led by a 4bp lower 2Y rate. A similar move was seen further on the back-end with the 10s30s growing steeper by a couple of basis points. The initial dip of the 2Y rate was triggered by the German manufacturing PMI coming in at 42.6 versus an expectation of 44.0, helping the composite fall below 50 again. Later, the eurozone composite PMI fell to 50.1, just an inch away from returning below 50. A €5bn 10Y Bund auction helped yields stay more anchored further out on the curve.

The pricing for European Central Bank cuts in 2024 just hit 50bp again, which would imply two more full cuts. The pricing of cuts has so far found resistance from mixed economic growth data – but if the picture of broader economic weakness starts dominating, we could see the steepening of curves accelerate and join the recent US dynamics. In its last meeting, the ECB put more emphasis on near-term growth concerns than in previous meetings and these PMIs resonate with that narrative.

We expect some pushback to price in more cuts for now, but another move lower for US yields will be hard to resist for EUR rates. Once growth concerns start materialising in the hard data, markets can easily be convinced that even three ECB cuts are a possibility, especially if the Fed is moving in that direction. Recent ECB comments that wage growth is projected to slow down significantly in 2025 if the latest numbers are extrapolated have helped further build the case for cuts.

Today's events and market view

From the US, we have the advanced second-quarter GDP reading, which consensus sees coming in at 2.0%, below our own projection of 2.5%. Furthermore, the PCE core deflator for the second quarter is projected at 2.7%, and durable goods orders in June are expected to grow by 0.3% versus 0.1% for the previous month. In the eurozone, we have German

Ifo survey outcomes and M3 money supply. In terms of speakers, the ECB's Christine Lagarde Lagarde and Joachim Nagel are scheduled.

Italy will auction a 2Y BTP, a 5Y BTPei and a 17Y BTPei for a total of €5.75bn.

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