

## Rates Spark: Yields back up as sentiment improves

A stumble in risk did seem increasingly probable last week, but Monday always seemed like an overreaction. Risk sentiment is now making a recovery, pushing equities and bond yields higher. Comforting ECB words and stabilising JGB yields helped reduce global volatility. US jobless claims will be watched closely for further signs of job market weakness



### A return to a more measured reaction to what in the end was not a whole lot

The 2-year yield is in effect an average for the funds rate over the coming two years, during which time the Federal Reserve is expected to have chopped the funds rate quite considerably. Assuming we continue on the build for a rate cut from the September meeting, and indeed for a sequence of cuts thereafter, the 2/10-year curve should swing into a positive slope. The risk-off tone on Monday accelerated some of that process – but history shows that material steepening of the curve is typically reserved for the period when the Fed is actually cutting rates, and that's all ahead of us.

Ultimately, expect to see the 2/10-year curve heading to at least 100bp, and at some point that

should limit the capacity for the 10-year yield to fall. For example, should the Fed cut to 3.5%, that would place fair value on the 10-year yield at 4.5% (or higher). The Fed would have to cut to 3% to give a 4% 10-year yield a chance to be viewed as fair value. In consequence, any material break under 4% for the 10-year yield should be viewed as an overshoot to the downside that will be unwound, and we suspect quite quickly.

At some point, likely by the end of 2024, the novelty of rate cuts will wear off, even as the Fed continues to cut, and attention at some point must shift to worries about financing the fiscal deficit.

The recent rally we saw to the 3.8% area for the 10-year yield is reminiscent of the rally to similar levels seen at the beginning of the year on quite an extreme rate cut expectation at the time. This time around there's been a wobble on equity markets, but not anything catastrophic. Moreover, the system is functioning fine. Talk of an inter-meeting cut neither made nor makes sense against that backdrop.

## Calmness returning to markets

Risk sentiment recovered further, helping equity markets and bond yields back up. The global unrest over the JPY carry unwind seems to be settling and Japanese Government Bond yields traded mostly flat on the day. From the European Central Bank, we had comforting words from Governing Council member Olli Rehn, who voiced that he sees the recent volatility as an overreaction and still deems the US economy relatively strong. So far, we have had little data of interest for the US and eurozone, and today's US jobless claims will therefore be focused on gauging whether a sigh of relief is justified.

As a result of calming sentiment, the Bund curve bear steepened quite sharply and there is potential for more of this if sentiment improves further. The 10-year yield moved some 6bp higher on the day whilst the front end stayed relatively anchored. Forwards pricing suggests a terminal ECB policy rate of around 2.3% in five years, around 20bp lower than a month ago. We still see a soft landing as a more likely scenario and the pricing of the terminal rate could return to previous levels, thereby steepening the curve further from the back end.

### Today's events and market view

Besides US jobless claims no notable data releases are scheduled. In terms of issuance, the US has scheduled a new 30Y Bond for \$25bn.

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