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Rates: The pull of Treasuries, and 4% inflation

There's a lot going on out there that can drive market rates. We home in on two factors. One is ongoing macro resilience in the US. The other is question marks around inflation at 4% in both the US and the eurozone, and its potential stickiness. There is enough there to tempt market rates higher still, at least until something actually breaks

Traders have the US 10-year at 5% on their minds

In the US, the lure of 5% for 10-year Treasuries remains convincing

The US 10-year has managed to touch 4.8%, a new cycle high. That's now split down the middle between inflation expectations and the real rate, both at about 2.35%. Inflation expectations, in fact, peaked out at a little over 3% in April 2022, about a year and a half ago. That peak in inflation expectations chimed with the start of the Federal Reserve's rate hiking process. Things are in a better place now.

The offsetting rise has been in real rates. April 2022 saw the 10-year real rate flip from deep negative territory to moderately positive. This was an important breakout moment, as negative real rates had suggested underlying macro angst, even as inflation expectations had clearly broken higher. Now the 10-year real rate is knocking on the door of 2.5%. It will likely get there, as the 10-year nominal yield approaches 5%. And that remains our baseline view.

The drivers here centre on macro resilience. But this is interesting, as the US economy is hardly roaring ahead right now. It's just chugging along, refusing to go into a recession, or even a growth recession (sub-trend growth). For example, the replacement rate in the labour market is around 150k, and the payroll reports have been hovering just above this. There is a vulnerability to that, but it also just keeps trucking along. Nothing stellar. But the persistence of it is what's got the market's attention.

This has put a floor under US market rates at 4.25% (the funds rate bottom currently discounted). A 75bp term premium on top of that gels perfectly with the typical evolution of a 75bp curve at the bottom of the rates cycle historically. That's the rationale for a 5% outcome for the 10-year. We head there until or unless something finally breaks down.

In the eurozone, there is also 4% inflation to tackle - mapping negative real yields

Eurozone market rates are being dragged higher by US Treasury yields. This is not unusual. Typically, the direction for market rates comes from Treasuries. It's not that long since the 5-year ESTR to SOFR spread narrowed to around 40bp (in fact briefly slightly below). That was in May this year. Now that spread is at 125bp. The journey from 40bp to 125bp was led by US market rates deciding to go ahead and rise. The Silicon Valley Bank demise occurred in March, and the economy had taken that and a few other hits, but was chugging along again regardless. Europe had seen the demise of Credit Swisse, and war angst lingered. Activity was, and has been, patchy. But the US at least continued to motor along.

But there is another important dimension to this. Even though inflation has fallen dramatically through 2023, in both the eurozone and the US, it could be argued that that was the easy lift (from double-digits to 4%). The heavy lift is getting that down to 2%. While the European Central Bank clearly takes that responsibility seriously, it does not mean it will happen, at least not easily. This is the other theme the market has latched on to. It's one that makes it tough to deliver meaningful or timely rate cuts. So even though eurozone market rates are indeed being dragged higher by US ones, there is also an ongoing realisation that inflation at 4% remains well above the 10-year ESTR rate at 3.25%.

Bottom line, the US 10-year has got 5% on its mind. The US 10-year real rate is homing in on 2.5% already. The 10-year Bund yield is knocking on the door of 3%, and can stretch towards 3.25%. The 10-year Euribor rate at around 3.5% still maps a negative real yield when measured against the latest inflation print. Enough there for market rates to continue to test higher.

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