

Rates: Upside pressures aren't going away any time soon

We identify a rising tilt to market rates in the coming months, and in particular for longer tenor rates. Shorter tenor rates remain contained by rate-cutting hopes. Consequently, curves should steepen, led by the US and mirrored by eurozone rates



The Federal Reserve is waiting in the wings to cut rates

There are clear macro risks, but there are also fiscal and tariff issues that can push longer tenor rates higher

It's never easy to predict what's coming. But especially now. Not only is there policy uncertainty to contend with, but the policies themselves are hugely impactful. Two of the biggest ones have come in the guise of 'Liberation Day' and the 'Big Beautiful Bill'. The former has left us with an average tariff rate of 13%, and rising, as letters get sent to those on the naughty list, while the latter brings a clear tax-cutting tint to fiscal policy, and leaves the US with a large ongoing structural fiscal deficit, with supply pressure to boot. Tariff revenues help finance the tax cuts, but likely push US inflation up towards 4% in the coming months.

The good news is the Federal Reserve is waiting in the wings to cut rates. The current funds rate is some 100bp above neutrality, thus sustaining a moderately tight policy stance. Fed Chair Jerome

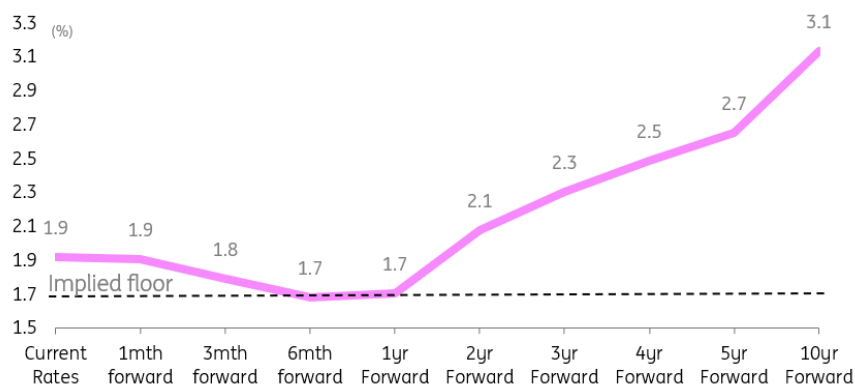
Powell has made it reasonably clear that an easing in policy is in the works, with only the tariff impact on inflation in the coming months the biggest element of uncertainty to be overcome. Once that clears, the odds firmly favour the Fed cutting rates.

Interestingly, the market discount has the funds rate bottoming in the 3% to 3.25% range, and then the forwards have the implied funds rate rising from 2027 onwards. This is, in fact, quite a good outcome, as it effectively discounts something of a soft landing, and no need for the funds rate to go deep below neutrality. If this is the realised outcome, we'd certainly take it. In our view, we will likely see sub-trend growth in 2025 and 2026, which means growth of below 2%, likely with a 1% handle. Not great, but also not a deep or damaging recession.

There are some risks to this outcome. The first comes from the elevated fiscal deficit. While Treasury Secretary Scott Bessent has no immediate plans to push issuance pressure out to longer tenors, that does not mean that issuance pressure goes away. To begin with, it is heavily bills-focused, and we'll feel this now that the debt ceiling has been raised (done in conjunction with the passing of the Big Beautiful Bill). The US Treasury will issue big, as it needs to replenish cash balances that have been spent down to stay within the debt ceiling to date. This will also act to take reserves out of the system, tightening conditions generally. This, alongside the tariff-induced spike in inflation, could be a problem for long rates.

The implied market discount for the ECB's depo rate has longer-term upside written all over it

The graph shows the market forwards for 1mth ESTR (as a proxy for the ECB's deposit rate)



Source: Macrobond, ING estimates

Eurozone upside pressure for long rates in 2026, but pull risks from the US loom in 3Q

In the eurozone, plans for more spending (on defence, among other things, and in particular Germany) won't push average fiscal deficits to US-style extremes, but will add to issuance pressures in a meaningful way, albeit likely more from 2026 onwards. This has implications for how we see longer-tenor market rates evolve in 2025/26. The bigger independent upside pressure for the 10yr Bund yield is in 2026 as the European Central Bank is done with cuts, and the aforementioned fiscal pressure builds. That pressures the 10yr yield towards 3%. And nearer term, should the US 10yr get to 4.75% in the third quarter (our view), there will be a nearer-term drag higher from that for eurozone yields as well.

Note also the market profile for 1mth Ester as shown in the graph above. While forwards are terrible forecasters of the future, they still provide a guide as to underlying market thinking, as priced into current rates right along the curve.

The bottom line outcome here is one of some material wobbles in the US economy, alongside a rise in inflation (even if temporary). The Fed should get the funds rate down to neutrality within the next 12 months, but we identify pressures that can pull longer tenor rates higher in the coming months.

Tariff-impacted US inflation at 4% can't be ignored, nor can fiscal pressures. There is some 25-50bp of upside here as a risk factor for the 10yr Treasury yield, even if temporary.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

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