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Rates: Why EU angst is prompting talk of topping out

European politics, namely Brexit and the dispute between Italy and the EU, is keeping a lid on US 10-year rates. Though we may not have seen market rates peak just yet, the bulk of rises in long-term yields are likely behind us

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Peak US 10-year rates?

We identify some diverging issues in play when it comes to core rates. First, our model for US 10-year rates continues to pitch fair value at between 3.4% and 3.9%. But second, some technical indicators are describing the 3.25% level hit by the US 10-year as the structural peak. In addition, the richening of the 5-year area of the curve that started about three weeks ago has historically been an end-of-rates-hike-cycle lead indicator.

The Fed isn't done hiking yet. Are they seeing something we're not?

However, there are two outstanding issues that warrant caution. First the Fed is not done yet. As long as the Fed is hiking, there will be the residual fear that the central bank is seeing something that we do not. Second, our model for the 10-year pitches fair value at 3.4% to 3.9% but we have not even entered the bottom end of that range. We're not far off it, but still not there yet. Bottom line, contemporaneous macro factors remain robust.

That 3.4% to 3.9% range is based off an assumption that the neutral policy rate in the US is between 2% and 2.5%. We add to that our calculation of how far market rates should be above normal right now based on how far the average current data readings deviate from normality. That is currently running at about 140 basis points. Hence the aforementioned range. For this to change, activity data needs to slow, considerably.

Reasons for low European rates is also containing those in the US

That said, we doubt that the top end of that range can be seriously entertained given the elevated risks in emerging markets. Also there is a massive focus on Europe, with Brexit on the horizon, and a focus on Italy's spat with the EU. This is fine provided it remains a spat, but very sinister if it extends to the limits (Quitaly). These factors are keeping core European rates down, and by extension containing US rates too.

EU angst elevated as row with Italy set to persist into 2019

And we come full circle here as this also filters into ECB policy. A muted uptick in rates is on the horizon. Domestic stresses are one factor. Another is the likelihood that the US is slowing (by 2020) just as the ECB could have had an ambition to hike. We still view 1% as the ultimate target, but that is now some way off. The German 10-year yield back at 36 basis points is behaving as a deutschemark proxy again, in part discounting a Quitaly.

It looks like the row between the EU and Italy persists into 2019. An excessive deficit procedure is a risk, but this does not have much teeth. No country has even been fined, even though there have been nearly 40 such procedures in the past, and Hungary was on such a procedure for nine years (came out in 2011). There is a vacuum here within which the populist government can operate, maintaining elevated angst.

Bulk of rises in long-end rates can be pretty much ruled out - from a US perspective

For the US 10-year to break back above 3.25%, a significant calming of jitters in Europe is needed, and every negative twist in the Brexit mess adds oxygen to the Italian populist government finger-pointing at Europe. The same goes for ambitions to get the German 10-year yield back into the 0.5% to 0.75% range. That needs a political calming. The 36 basis points is not reflective of macroeconomics but of an EU/euro existential discussion.

We may not have seen the peak in market rates yet but the bulk of the rises in long-end rates are likely behind us from a US perspective. The same goes for the Fed; a few more hikes to deliver, but the peak is much closer now. Meanwhile, the ECB is staring at the headlights of a car being driven by EU antagonists, while Angela Merkel fades quietly into the background. Add to that wobbles in global risk assets, and the recipe is there for core rates containment at a minimum, at least for as long as this combination persists.

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