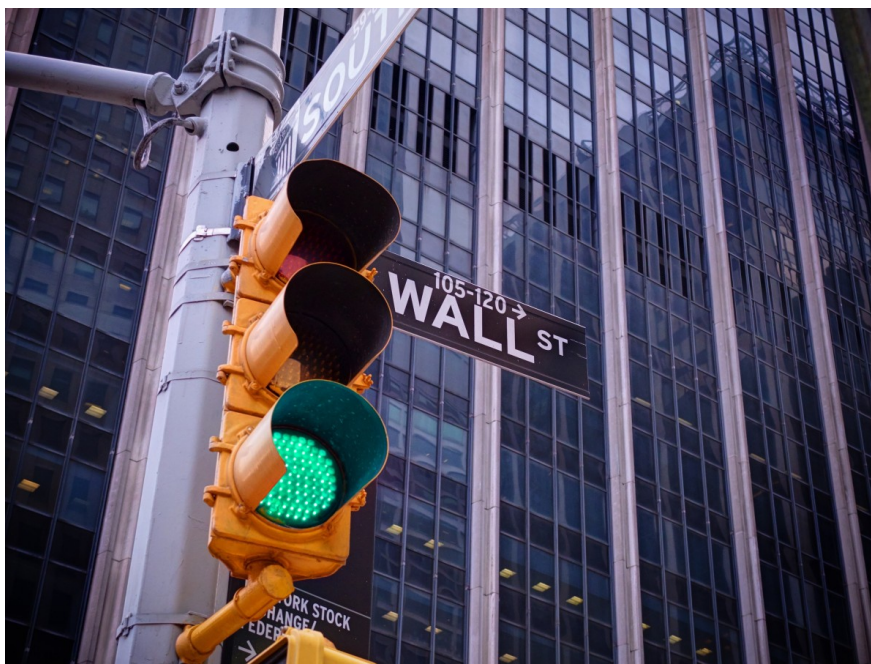


Rates: Why market rates remain under upward pressure

Shouldn't market rates be falling by now? No, not yet and we'll tell you why they remain under upward pressure. Most of it reflects US resilience; that's reflected in the market discount to where rates get cut in the future, and that discount remains relatively tame. In fact, delivery of that discount justifies 10yr rates being higher versus now



The big driver of widening American and European spreads is US resilience

The rise in US market rates has been pulling eurozone ones higher

One of the most persistent trends in the past number of months has been the re-widening of spreads between US and eurozone market rates. We tend to look at the 10yr differential here, as it's well clear of a direct central bank influence. The Treasury – (German) Bund spread, the classic reference, is now back out to 165bp. It was below 100bp in April. A better reference is the Secured Overnight Financing Rate (SOFR) – (eurozone) ESTR spread, and that 10yr spread is now out to 100bp. It was around 25bp in April. The big driver of this has been US macro resilience, so much so that the upward pressure on US market rates has been strong enough to pull eurozone market

rates up with them. So what now?

A limited rate cut discount limits the ability for eurozone market rates to fall

On the eurozone side, it seems that the European Central Bank is intent on remaining in a hiking mode even as activity gets hurt more, all in an effort to kill inflation. And European inflation has shown itself to be that bit stickier than its US counterpart. As a stand-alone impact, higher ECB rates heighten carry costs and place natural upward pressure on rates right out the curve. But there are also forces there that can cause longer-dated market rates to fall, namely the end of the rate hiking cycle, as longer rates would then begin to focus on where the ECB will be 18 months from now. That's far enough forward to have a reasonable feel. It is currently discounted at cumulative cuts of around 100bp. That's not a lot and provides little room for lower long tenor rates.

Delivery of the US rate cut discount rationalises higher longer tenor rates

In the US, there is a similar narrative in play. The size of discounted rate cuts is more - closer to 125bp - so not dramatically more. Again, that allows very little room for longer tenor rates to fall. Currently, 1yr SOFR is 5.5%, and 10yr SOFR is just under 4%, for example. So if the 1yr SOFR rate were to fall by 125bp, it would bring it to 4.25%, and that's still higher than the current 10yr SOFR rate of just under 4%.

And remember, when we get to the end of the next rate-cutting cycle, we should have an upward-sloping curve, typically 50bp at minimum. Based on that, longer tenor rates need to be higher than they currently are, both in the US and in the eurozone. And, by the way, in the US, there is an elevated supply projection to get worried about too. It's one that rationalises higher rates and steeper curves with all other things being equal.

We continue to identify net upwards pressure on market rates

That all being said, when - or if - something really breaks in the US, there could be a radical re-pricing rate of cuts to come, pushing the discount towards much lower levels. That would be a game-changer, allowing longer tenor rates some run-way to move lower. But until - or if - that happens, the path of least resistance is for longer tenor (say the 10yr) rates to remain under upward pressure in the US and the eurozone and for curves to remain under dis-inversion (steepening) pressure.

So, to sum all that up, we remain bearish on bonds and anticipate further upward pressure on market rates from a tactical view.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

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