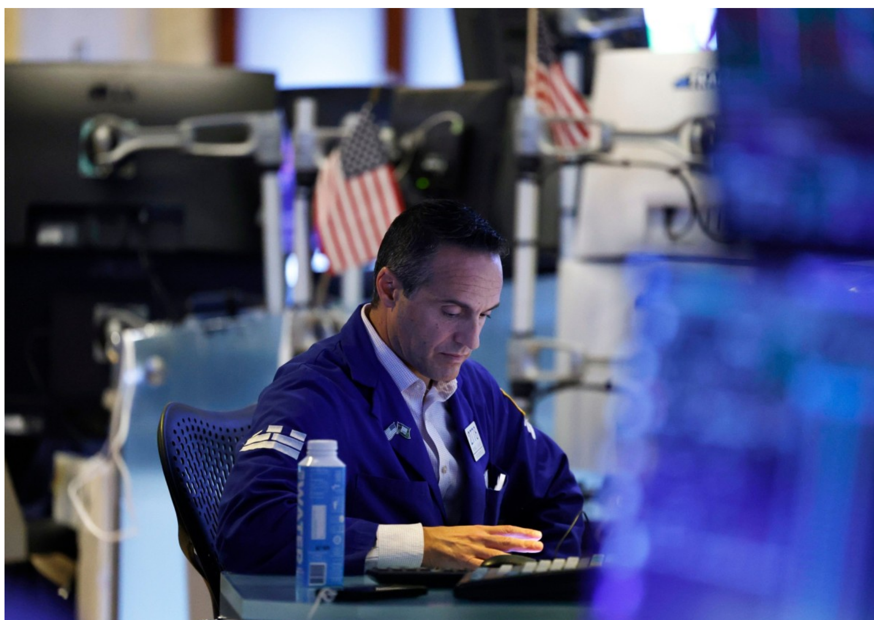
Rates: Yields want to test lower first – let them overshoot

Are there reasons for longer-dated yields to fall? For sure, there are - both in the US and the eurozone. But we view such moves as more tactical than structural. Our preference further down the line is for longer-tenor yields to end up higher than today, while the front end is broadly anchored. Hence, a steeper curve is anticipated, too



The US government shutdown is depriving traders of crucial data

The US 10yr could soon break below 4%

The US 10yr could well break below 4%, but in the medium term, we're targeting 4.25% - 4.5%. Right now, though, we're flying blind in the US as we continue to navigate the government shutdown. As a stand-alone element, it's bond positive, on the theory that a smaller pay packet for those affected means less spending. There is even an element of fear injected, as some will worry that their particular job could be gone for good (at least that's the implied threat). This is not determinative of labour market fortunes, but with a negative ADP report continuing to reverberate in the background, there is an increasingly dominant degree of apprehension about the economy.

Given that snapshot, why are long tenor yields not falling? For a couple of reasons. First, a tariff-impacted ratchet higher in inflation in the coming months remains a risk (we think inflation heads

for the 3.5% area). Second, the 10yr SOFR rate is at 3.6%. That's low versus a forward bottoming for the funds rate in the 3% area. The 10yr could, of course, compress lower, but would then be pressured to revert back up again. A 75bp curve to the funds rate should not be too much to ask for 10yr SOFR, and could be justified up at 4% given the prognosis for inflation in the coming months.

Overall, that leaves us with a justification for the 10yr Treasury yield to remain above 4%, and indeed to edge in the direction of 4.25% to 4.5% in due course. If we were to break below 4% on very poor data, such a move is justifiable given the fog out there. But it is more likely to be temporary than permanent.

It remains complicated in the eurozone

The 10yr Bund could break below 2.5%, but we're still eyeing the 3% area as an ultimate target. The straightforward stuff that argues for upside pressure on longer-dated yields centres on defence spending ambitions and associated upward pressure on fiscal deficits and supply. A more technical angle comes from the likes of Dutch pension fund reform, where the move from the regulatory straight-jacket of defined benefit to defined contribution means a forward unwinding of a large rump of 30yr to 60yr fixed rate receivers in the years ahead. There is also a bit of inflation in the eurozone. Not worrying, but enough to keep long rates on edge.

Then again, a big negative industrial production number out of Germany this week reminds us that the economic dynamo of the region remains in a state of stress. Survey evidence has seen some hints of a decent German recovery theme. But it's not enough to get overly excited by. And then there's France, where economic sentiment is going the way of Germany, with political malaise to boot. Most of the rest of the eurozone is in better shape, which helps contain spreads and wider macro risks. But there is still a macro tilt here that can absolutely worry the bond bears.

Like for US Treasuries, there is ammunition here for a break lower in the 10yr yield. But it would require quite some negativity to see it go below 2.5% for the 10yr Bund. Our baseline view remains glass half full on the economy, with the 3% area for the 10yr Bund still the medium-term target. It may take quite some months to get there, but that's the distilled view. All against a front end that's anchored by the 2% European Central Bank depo rate.

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