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RATES

Rates Spark: Growth disappointments would still build a bullish case

With oil approaching $100 again, euro rates are following higher. But the upward pressure is not just about energy costs; the growth picture is important too. That also means disappointing economic performance can quickly trigger a material bullish move in rates

Oil prices are pushing rates up again

Energy and inflation dynamics still driving euro rates

While US markets closed for the Labor Day holiday on Monday, pressure on EUR rates continued to build at the short end as geopolitical headlines pushed up oil prices. The 2y Bund yield is back to 3%, nearing the peaks of last week.

Energy prices remain an area where EUR rates are more sensitive than their US counterparts. But it is worth remembering that the impact is not distributed evenly across the curve.

While 2y Bund yields have risen 90bp versus levels observed at the start of the year, 10y yields have risen around 55bp. More importantly, only 30bp is due to actual inflation expectations rising (measured by inflation swaps). In terms of contributions, that is still more than in the US, underscoring the exposed position of the eurozone.

The flipside is that, even without the rise in inflation expectations, the 10-year Bund yield would still be above 3.1%. The remaining increase in real yields reflects not only more resilient domestic growth expectations, but also a higher global term premium linked to rising actual and expected debt levels. As a result, a significant decline in long-end yields hinges on more than just easing geopolitics.

Disappointing growth can still easily trigger lower rates

Imagining a scenario whereby EUR rates reprice significantly lower is not that difficult. If the improving growth outlook were to disappoint, the ECB's reaction function could change quickly. Not only would near-term policy rate expectations see a dovish repricing, but the neutral rate would likely be pulled lower as well.

Arguably a one-off inflation shock from oil should not have a lasting impact on the neutral rate. The EUR curve currently positions for an ECB terminal rate of around 3%, well above the 2% that was targeted for much of 2025. If the eurozone economy does not deliver on the heightened expectations, a repricing of the ECB landing zone could easily shave off 50-100bp from longer rates. Not our base case, but something to keep in mind.

Tuesday's events and market views

A light day in terms of data. From the US, we have the NFIB small business survey. Consensus sees a slight deterioration in the sentiment index. More interesting could be Bank of England speakers in the UK Parliament. The central bank's pace of quantitative tightening will be reviewed in September, so any hints of a slower pace will be watched by markets.

Austria will auction €1.4bn in total across a 4y RAGB and a 9y RAGB. Germany will offer €1.5bn of Green Bunds across 6y and 15y maturities. Spain is set to bring a €4bn 20y SPGB Green via syndication.

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