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Oil, Rates and Central Banks: Markets Await the Next Catalyst

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Oil prices remain the main driver of rates, and the correlation has been quite clear over the last few weeks. However, uncertainty around the next developments remains high. If the latest escalation is followed by a resumption of talks between Iran and the US, together with the acceptance of some form of tariff arrangement to reopen oil flows, lower oil prices would be supportive for rates.

On the macroeconomic front, the US economy continues to be resilient, while the latest euro area data remain reassuring for second-quarter growth. The latest GDP data confirm that the euro area recorded solid growth in the second quarter and recent PMI releases are confirming that the eurozone economy is bottoming out, although it remains to be seen whether this trend will be confirmed after the summer. Inflation data have generally surprised to the upside over the past month, but erratic oil price movements continue to create uncertainty about the next inflation prints. In Europe, we may have already seen the peak in CPI, while it is more difficult to make the same call in the US given different economic dynamics and the impact of AI-related investment.

Both the ECB and the Fed are in a wait-and-see mode, but with different attitudes. The ECB remains focused on second-round effects and is highly dependent on energy price developments. Lagarde noted that the latest geopolitical escalation has worsened the balance of risks, with some Governing Council members even discussing the possibility of a hike. A 25 bps hike in September is quite likely, to see if another one will follow. The Fed, meanwhile, has become more difficult to interpret, following Warsh's new communication style.

The Fed could still hike rates in the coming months, but Warsh's references to markets pricing higher rates suggest a reluctance to move aggressively and may instead signal a preference for a steeper yield curve. At the same time, the risk of the Fed falling behind the curve is rising. The US 30-year yields have moved to around 5.2%, with a strong steepening of the curve, and this trend could continue, affecting euro rates as well. US 10-year real rates are close to the highs reached three years ago, and if the upward move continues, the impact on both the economy and financial markets will increasingly be felt. At this point, the September meeting will be a live one, with a high probability of a hike.

The US 10-year Treasury yields, at around 4.7%, are trading in the upper part of the range seen over recent months, and the risk of further increases is not negligible. Higher levels would likely be driven by breakeven inflation rates following the recent rise in real yields. Bund yields could continue to trade around the 2.9% - 3.2% area, with any move higher potentially offering an opportunity to adopt a more constructive duration stance.

Italian BTPs are suffering somewhat from the recent risk-off environment, but the economic backdrop remains solid enough to support tighter spreads, provided political noise does not increase over the coming months. The situation is different in France, where political risk is likely to increase after the summer as the presidential race will begin to take shape and fiscal risks remain an ongoing concern.

Portfolio positioning is managed around neutrality, with a constructive bias for euro rates with bund yields over 3.1% and stand ready to increase exposure should yields move higher. Different story for US rates, as we have a neutral stance with a defensive bias, as persistent inflation risks could prompt the Fed to resume tightening. Recent curve steepening dynamics may continue in the coming weeks, and our positioning is aligned with this expectation.