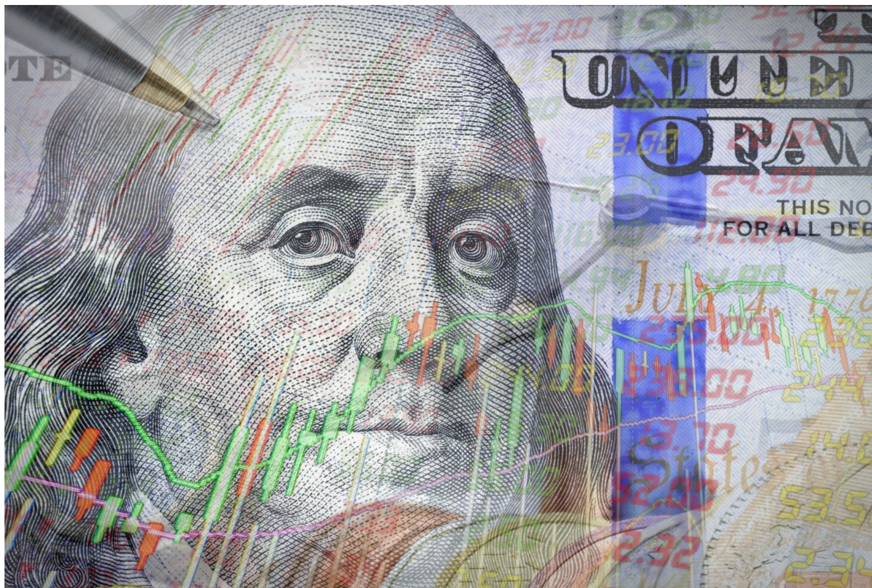
Rates Spark: Back end vulnerabilities

While there's been a material rate-cut-driven fall in US market rates, there are some risks ahead for longer tenor rates coming from inflation and the fiscal deficit. In the UK, a potential slowdown of the Bank of England's balance sheet could help keep longer-dated Gilt yields down, but the global environment is not conducive to this



US rates are taking the lead as EUR rates followed the bullish mood in US Treasuries

The front end remains solid, the back end less so as the tax bill gets passed ahead

The market discount has the funds rate bottoming in the 3% to 3.25% range, and then the forwards have the implied funds rate rising from 2027 onwards. It discounts something of a soft landing, and no need for the funds rate to go deep below neutrality. The rate-cutting expectation is being bullied by President Trump and his administration. Apart from it being an annoying nagging voice in Chair Powell's ear, the wires are making this out to be a bigger deal than it actually is. It still points to some steepening pressure from the front end ahead.

There are some risks. The first comes from the elevated fiscal deficit. While Treasury Secretary Bessent has no immediate plans to push issuance pressure out to longer tenors, that does not mean that issuance pressure goes away. To begin with, it is heavily bills focused, and we'll feel this once the debt ceiling is raised in conjunction with the passing of the Big Beautiful Bill. The US

Treasury will issue big, as they need to replenish cash balances that have been spent down in an effort to stay within the debt ceiling to date. This will also act to take reserves out of the system, tightening conditions generally. This, alongside the tariff-induced spike in inflation could well be a problem for long rates.

Longer tenor rates can ease down as a theme through 2026, but we identify pressure that can hurt long tenor rates in the coming months. Inflation at 4% can't really be ignored, when we consider that 10yr SOFR is now at 3.7%. There is some 50bp of upside here as a risk factor, even if temporary. That's where the steepening can come from the back end.

A slower pace of QT can help mitigate upward pressure on 30Y gilts

Comments from Governor Bailey of the Bank of England (BoE) suggest a potential slowing of the pace of quantitative tightening (QT) as longer-dated Gilt yields rose significantly. Starting in 2023, the BoE has unwound its balance sheet at a relatively faster pace than its peers. Over this same period, fiscal concerns from the UK have contributed to higher rates, especially at the long end of the curve. The 30Y Gilt yield at 5.2% is at its highest level since the 1990s. Markets are welcoming the idea of a slower pace of QT, but so far 5bp lower 30Y yields is just a small move in the bigger picture.

The slowing of QT would be purely to reduce the interest rate risk in the market, as liquidity conditions seem to hold well. Both the short- and long-term repo facilities have started adding reserves to the system, thereby mitigating the risk of a liquidity crunch. As such, reducing the unwind of the bond portfolio would be aimed more at containing the term premium. Having said that, we think the upward pressure on the back end of the Gilt curve can remain for now due to global factors. Also in the US, Japan and eurozone we see the risk of higher 30Y rates on the back of fiscal worries.

Wednesday's events and market views

The eurozone's unemployment rate is set to remain stable at 6.2%. From the US we have ADP employment numbers, as a preview for Thursday's payroll numbers. Besides data we'll be listening to the various central bank speakers at the Sintra conference in Portugal.

In terms of supply we have a UK 3Y Gilt auction for £5bn and from Germany a €6bn auction of 10Y bunds.

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