

Rates Spark: Bank of England cut likely

Eurozone inflation remains stubborn and recent declines in Bund yields seem overly pessimistic about growth. We expect the Bank of England to cut for the first time today, while markets only partially price in a 25bp cut. In the US, there was enough from the FOMC to sustain the expectation for a cut from the 18 September meeting



Post FOMC: The 2yr and 10yr are still heading to 4% in anticipation of a first cut by September

The edge higher in yields post the FOMC statement is understandable. Into the meeting, the 10-year and 2-year yields had driven lower in a significant fashion in previous weeks, practically to the point where a material dovish pivot was required to help ratify recent moves. Neither the FOMC statement nor Chair Jerome Powell have said anything to stand in the way of a September cut. In fact, they've moved further in that direction. But there are enough ifs and buts in the running commentary, which is probably smart; as some taming in the rate cut enthusiasm was warranted. There is still a sense that the Federal Reserve is winding up slowly to cut, and the follow-through reaction should eventually see yields resume their falls, but likely at a more subdued rate.

The spread from the 2-year yield to the effective funds rate been hitting new lows in the -95bp area as we build to a first rate cut in the cycle ahead. The magic level is -100bp, as traditionally

once we hit that level the market is fully primed for a first cut and the beginning of a sequence of cuts. The 2-year yield is now in the 4.35% area, and tracking towards 4% as a call in the coming couple of months. The reason for a longer-term call is that the Fed was never expected to cut at this meeting, and seems more minded to cut at the 18 September meeting. The 10-year yield is also tracking towards 4%. Now in the 4.1% area, the inversion of the curve is under 20bp. As the 2-year yield and the 10-year yield head towards 4%, the curve completely flattens out in the next couple of months.

In terms of liquidity conditions, the Fed has already pre-positioned with a prior tapering of the quantitative tightening process. This continues in the background, and has not yet hit levels where particular concern for liquidity circumstances are warranted. That said, we find it noteworthy that balances going back to the Federal Reserve on the reverse repo facility have been sticky at just under the US\$400bn area, a material change from the big falls seen through 2023 and into early 2024. We view this balance as a manifestation of excess liquidity, and ideally should shrink in line with the quantitative tightening process. If it doesn't, then bank reserves, now at US\$3.3tr will be pressured to fall. Should they get under US\$3tr, then we've have a contradictory material tightening in liquidity conditions, just as the Fed starts to ease interest rate policy.

Euro rates seem overly pessimistic about macro backdrop

Eurozone CPI remains stubborn, with the core component rising from 2.8% to 2.9% year-on-year in July. But Bund yields fell again by a couple of basis points, bringing the 10-year yield to just above 2.3%. We tend to disagree with the extent of the fall in 10-year euro rates the past few days based on this week's macro data. Yes, Germany's economy is a concern, but signs of a severe economic downturn are not yet materialising.

Perhaps the gradual turning of global risk sentiment can be blamed for the decline in Bund yields. Unrest in the Middle East continues to lurk and expectations from the US earnings seasons risk being excessively exuberant. The VIX is trading relatively elevated compared to most of this year and the Euro Stoxx has trended downwards the past months.

At the same time, we have to admit that the drift of UST yields lower is hard to resist for Bunds. On Friday we have US payrolls data coming in which could prove more impactful than the eurozone's macro readings this week. We see US rates going lower as the economy keeps cooling and Bund yields are therefore unlikely to make a move back up before those job numbers are in.

Bank of England ready to cut, but delaying has its advantages

We think [the Bank of England will cut today](#), but markets are not fully convinced. Around 60% is priced in, so a 25bp cut will find its way through the yield curve. The 10-year Gilt yield could fall 10bp lower, helping tighten the spread with the 10-year Bund. If the BoE refrains from a cut this time, then September will be the month to watch. The September meeting is scheduled just a day after the FOMC meeting and could therefore make a safer choice for a cut.

Today's events and market views

Other data includes Spain and Italy's manufacturing PMIs in the morning. Both are expected to nudge higher but the Italian PMI will most likely remain well below 50 at 45.7 currently. Later we will get the unemployment rate number from the eurozone for June. At 6.8%, the rate is at its lowest since 2009, but should be bottoming out.

Spain will auction 3Y, 10Y and 20Y SPGBs, together with a 3Y SPGBei, totalling €7bn. From France we have 10Y, 14Y, 19Y and 31Y OATs for a total of €11bn.

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