Rates Spark: Bessent and payrolls key as we end a tumultuous week

What a week! Tariff threats switched on and off, Bessent laser focussed on the 10yr yield, and next up is payrolls Friday. Meanwhile, a 25bp cut by the Bank of England safely delivered, and a dovish aftertaste, supports three more 25bp cuts this year. The ECB will publish a report on the neutral rate – potentially interesting. Lots to chew on over the weekend

Treasuries take a pause as they brace for a "not-half-bad" payrolls report

Scott Bessent's laser focus on the US 10yr yield continued to reverberate through Thursday's trading, but this time without material effect on direction. We note the tightening between the 10yr Treasury yield and the 10yr SOFR rate into 43bp. That's down from the 50bp area over the turn of the year. It may appear to be an academic observation, but it's important. That 50bp spread was rationalised, in our view, by the size of the US fiscal deficit.

The thinking being that the SOFR curve is the risk free rate curve, and the Treasury curve sits above this to reflect its credit risk. This ranges from virtually zero in very short tenors out to much wider spreads in longer tenors. The 10yr spread had been in the 25bp to 30bp area in the wake of derivation of the SOFR rate and curve a few years back (Libor transition). But it shot up to above 50bp in late 2024, which we read as an extra spread to account for the implied credit risk coming from the elevated fiscal deficit and growing absolute debt levels.

So far in 2025, that spread has shown a tendency to narrow, and as mentioned, got down to 43bp on Wednesday, in part pressured there by a falling 10yr Treasury yield (Bessent's doing). This can be rationalised to the extent that e.g. DOGE will show some results, thus taking pressure off the fiscal deficit. That said, it remains to be seen whether this theme is a real runner as a genuine driver. If it is, there is room for Treasury yields to squeeze further lower (and for the spread to SOFR to tighten). If it isn't, then it can easily revert back up again. Which brings us to payrolls.

Payrolls Friday is anticipated to be a Goldilocks outcome, but with a clear tint of macro firmness – nothing wrong with a 175k expectation for jobs growth (above the 150k replacement rate), and a 4.1% unemployment rate. Get that, and Treasury yields won't have a clear route to head lower, at least not based off that number alone. The Fed would also look at this as the type of data that rationalizes an ongoing pause on any rate cutting ambition that the dots imply for 2025.

ECB staff forecasts of the neutral rate could in the end even help reopen the policy debate

European Central Bank staff is set to publish updated neutral rate estimates at 10:00am CET on Friday. The already known sub-title “statistical uncertainties and conceptual shortcomings” of this research bulletin already suggests that one should not draw too firm conclusions from the results. The market may still focus on the mid-point and how it compares to the range 1.75-2.25% that currently frames the discussions. On the other hand, a broader range (both to the up and downside) could also blunt the impact of calls such as those from individual officials more recently who have pointed out policy "target"-levels of around 2%. In the end, a broader range and more caveated results could open up the discussion again and lead the ECB back to a truer meeting-by-meeting approach – thus softening the current gravitational pull of the 2% level for market expectations.

The ECB has so far tried to steer the attention to broader measures of the ECB’s policy stance, and not just the distance from a vague neutral measure. There was no way of summarising the restrictiveness of monetary policy into a single number, but Chief economist Lane did outline at least nine factors that would have to go into any assessment. These range from taking into account the rolling off of super-cheap debt, the market's rate expectations, measures of policy transmission, to bond and equity risk premia which can also be exogenously influenced.

The Bank of England delivers cut with dovish aftertaste

The Bank of England (BoE) cut rates by 25bp as expected, but the votes did initially give a dovish flavour to the decision. Not only did the arch-hawk Mann support a cut, she even voted in favour of 50bp, together with the more dovish Swati Dhingra. On the other hand, the updated forecasts were more on the hawkish side, with inflation remaining just above target in two years’ time. Overall the net impact from the meeting on sterling rates was close to zero on the day.

We maintain a more dovish view compared to market pricing and in our view the outcome of the meeting was in line with our baseline of three more cuts in 2025. The risks seem tilted to the downside, with services inflation coming down and the jobs markets showing fragilities. If these trends were to accelerate, a 50bp suddenly seems less remote. As such we would argue that the front end of the sterling rates curve can still nudge lower from here. A more dovish BoE helps convince markets to lower rates, but we probably first need a series of better inflation number to really see a structural move lower.

Friday's events and market views

US payroll numbers will take the front stage with the nonfarm component expected to increase by 170k, down from the prior reading of 256k. The payroll revisions come in at the same time. The unemployment rate is expected to hold at 4.1%. The other US data point to watch is the University of Michigan consumer confidence indicator which is seen nudging slightly higher from 71.1 to 71.7. From Europe we have German industrial production and trade figures, although these usually aren't market moving. In terms of central bank activities, the ECB will publish its report on the neutral rate and from the BoE we have Chief economist Pill speaking.

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