Rates Spark: BoE and Fed follow up with more cuts

Both the BoE and Fed delivered cuts that were largely anticipated. But both were reluctant to provide much guidance in the face of the changing political backdrop. 10y Treasury and Gilt yields declined, but more due to repositioning after the Trump trade it would seem. Bunds underperformed, now trading above swaps amid political turmoil in Germany

The 10y Bund yield tops swap rate for the first time

One of the main developments in EUR rates was that 10Y Bunds started to trade above swaps for the first time by almost 5bp at yesterday's peak. The additional trigger among the structural headwinds was the downfall of the German government coalition with the fiscally conservative finance minister having been dismissed.

But one could argue that part of that historical feat in the spread is actually due to the Euribor swap leg, where in the past decade we have seen a repricing lower of the bank risks reflected in the Euribor fixing. If we instead look at a longer history of 10y Bund spreads over the Overnight Index Swap, we actually see that we have now reached levels in line with those observed just before the European Central Bank started quantitative easing (QE) at the beginning of 2015 Bunds traded at spread levels in the area of 15-20bp above the OIS.

With the QE impact now seemingly fully unwound, there is some reason to look for a stabilisation following the notable 25bp underperformance of Bunds versus swaps since early October. We would still remain wary though, especially in longer swap spreads as the structural headwinds related to supply among others still persist. The more global sentiment with regard to sovereign bond spreads could still have momentum, too, when looking over to the election outcome in the US. And of course, we have the domestic political developments in Germany.

Fed cut leaves markets unimpressed as the Trump trade in rates fades

The Federal Reserve cutting by 25bp left markets unimpressed. It had been well flagged and came as no surprise, as 10y US Treasury yields continued their slide lower, hitting 4.33% while glossing over any hints of hawkishness from Chairman Jerome Powell. But as our economists note, Powell was reluctant to discuss the repercussions of the election outcome.

The correction lower in yields now comes after a long run higher amid growing anticipation of a Trump win, but we are now moving from a phase of pricing in the promises to one of actual policy delivery and here, the outlines and actual timelines will have to become clearer in coming months before rates can move higher again. In the meantime, the market might turn back to the data for the near-term direction.

Bank of England cuts, but Gilt investors remain wary

The Bank of England went for a 25bp cut as we projected, but gave little forward guidance about the next steps. Gilt yields have been on a bit of a rollercoaster of late (a steep upward-sloping one), but found some relief in today's decision. Fears about the inflationary impact of Reeves' budget continue to linger in investors' minds but the BoE tried to downplay the potential impact on future rate cuts. Gilt investors were not fully convinced during the meeting itself, yet yields did fall further alongside UST yields later in the day.

Even though we believe the fair value for Gilt yields should be lower, the catalysts for a price recalibration may take some time. We expect inflation to come down quicker than markets are positioned for, but it may take multiple readings for that case to build. More likely is that Gilt yields will be dragged lower again on the back of weaker US data. Gilt yields have been very sensitive to UST yields and thus a series of disappointing job numbers from the US could drag them down.

Friday's events and market views

In terms of data releases, from Italy we have industrial production and retail sales, which usually don't have a big impact on markets. From the US, the Michigan indices are on the agenda, of which the headline sentiment index is expected to nudge up from 70.5 to 71.0. The central bank speakers may be of more interest and include the ECB's Piero Cipollone, the BoE's Huw Pill and from the Fed, Michelle Bowman.

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