Rates Spark: Triple-whammy for gilts

The 10Y gilt yield is hitting new records and politics could turn a double-whammy into a triple-whammy. Meanwhile, the US yields backdrop has come off extremes, but the problems that drove us there remain

US rates dipped while sterling rates hit new highs

New record highs for sterling rates, but don't just blame politics

Sterling rates are reaching new record highs, but even though politics are easily blamed, external factors are the more obvious culprit. The 10Y gilt yield touched 5.1% during intraday trading, a level last seen in 2008. Gilts are facing a double-whammy, being both sensitive to inflation through higher oil prices and by being relatively vulnerable to spillovers from US markets. Already since the start of the crisis, markets have had a more hawkish take on the Bank of England's reaction function to higher oil prices. It is more hawkish than for the Fed or the European Central Bank (ECB).

Secondly, gilts' tight correlation with UST's is pushing rates higher on the back of US optimism. With equities in the US hitting new records, the 10Y UST yield has now drifted above 4.4% and seems to find little resistance. A sharp risk-off episode could push yields down again, but so far market sentiment seems very resilient. US macro data is also sturdy, which means that real rates are not showing any signs of economic weakness.

Gilt yields can therefore rise even higher from here, with politics posing the risk of turning the situation into a triple-whammy. So far, however, we're not seeing clear signs of investors turning more wary of the UK because of the political turmoil. For instance, the spread between gilt yields and swaps, which is often seen as a gauge of gilt market stress, has been relatively stable. Also, our FX strategists point out that the currency is not showing any weakness when accounting for rate dynamics. This could change, of course, but with eyes still fixated on the Middle East conflict, politics is likely to remain in the passenger seat.

The US backdrop has come off extremes, but the problems that drove us there remain

Key US market rates had a dip day on Tuesday. The 10yr SOFR rate dipped back below 4%. But only just. Same for the 30yr Treasury yield, dipping below 5%. But to all intents and purposes, we are still looking at these two key metrics at 4% and 5% respectively, with the risk that these are floors for now rather than ceilings.

There is, at the same time, a credible narrative that these aforementioned levels represent 'value'. The 4% level for 10yr SOFR is a nice level to receive at (see more here). And for many players, getting a 5% handle on US Treasuries has been something of a novelty in recent decades. In addition, many players mark 4.5% on the 10yr Treasury yield as a structural buy.

We'd generally agree with these latter thoughts, as a structural view. But that does not mean we can't continue to move higher first, as a tactical view.

The issue here is inflation breakevens remain under rising pressure. They eased lower on Tuesday in tandem with an easing in the price of oil. But there is no dynamic that we can latch on to whereby there is any structural resolution to the supply shock coming from the Strait of Hormuz. Just because the ceasefire is holding does not translate into any imminent release of upward pressure on the oil price.

Change that narrative, and we can absolutely regard the aforementioned levels as in the buy zone. But until then, the risk is market rates continue to edge higher.

Wednesday's events and market views

From the eurozone we have Spanish and Italian PMIs which will be watched. Over the past few weeks, the eurozone economic data have consistently disappointed to the downside relative to consensus. But with the Middle East conflict lingering on, we doubt we will see a positive spin on the data. Markets will also be watching the ECB wage tracker and PPI data for any signs of underlying inflation pressures in addition to the rising energy costs. From the US, we have the ADP employment data for April, which will be watched for signs of weakness, given the payrolls number is due on Friday. The US will also announce the new quarterly refunding plans.

In terms of supply, we open with a 30Y German Bund syndication for €3.5bn. Germany will also auction a 7Y Bund for a similar amount. From the UK we'll see a 9Y Gilt linker for £1.6bn.

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