Rates Spark: Feels a bit like a hike, for bonds

We got the 25bp cut. And it *was* dovish. Maybe not as dovish as some would like, but it's reasonably clear that there are more cuts coming. Rates are up though. On both ends. And the curve steeper, mostly on 10yr underperformance (10/30yr even flatter). The 10yr still looks off here. Nagging question – why should the 10yr rate fall as inflation rises?

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

The Fed has come and gone, and we end up with higher rates and a steeper curve

Our detailed Fed note is here. We won't re-hash it. Instead, here are a few additional observations.

First, it is interesting that Stephen Miran was the only dissenter. It seems to us that this could be a purposeful decision on the part of the rest of the FOMC to show some support to Chair Powell, and, indeed, as an implicit act of support for Fed independence. Maybe we're reading too much into this, but if true, that's a positive messaging.

Second, while Chair Powell has pointed to weakness in the labour market, it's clear that there is quite some confusion on where exactly we are on the labour market. In particular with respect to revisions that have completely taken away the relative oomph that we had assumed to be in place in the past year. But also on how to interpret the labour market ahead, in light of immigration controls in particular.

Third, it's clear the Fed continues to expect some upward pressure on prices from tariffs. The Fed has cut as inflation is rising – unusual to say the least.

Fourth, the bond market is all over the place on the back of a lot of this. Rates went down and up and back down again, only to end up higher. The curve too, was up and down and shake it all about, but in the end the 2/10yr got steeper while the 10/30yr flattened. Mostly, this reflected an underperformance by the 10yr. And interestingly enough, the immediate post-Fed cut announcement was met with the 10yr briefly breaking below 4%, only to then decide to get much closer to 4.1%.

In the end, we come away with the notion that, ultimately, this curve steepens out, and from both ends. So far, it's the back end that's holding in (in light of the big pre-FOMC moves to the downside for long yields). For a long time it's felt vulnerable out there. Some day, that will manifest in a 'proper' move to the upside for long yields. Or you would think so. We're still waiting.

BoE quantitative tightening tweaks and the German issuance calendar for long-end impact

A rate cut was never likely at Thursday's Bank of England meeting and markets perfectly reflect that view. Front-end rates will try to glean any hints regarding the remaining rate decisions this year from the voting split and the forward guidance. Our economist still narrowly leans toward a cut in November.

Long-end rates and curves in particular will likely be more focused on the BoE's planned reduction of its gilt portfolio for the upcoming 12 months. Keeping the portfolio reduction at a £100bn/year pace amid lower redemptions would imply a higher proportion of active gilt sales by the BoE. Market participants fear that long-end rates would struggle in this scenario amid shifting supply-demand balances which have already pushed 30y gilt yields to their highest levels since the late 1990s. A BoE survey of market participants had shown median expectations for a reduction to the tune of only £72bn. An additional tweak to relieve the pressure on the long end that markets are looking for is a shift of active sales away from the 20Y or longer gilts bucket.

Since the structural steepening pressure has been a global story, the adjustments from the BoE could be seen as a signal to extend the current flattening relief in long-end curves – not just in gilts. The other event that markets will likely be keeping an eye on is the German issuance calendar update for the fourth quarter. Markets are looking for a somewhat more moderate increase compared to the €19bn we got in the third quarter (€15bn of which via the bond market), but will also be looking at what maturities the funding agency chooses to raise the additional funds.

Thursday's events and market view

The BoE policy decision, including the QT update, will be one of the main events to watch, although the US release of initial claims data should later ensure some continued influence of the US job market concerns on rates. EUR rates will have to contend with comments from European Central Bank officials, including Schnabel, over the course of the day while Bunds will watch the fourth quarter funding update.

In primary markets, Spain will auction bonds for up to €6bn and France sells short-to-medium term bonds as well as linkers for a total of up to €13bn. The US Treasury will sell US$19bn in 10y TIPS.

Author

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com