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Rates Spark: Gilts don’t like political uncertainty

Mixed signals from Christine Lagarde are suggesting a more balanced view from the ECB, potentially with more focus on growth after new PMI data. Meanwhile, UK gilt yields are likely to keep a material risk premium as we head into a period of economic policy uncertainty

Andy Burnham is likely to replace Starmer as PM, and the associated political uncertainty could keep gilt yields higher

A more balanced ECB view could increase focus on growth dynamics

The market is staying optimistic about the developments in the Middle East, having brushed away the somewhat rough start to the negotiations over the weekend. Brent oil is stabilising below US$80/bbl.

Had these developments come two weeks earlier, it is unclear whether the ECB would still have hiked. However, once it did, it had to commit to its action. One might be tempted to put down the hawkish comments as ex-post justification and defence of past action rather than any guidance of what is still in store. Lagarde’s latest comments also seem to tone down the relevance of her assessment that there had already been signs of second-round inflation effects. To the EU parliament, she said there was no need for a more forceful ECB response to the Iran war, although that is not out of line with the "measured adjustment" she mentioned in the case of a "sizeable but not-too-persistent overshoot" of inflation.

That said, there is still a lot of uncertainty around the geopolitical outlook. We would even go as far as to say the market – as reflected in oil prices – might be a bit too optimistic about how fast disruptions in the energy flow can be cleared. That might also explain why the rates market, at least, is still holding on to the notion of another hike from the ECB, even if now only fully discounted by year-end rather than already by October.

The easing of tensions might allow for a more balanced assessment of inflation versus growth, though already now, meaning the eurozone flash PMIs as a more contemporaneous barometer of the state of the economy, could be more influential this time. That is, if we were to get a larger surprise to the downside. Currently, the market is actually looking for a slight improvement coming from the services side, though still seeing the sector in contractionary territory.

Political uncertainty adds to risk premium in gilt yields

Starmer's resignation is now official, but we're still in guessing mode about Burnham's concrete plans for the economy. Burnham becoming the next prime minister is not confirmed yet, but a lack of competition and polling websites suggests an almost certain chance. The inflation story remains the primary focus of markets, but the additional political uncertainty can add to the risk premium. In theory, Burnham pursuing an expansionary fiscal policy could pose further upward pressure on rates. Higher government spending in the near term would further feed the hawkish narrative, whilst more gilt issuance would add to the term premium.

We estimate that the risk premium for 10Y gilt yields has been creeping higher to around 15bp, and there is room to rise more. In the weeks leading to Reeve's budget presentation in November, we estimated a risk premium of around 25bp. Burnham has expressed his support for the fiscal rules, which has eased concerns, but even within the existing framework there is room for significant economic reforms. Also, Burnham's choice of a Chancellor can be important for markets. So whilst our baseline doesn't see much upward risk in terms of rates, we do acknowledge that political uncertainties are likely to keep upward pressure on gilts.

Tuesday's events and market view

The data highlight will be a long list of country PMIs. The eurozone composite indicator is expected to nudge up slightly from 48.5 to 49.2, which would still be in contractionary territory. Consensus sees the UK composite PMI tick up to 50.5, just about in positive territory again. The forecast for the US composite PMI is an improvement from 51.5 to 52.1. Other data includes the Richmond manufacturing index and US ADP weekly employment numbers.

The Netherlands will auction €2bn of 30y DSL, Germany will auction €5bn of 2y Schatz, and the US will auction $69bn of a new 2y note.

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