Rates Spark: Gilts uneasy about UK budget plans

US data continues to show resilience, whereas in the eurozone, the sentiment is increasingly dovish, driving the rates spread wider. UK Gilts went against the current, and yields moved higher as speculation of increased government expenditure ahead did the rounds

UK Chancellor Rachel Reeves and US Treasury Secretary Janet Yellen at the IMF in Washington

Even hawkish ECB members seem in favour of significant easing

The wedge between US and EUR rates continues to widen. While in absolute rate levels there are signs that investors are seeing the levels as oversold, the case for US rates to underperform on a relative basis is easier to make. Against a backdrop of a likely Donald Trump win, if the polls are to be believed, the data continues to surprise. This time it was an unexpected decline in jobless claims alongside slightly better S&P PMIs.

On the EUR side, one could argue that a prospective Trump administration will have negative repercussions on the eurozone's economic outlook – Lagarde has even flagged it. The data itself, as seen in the latest PMIs, does not paint a picture as gloomy as the sudden dovish push by European Central Bank officials suggests. But again, we heard from ECB officials that policy rates should no longer be restrictive once the inflation target of 2% is sustainably met. Paired with earlier sources, the next projections by the ECB could see inflation at the target level in the first half of next year. Thus, the market has reason enough to price growing chances of a 50bp cut in December and a terminal rate below 2%.

Gilt investors likely to remain nervous until budget plans are final

Going against the prevailing tide, Gilts saw quite a sell-off, seemingly triggered by increasing unease about upcoming budget plans. Speculation is that Chancellor Reeves is preparing to free an additional £50bn by changing the key debt metric underlying the UK's fiscal rules. Such a cosmetic adjustment would enable more infrastructure investments without the need for stringent tax increases. Funding this would require more Gilt issuance, pushing yields up.

Perhaps more important for rates was the recalibration of the Bank of England's terminal rate, which markets see landing higher on the back of more government expenditure. The 1-month swap rate 2 years forward increased by some 4bp to around 3.7%. We still think this is high, and given Bailey's more dovish tone this week, the priced-in terminal rate could still come down. Having said that, markets will probably want to await the official budget announcement on Wednesday before making the move lower.

We may also have a modest risk premium as the government's fiscal discipline comes under closer examination again. Investors have not forgotten about the short-lived UK Prime Minister, Liz Truss, when she presented an unfunded budget and Gilt yields soared. For the moment, such a situation seems averted, and markets appear confident that Reeves will remain broadly committed to budget rules.

Friday's events and market view

Today, the German Ifo should attract some attention. If it echoes the slight improvement we saw in the German PMI then it would be somewhat at odds with the ECB's sudden sense of alarm.. We'll get other data on money supply and the ECB's consumer inflation expectations survey. The ECB's Villeroy will speak later in the evening. In the US, we will get the durable goods orders as well as the final University of Michigan consumer sentiment index.

One highlight for government bond markets will come only after markets close. Moody's is slated to review the French Aa2/Stable rating and S&P is scheduled to review Belgium's AA/Stable. For both, there is some downside risk, clearly for France, since Moody's assessment is still one notch above where S&P and Fitch rate the country, the latter of the two only recently having assigned a negative outlook. Markets, however, appear to have already baked in a healthy dose of pessimism and spreads over Bunds have trended tighter since October.

Primary markets see Italy issuing short-dated and inflation-linked bonds for up to €5bn.

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