

## Rates Spark: Hello Brexit

Brexit risk is back at the forefront of European markets' worries, and threatens to remain there until at least this week's EU summit. Short-dated Sonia swaps have started pricing a Bank of England cut, but a move below zero is unlikely next week.



### Overnight: not much progress

EU and UK teams remain far apart on the three remaining sticking points of their trade negotiations, according to a joint statement issued late yesterday. PM Johnson will travel to Brussels to meet EU Commission president von der Leyen. The House of Commons reinstated the controversial clause in the internal market bill but PM Johnson said it could be removed.

The lack of new significant development left bond futures close to their highs in the overnight session.

### Brexit risk, another driver of rates divergence

After months of largely ignoring Brexit headlines, talks between the UK and EU are back at the forefront of international (ie non-GBP) investors' worries. With this week's EU summit approaching fast, no-deal Brexit is now a real near-term risk that threatens to add to an already worrying

macro backdrop for Europe, although this week's EU summit is likely not the final deadline for the talks. We expect Brexit news to remain relevant for EUR rates as well, adding another driver to our USD-EUR rates divergence view.

Translating this statement into a GBP rate view looks straightforward enough. The Gilt outperformance over EUR and USD counterparts should extend until more tangible signs of progress in the talks are made public. As is often the case there is a risk that this only occurs in the very last moment, in this case, just ahead of the December 10-11th EU leaders summit that should sign off on any trade deal.

## December BOE in play? Not below zero

There has also been a noticeable drop in near-dated Sonia swaps (ie 1-3 months), in fact to their lower level since the series began. Earlier this year, when expectations of negative rates were rife, it was longer-dated Sonia forwards (ie 12-18 months ahead) that were typically affected. The recent move suggests that markets are starting to believe a no-deal Brexit could push the Bank of England (BOE) into emergency measures fairly quickly.

With the next BOE meeting being scheduled for December 17th, we would not wager that the central bank will have enough certainty about whether a deal is likely or not by that date. At a push, the Bank rate could be cut to just above 0%, but our economics team thinks ramping up the pace of QE purchases would be a more natural reaction.

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*Ramping up the pace of QE purchases would be a more natural reaction*

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It is less certain that the Bank will have concluded its review into negative rates policy (NIRP) by that date, as MNI reported yesterday. Be it as it may, a collapse in EU-UK talks would call for quick and aggressive action. It is debatable whether the BOE would refrain from providing the economy with the support it needs for that reason, but it has enough policy options to wait until the February meeting.

## Today's events: Brexit Brexit Brexit

In between Brexit headlines, German/European Zew and US NFIB will provide some distraction.

The US Treasury will auction 3Y notes, followed by 10Y tomorrow, and 30Y on Thursday.

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