

Rates Spark: Growing stresses pushing rates down

US Treasury yields were tracking the probability for a March cut, but now tracking the regional bank performance. Eurozone inflation surprised to the upside, but markets keep their view of April cuts. We think June is more likely. The BoE meeting was more dovish compared to the last meeting, but more hawkish than market expectations



The share price of New York Community Bancorp has dropped the past few days, impacting regional banks, which seem to correlate with the 10yr yield

Focus on regional banks featuring in the US

Up until a few days back the biggest driver of the 10yr US yield was the unwind of the rate cut discount for March. That is still relevant, and arguably at 38% it's still too high, especially as Chair Powell virtually ruled out a cut at yesterday's press conference. That said, the new thing to correlate the 10yr yield against is the Regional Banking Index (KRX). That was down 7 points yesterday. And so far another 5 points today. It can fall a lot more as it's still 20 points above the lows hit when Silicon Valley Bank went down. Egging that on is the New York Community Bancorp (NYCB) share price. It's down on Wednesday, and so far showing no inclination to recover Tuesday's 45% down move.

The 10yr Treasury yield is looking beyond March now, and re-thinking Chair Powell's virtual promise that cuts will happen in 2024. Every fall in the KRX means either an earlier insurance cut

(May at minimum), and/or bigger cuts. The terminal rate discounted has fallen by 25bp since the NYCB story broke, now down to the fed funds range of 3% to 3.25%. It should likely fall further towards 3%. Anticipatory rate cuts is dominating sentiment, securing the 10yr below 4%, and it's tough to argue against it given what we know (or don't know).

Payrolls Friday is the key, and it looks like we'd need quite an upside surprise to shake the heavy black cloud overhead.

Euro markets wanted a downside inflation surprise but did not get one

For euro markets the flash estimates of eurozone inflation numbers claimed the spotlights. Markets hoped that another downside surprise would cement an April rate cut but unfortunately both headline and core inflation came in just 0.1% above consensus. Nevertheless, the clear downward trend continued and rate cuts this year remain a given, but when, that's the question. The decline of inflation comes at a time where growth seems to bottom out and even a careful recovery is pencilled in by our economists. Rate cuts in an economic environment of tight labour markets and recovering growth warrants caution to prevent a policy mistake.

Not only do we pencil in the first European Central Bank later than market prices (April vs June), we also think the pace at which rate cuts will be followed-up by will be more gradual. Forwards indicate a 150bp reduction of the policy rate by year-end, which translates to a full 25bp cut every meeting from April onwards. If growth indeed stabilises or even picks up, we don't think the ECB will be pressured into such a steep rate cut trajectory. One reason is that the amount of new data available between meetings will be limited. If nothing breaks and a severe recession is averted, the ECB will stick to a data-driven approach, which may warrant longer pauses between cuts. As markets digest this view, we think the short end should recalibrate upwards over the next few weeks whilst the endpoint remains relatively anchored, bear flattening the yield curve.

The Bank of England was not quite as dovish as expected

The BoE dropped its reference to any need of further tightening, marking another central bank shifting towards the eventual easing cycle that markets are already largely discounting. To that end, the voting split still showing two members opt for hikes, even if offset by one for a cut, alongside the unchanged reference to policy having to remain "sufficiently restrictive" for long enough made for an overall slightly hawkish interpretation of the BoE's actions and communication, at least on impact and relative to market expectations.

Yet that bit of bear flattening sterling money markets got muddied by wider market developments and relatively little change remained by the end of the day. In Gilts the initial nudge higher in yields was more than reversed when US Treasury yields resumed their decline. This took the 10Y Gilt yield back below 3.8% in the process also outperforming Bunds again. It compressed the 10Y Gilt-Bund spread a little further below its average since October, and our base case remains that this spread tightening should have further to run near-term also premised on the view that pricing for the ECB is too aggressive but remains more balanced for the BoE.

Friday's events and market view

A quiet Friday in terms of events and releases, with payroll data clearly the highlight. In terms of speakers we have Centeno from the ECB who will talk about monetary policy and

the European labour market.

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