Rates Spark: The Fed is talking a lot but the BoE will deliver

The Fed was balanced but yields managed to edge lower on rate cut optimism; cuts still seen as inevitable, eventually. The Bank of England will likely cut rates but this won't come as a surprise to the market. Having said that, sterling rates remain sensitive to moves in US rates, which puts markets at risk of pricing in too many more cuts in the near term

We expect the Bank of England to cut rates by 25 basis points

A move lower in US rates could overprice the number of Bank of England cuts

We think the Bank of England will cut the policy rate by 25bp, and so do markets, with a full cut already priced in. Markets see the chance for a consecutive cut in June at around 50%, but here we disagree. Instead, our economists still sees the BoE sticking to a gradual easing of one cut per quarter. The sharper pricing of markets is mainly a spillover from the global unrest since Trump's tariff's announcements. We therefore wouldn't push against this for now – trade negotiations are still underway and the consequences have not yet had a chance to materialise in the data.

While short end EUR rates have disentangled almost entirely from US rate dynamics, sterling rates still show significant correlations along the entire curve. This means that UST yields can continue to be a stronger driver of gilt yields than domestic data over the near term. With global risk sentiment still fragile and US data disappointments likely, we think the next move in gilt yields could therefore be lower along with UST yields. At the same time price pressures are still on the hot side in the UK and thus we don't think the BoE will be accelerating its cuts. As such the very short end is at risk of falling below what we consider fair.

No material comment on the tapering process, and bonds trade both sides of the rate cut outlook

From the FOMC outcome, the main immediate impulse from the preliminary headlines was lower rates and a steeper curve, with most of the action coming in the real rates space. From that, there was a supposition that the Fed is primed to react to higher unemployment and hold its nose to rising price rise risks. That was quite the reaction, on some brief and in fact balanced snippets from the press release. That type of price reaction needed to be validated from the press conference. In fact the commentary at the press conference was not quite in sync with the early price action, and market rates edged back up again. Overall, the net outcome is slightly lower for market rates, and in our opinion there is an avenue for that to be extrapolated ahead on a theory that we see some macro pressures build. The 10yr yield can easily get down to the 4% area in such a scenario. But for now, the contemporaneous economy is just about firm enough to validate market rates staying about where they are for now.

Nothing new on the bond roll-off programme (quantitative tightening). Last time, the Fed lowered the cap on the roll-off of Treasuries to $5bn per month, which is effectively zero. In turn that means that the Fed continues to be a net buyer of Treasuries, as the roll-off ranges from $20bn to $60bn per month. No change to this policy. At the same time a $35bn cap remains on the MBS roll-off, but we've not been hitting that cap, which means that MBS bonds that mature do not get re-invested. Anything in excess of $35bn would be re-invested in Treasuries (which is in fact rare). Long term, the Fed would have an ambition to take the MBS bonds off its books completely, and ideally replace them with Treasuries. No (new) commentary on this today though. Clearly all this being left to another occasion, perhaps awaiting less impactful times. For now the slower tapering process continues, and can do so as bank reserves remain ample enough. One technical help here comes from the debt ceiling, as until this is raised or suspended, the US Treasury is spending down and in so doing, adding to bank reserves.

Thursday's events and market view

The Bank of England is widely expected to cut rates by 25bp on Thursday. Beyond that there is little data on the European side apart from German industrial production data and trade balance in the morning. In the US the data highlights are weekly jobless claims figures which are seen slightly lower as well as the NY Fed's 1y inflation expectations survey in light of the tariffs.

In primary markets Spain will auction 3y, 5y and 30y bonds as well as an inflation linked bond for up to €7.25bn in total. Ireland auctions up to €1.25bn in 10y bonds. Later, the US Treasury will sell US$25bn in new 30y bonds.

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