Rates Spark: Differing degrees of decoupling

The US narrative is driving rates, but we see differing degrees of decoupling on the European side. While ECB pricing continues to be relativley firm, pricing for the BoE looks more aligned shifted Fed expectations. This week's UK data worked in that direction, but officials drawing a distinction between US and domestic inflation saw little reaction

Various degrees of decoupling on the European side

Pricing for the European Central Bank has remained surprisingly firm in the wake of US policy expectations adjusting higher. The ECB may have had the advantage of having had the opportunity to provide guidance at a policy meeting last week. Central bankers have all reaffirmed the notion that June should see the first cut, with perhaps only the extreme ECB hawk Holzmann sounding less convinced. But fellow hawk Nagel just stated yesterday that the probability for a June cut had increased, even when he warned about price pressures proving more lasting. However, that relative proximity of the June meeting might help anchor expectations.

Pricing for the Bank of England on the other hand has seen expectations rise more in line with the

US narrative. Certainly, the stickier-than-anticipated inflation data and still hotter wage growth have contributed to that sentiment this week. But at the same time we have had Governor Bailey trying to put the same distance between domestic monetary policy and the Fed's, stating that European inflation dynamics were different from those in the US where they were more demand led.

Still markets temporarily had pushed back the first fully discounted rate cut as far back as November and an overall discount of noticeably less than two cuts in total for the year. This has corrected somewhat on the back of more dovish comments from BoE members on Wednesday, but overall pricing still appears more aligned with the Fed's despite official pushback. Short-end spreads of 2y SONIA versus ESTR had lurched higher by close to 20bp over the past week to 165bp, which followed after a gradual narrowing since January. Considering we have seen the peak at 250bp in the middle of last year, that might not seem too dramatic yet.

Clearly, the BoE should be lodged between the ECB and Fed in terms of timing, and we think should likely correct more towards August as the most likely rate-cut date according to our economist's current forecast. More importantly, the priced pace of cuts looks shallow, especially compared to the firmness of expectations with regards to the ECB. This should be backed up by the prospect of UK headline inflation dropping close to target with the data for April, and even staying below target for most of 2024 then.

Thursday's events and market view

While data remains the main driver of market direction, Thursday only holds second tier data. In the US we will look out for the weekly initial jobless claims data where consensus is looking for very little change. It would probably require a larger surprise outside the 200-220k range to move the market here. We will also get existing home sales as well as the Conference Board's Leading Index.

Against that backdrop central bank communication can be more relevant, although we have seen that the shifts to the hawkish side have merely been a confirmation of recent price action. It is still a busy slate from the US with appearances by Bowman, Williams, Bostic and Collins. From the ECB we have appearances by Vice President de Guindos and Buba's Nagel among others.

In European primary markets France sells short-to-medium-term bonds including a new 6y bond for a total of €12.5bn. France will also tap inflation linked bonds for €2bn. Spain sells bonds from 3Y out to 40Y for €6.5bn in total. The US Treasury sells US$23bn in a new 5Y TIPS.

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