Rates Spark: Unless the print is sub-150k, no change in tone

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Given the move already in Treasuries, there is some talk that Friday's numbers will need to be strong to continue this momentum, and in that sense there is some vulnerabilty for a lower yield reaction to a consensus outcome. The counter is that the dominant driver of the rise in the US 10yr Treasury yield has been a downsizing in capacity for the Fed to cut rates. When the Fed first cut in September 2024, the December 2025 funds rate was discounted at 2.8%. Since then, that's risen to 3.9%, broadly equivalent to the 100bp move higher in the 10yr rate. Given that, we'd need an outright weak number to shake things up.

On the payrolls, it's averaged 180k per month through 2024 – and averaged 150k per month through the last four months of 2024. The number expected this month is within these parameters, and in consequence we doubt that delivery of say 165k (the consensus) will be dramatically impactful for Treasuries. Part of the rationale for that indeed centres on next week's CPI data. Look at that data with your eyes squinted and you see the US as a 3% inflation economy. Inflation is clearly in better shape now, but has not gone away as an issue.

Since the Fed cut, the economy too has shown a degree of resilience. And the Trump election win has added a degree of oomph to the perception of the macro environment. His stated policies too are, if anything, likely to place upward pressure on prices. The latest FOMC dots reflect this, with some members openly accepting that potential Trump policies impacted their dot decision making.

Payrolls, as always, are a pivotal report. But we need to deviate materially from consensus to have an effect this time around.

Upward potential for gilt yields capped

The rise in GBP rates has come to a halt, but at 4.8% the 10Y gilt yield has settled at a significantly higher level compared to the 3.8% low from last year. Having said that, in November the 10Y stood at 4.6%, so not that much lower than today. The sharp rise in yields can partly be attributed to fiscal concerns but should be framed against significantly higher rates in both the US and eurozone. The 10Y UST yield is also some 100bp higher than September 2024.

The rise in gilt yields has a self-reinforcing feedback loop through the UK's debt sustainability, by increasing borrowing costs used for budgeting purposes. An earlier sensitivity analysis from the Office of Budget Responsibility suggests that the recent rise in rates, if sustained, would be enough to wipe out the government's estimated fiscal headroom of £9.9bn. After the recent developments in France and the US, markets seem to put more emphasis on such debt dynamics.

What markets may be underestimating is how higher rates also pass through to growth and inflation by tightening financial conditions. The Bank of England is now priced to cut rates by just 50bp this year, resulting in constraining Bank Rate of 4.25%. And the increase further out on the curve will hurt investment activity through lending rates. Lower growth and inflation should help bring rates down eventually, thereby capping the upward potential for gilt yields from here in our view.

Friday's events and market view

We'll first have industrial production figures from Spain and France, and then retail sales from Italy. But US payroll numbers will be the main attraction, together with the unemployment rate. Later we'll also see the Michigan sentiment indices, which are broadly expected to remain stable.

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