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RATES SPARK

Rates Spark: Warsh's Fed takes inflation seriously

The 10yr yield is up, back to the 4.45% area. The rise in the 10yr yield came from a bigger pop in the real yield versus the fall in breakeven inflation. Long-dated yields are liable to remain sticky to the upside. In the UK, we think markets are too hawkish on the Bank of England, but we won't be turning bullish yet given inflation risks and political uncertainty



We, along with the market, expect the Bank of England to keep rates on hold at 3.75%

The Treasury curve shifts higher and flatter, but the curve structure remains benign

What was interesting from Warsh's first FOMC outcome is a clear message to markets that the Federal Reserve sees inflation as an issue to be solved, and if they do identify an inflation problem, they are prepared to act. Not exactly what was expected when President Trump gave the job to Warsh. But it does add a proper layer of credibility to Warsh's FOMC. This is important, as it has the power to at least tame the back end of the curve. But note, rate hikes don't necessarily need to be delivered. We don't think the Fed needs to hike. But we can't rule out a hike. Importantly, if there was a hike, we'd expect to see it subsequently reversed. The curve structure telegraphs this.

Impact reaction to the FOMC outcome was a flatter curve, led by the front end. That bit is straightforward given the change in tone of the FOMC as a whole, and the upshift in the median dots. The 10yr yield is up, back to the 4.45% area, and rising. What's interesting is the breakout of this, as the breakeven inflation rate fell, while the real rate rose. The aggregate rise in the 10yr yield came from a bigger pop in the real yield versus the fall in breakeven inflation.

This has been a key theme in the past few months – ongoing upside to real rates, alongside falls in inflation expectations. In fact, breakeven inflation is on aggregate quite tame. Printed inflation is in the 4% area, while the 10yr breakeven is just under 2.3%. And in fact, breakevens remain tame right along the curve. Our bottom line view from all of this is that long-dated yields are liable to remain sticky to the upside (breakevens are already tame and real yields are on the rise, or at the very least holding steady).

The hawkish tilt is classically not good for the front end, and theoretically, it can be a calming influence for the back end, on a theory that the Fed is showing some preparedness to take action, if needed, to help tame inflation. The overall outcome of a flatter curve based on this is straightforward. We still worry that the 10yr yield can drift higher from here, to the 4.5% area and above. That said, the 5yr area has richened further slightly, showing the market is not fully bought in on rate hikes being a dominant theme in the coming quarters.

Beyond that, we had expected something on balance sheet management, but little to nothing on this. The bill-buying programme continues, and the ample reserves environment is sustained. It seems that the balance sheet reduction project is all being left to another day.

We show patience before turning more bullish on GBP rates

Markets think the Bank of England will hold rates at 3.75% at this meeting, [and so do we](#). We still think markets' pricing of a hike later this year is overdone, however. A terminal rate of 4% seems too high, especially when underlying inflation dynamics are improving. And compared to 2022, gas prices have risen significantly less, and also wage growth has turned more benign.

But at the same time, we refrain from taking a more bullish stance from a tactical perspective. For one, we still see significant upside risks to oil prices given the fragile backdrop of the current deal. Meanwhile, markets won't be comfortable about second-round risks until later this year, when we have more data. Unless we see a strong downturn in economic activity, we expect rates to remain elevated for the coming months.

In addition, we have political risks adding into the mix. Burnham is likely to get closer to replacing Starmer as Prime Minister and that brings along new fiscal risks. We estimate that the 10Y gilt yield bears a risk premium of some 15bp currently, which is higher than a few weeks ago, but still below the 25bp in the period leading to the Reeves budget last November. Even though we don't think Burnham will have a big impact on the Bank of England's trajectory, we do understand that markets will stick to a risk premium for the time being.

Tuesday's events and market views

After jobs data in the morning, UK markets will be watching the Bank of England meeting. Other releases include weekly US jobless claims and the foreign US Treasury holdings data. We also have plenty of ECB speakers scheduled, which could offer more insights on the ECB's reaction function after oil turned significantly lower.

Italy will continue its retail issuance of 5y BTP Italia Si with an estimated size of €10-15bn. Spain will auction 7y, 10y and 14y SPGBs for a total of €6bn. France will auction 3y, 6y and 8y OATs for €14bn, alongside 6y, 12y and 14y OATe, including a green tranche for €1.5bn. The US will auction \$24bn of 5y TIPS.

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