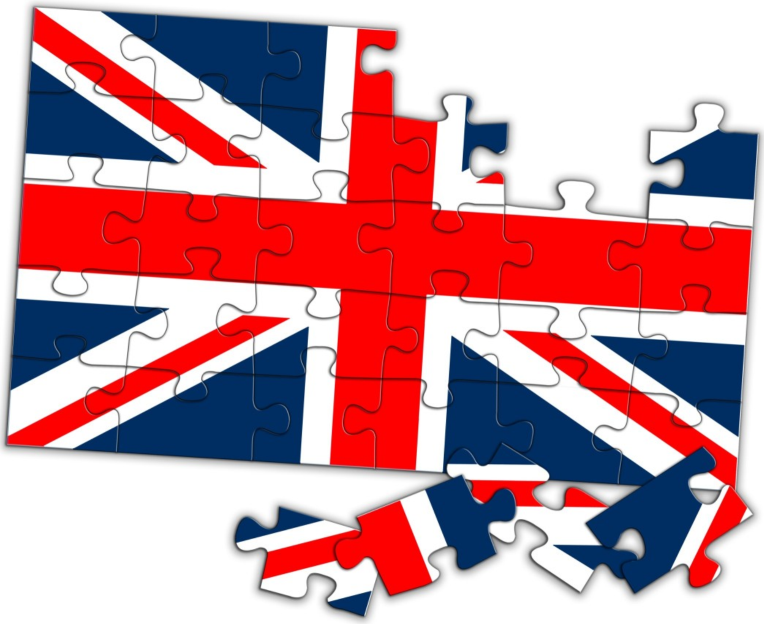
Rates Spark: Pieces falling into place

After the MPC meeting the market is now making an August rate cut for the BoE the base case. Not yet by a large margin, but it does reflect a shift in sentiment which we think is not unique to sterling. The bias for rates markets should remain bullish in our view, as cuts soon after summer become the baseline and data is scanned for evidence that negates that view



Cuts soon after summer to become the markets' baseline

The Bank of England kept rates on hold with 7-2 voting split in the committee, but the fact that the decision was “finely balanced” for some of the voters gave the overall outcome a dovish spin. The notion is that the Bank is inclined to cut, and now the August meeting is shifting into focus as the baseline scenario. This is what our economists have flagged for a while now. The market implied probability for a cut at that meeting has tipped to 63%.

In the case of the European Central Bank and the Fed the market is eyeing the September meetings with similar probabilities for respective interest rate cuts. The general assumption appears that cuts will come soon after summer, but markets are now looking at the data for any evidence that could still negate this view. From that perspective the bias for rates markets should remain bullish for the coming weeks and months in our view.

The latest data in the US remains in line with a scenario of further cooling. The main point of attention of course remains inflation where the expectation is for 0.1% core PCE month-on-month next week – it would be the second consecutive reading of 0.2% or lower and a much needed signal to bring the Fed closer to a September cut. But other data also remain on the cooler side of expectations, be it the retail sales data earlier this week or the initial jobless claims recovering less than anticipated on Thursday. That expectation of further moderation is also baked into the consensus for this Friday's US S&P PMIs.

While the PMIs have less market relevance compared to their ISM counterparts in the US, the eurozone PMIs are an important input for the ECB outlook. If there were some further signs of bottoming out in the growth picture, it would come as a reminder of lingering reflationary risks that the ECB will be wary about. But it would be in line with the commentary we currently get from ECB officials. This has remained non-commital in the wake of the June cut. More recently, Klaas Knot made a strong case for only quarter policy recalibrations based on a "richer set of information" when also new forecasts are available.

Friday's events and market view

Back from holiday US rates did nudge a little higher despite softer data and the bullish resistance. We still think the overall bias should be lower. While some cooling of the US PMIs is baked into the consensus it should still be seen as a confirmation of this bias. The story might be a little different for the eurozone PMIs where better data would highlight the lingering reflationary risks to the outlook.

No supply is scheduled for today. Thurday's French auction passed without any major hiccups, although admittedly with a lower overall target volume compared to prior auctions. It still helped French and overall sovereign bond spreads in the eurozone ease tighter yesterday.

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