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RATES

Rates Spark: Sterling's hawkish pricing still looks overdone

UK rates look too hawkish relative to Bank of England guidance and macro fundamentals. But oil sensitivity and fiscal uncertainty are sustaining a sizeable risk premium, complicating the near-term expression of our structurally bullish view

Bank of England Governor Andrew Bailey has pushed back against the idea of multiple hikes as priced in by the GBP curve

Oil price uncertainty and fiscal risks complicate an otherwise bullish structural outlook for UK rates

Sterling rates continue to reflect a very hawkish narrative and seem overdone relative to central bank communications and macro fundamentals. In parliament on Tuesday, Bank of England Governor Andrew Bailey pushed back against the idea of multiple hikes as priced in by the GBP curve. And this is not the first time the Bank of England has struck a much more dovish tone than markets' positioning. The question is whether markets are genuinely expecting almost three hikes over the next year or whether we are dealing with some form of risk premium. We think the latter.

Sterling rates show high sensitivity to oil prices, which means any bet on GBP rates is also a bet on Trump's next move. Since the start of the conflict in the Middle East, every $10 increase in

Brent added around 15bp to 2Y rates, more than the 11bp for EUR and 8bp for USD rates.

In addition, the new Labour government adds budget-related risks. We don't expect a material fiscal expansion, but we cannot fully dismiss the probability either. More government spending would delay Bank of England cuts, and according to markets, even add more hikes.

So whilst we take a structurally bullish view on sterling rates, trading this view in the near term remains a challenge. We also believe many market players face the same issue, explaining why sterling rates seem to bear a significant risk premium. Only once the predictability of oil prices improves do we see scope for tactical opportunities. But with oil likely to test $100 again, we stay on the sidelines.

Wednesday's events and market view

There is not much data on Wednesday, in theory leaving the markets to be mostly dictated by geopolitical headlines and energy prices.

On long-end US yields, the Treasury's announcement of the 10-20y buyback operations will receive more attention. Recall, in a surprise move in August, the Treasury had announced to at least double its long-end buyback operations – a size announcement of US$4bn would thus mark the bare minimum. Note also that the announcement comes just two hours ahead of the Treasury's 10y note auction.

In Europe, Germany will sell €5.5bn in 10y Bunds and Portugal will tap 3y, 8y and 9y bonds for up to €1.75bn in total.

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