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RATES SPARK

Rates Spark: Kevin Warsh and John Healey walk into a bar

Barring a Brazilian-style election surprise, the Fed should leave rates unchanged. It seems the US 10yr is waiting to tick this off before it deviates too much from 5%. Meanwhile, the UK 10yr yield should ease lower after the UK Autumn Budget as the tail risk of spending surprises get priced out (we estimate a political risk premium of c.20bp in the 10yr)



UK Chancellor John Healey. Gilt yields could ease a bit lower after the UK Autumn Budget as the tail risk of spending surprises gets priced out

Gilts should find some relief in a boring budget, but risks remain

Gilt markets are always a bit nervous heading into the Autumn Budget announcement, and this year is no different. We estimate the risk premium embedded in the 10Y gilt yield to be around 20bp, whereas this was close to zero a few months ago. Overall though, global factors continue to be the bigger driver of sterling rates and with energy hitting new highs, we don't expect this to change.

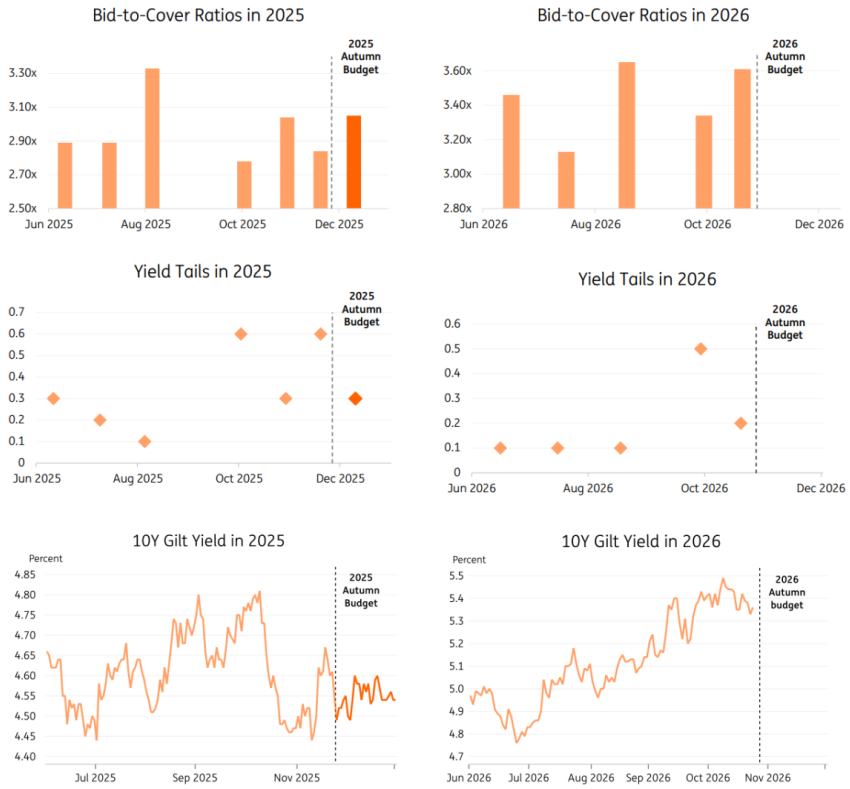
Gilt auction results held up relatively well leading up to this budget, whereas last year's

auctions reflected more nervousness. The bid-to-cover ratios and yield tails in the three auctions preceding the 2025 budget announcement showed some weakness. However, this is not evident in the most recent 10yr gilt auction last week. And also Tuesday's 6yr gilt auction showed healthy demand.

But we do think a bit of a relief rally could take place as the budget turns out to be more boring than Burnham's ambitions would imply. Also, last year the auctions just after the budget looked slightly better and gilts rallied on the shortening of issuance maturities. An unwinding of the risk premium would offer up to 20bp of relief for 10yr gilts. Of course, a surprise spending splurge could turn the story quite bearish as this would compound with energy-related inflation fears.

Broader political risks, however, are likely to stay, and early elections could be the next surprise for markets to deal with. We've learnt from France that markets attach more value to political stability than to the decimal place of the fiscal deficit. If Burnham decides to reopen the political battleground, we can expect investors to take a more cautious approach again to gilts. Until inflation is under control, any government spending promises would quickly translate to more upward pressure on gilt yields.

Gilt auctions holding up better than ahead of last year's Budget



Source: ING, DMO, Macrobond

Auctions filtered for Normal Type and 8-12y Tenor

It seems the US 10yr is waiting to tick this FOMC meeting off before it deviates too much from 5%

A solid performance for US Treasuries in the past couple of weeks has acted to reduce the prior tightening impulse that had gripped the market. The 10yr yield below 5% obviously contrasts dramatically with the prior break above 5.25%. We're not convinced that the more recent downward lurch will persist. But its genesis lends itself to a softer approach from the FOMC at this meeting.

Whether we remain below 5% for the 10yr yield is a whole other question. We're minded to expect it to snap back above, as we still have inflation, a fiscal deficit, and AI-boom-related impulses at play. The Fed will no doubt remind us of these ongoing pressures. We think it should ultimately move back above 5%; the timing, however, is a tougher call.

It's remarkable how the 10yr yield has been clinging to the 4.99% level. It's like a comfort level; technically below 5%, but not too far below in case it needs to turn tail and shoot back up again. A super dovish Warsh would validate its recent break below 5%. In contrast, a super hawkish Warsh (without an actual hike) would tempt it back above. Anything in between (which is most likely) would leave it where it is.

We're likely still some way from the Fed spelling out a plan to shrink its balance sheet, which we know remains a policy objective for Chair Warsh. We expect recommendations from the various committees to surface closer to the turn of the year. Meanwhile, liquidity conditions are stable, with repo behaving far better than it did a year ago.

Wednesday's events and market views

The FOMC meeting will be the highlight, but European markets will be closed by then. Data releases include US weekly MBA mortgage applications and wholesale inventories for September. Neither are market-moving.

In terms of supply, Germany will auction €5.5bn of 10y Bunds. The US will auction a new 2y FRN for a total of $30bn.

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