Market Summary and Related Views (USD, GBP, EUR)

RBC Capital Markets

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Outline

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Market Overview

- **Fed Funds Target**: **4.25%–4.50%**. At the July meeting, Powell held rates steady as expected, citing continued uncertainty from tariffs and rising inflationary pressures, notably from the risk of a potential US strike on Iran (with Brent Crude projected at **$130/barrel**).
- Growth projections were revised lower, raising concerns over a slowing economy, now forecast at **1.4%, down from 1.7%**. This may reflect early signs of tariff-related drag on economic performance. The Dollar Spot Index is down **7% year-to-date**, Options markets are signaling a shift away from the 'safe haven' greenback, **with rising demand for euro-linked options** as investors seek hedging exposure in Europe.
- A similar picture emerges with the BoE, which also held rates steady at **4.25%**. However, a surprising **6/3 dovish split vote** caught markets off guard, suggesting a shift toward gradual rate cuts. **WIRP<GO>** now implies a **78% probability of a 25bps cut** in August.

Market Overview

- A surprise shock to retail sales last Friday, with figures coming in at **-2.8% from 1.3%** last period — marking the **sharpest decline since 2023**. This points to a weakening retail sector. A number of factors may have contributed: inflationary price pressures, trade disruptions, and cautious consumer sentiment. This creates significant uncertainty around the direction the BoE will take in August.
- GBP/USD is down **-0.87%** on the week, showing turbulence following the earlier rally that pushed the pound up **0.26%** against the dollar this month. This likely reflects volatility from rising concerns over UK growth and potential rate cuts, **widening rate differentials with the US**.
- Lastly, in the Eurozone, the ECB cut rates by 25bps to a 2% target in June amid cooling inflation and a weaker growth outlook driven by tariffs. Decision-makers appear near the end of the cutting cycle — 'Cautious Dovish'.

Market Overview

- The SNB also cut by **25bps to 1.25%**, citing weak inflation and a strong CHF. Norges Bank surprised markets with a **25bps cut to 4.25%**, the first since 2020, signaling further easing. Riksbank **held at 3.50%** in June, with further cuts likely if inflation remains subdued.

Yield Curve Predictions

We focus on two key points:

US Yield Curve

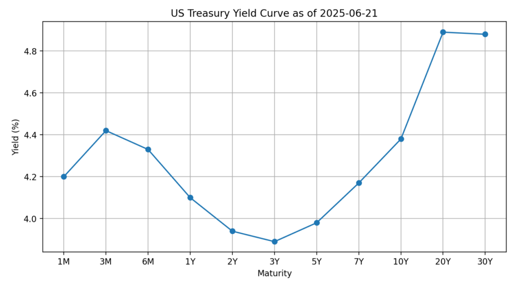
With crippling US debt and underfunded tax cuts, the uplifted long-term bond market faces a long road ahead. Coupled with strong inflation from tariffs and a Fed seemingly pressured into cuts to boost growth, **we observe steepening at the long end of the curve**. Traditionally, higher yields support a strong dollar, but a speculative move by Trump to devalue it for trade purposes is breaking that link. So, how will the US fund its ever-increasing fiscal deficit? Forecasts show the dollar could plunge **by more than 10% at the end of the year, leading investors to demand even higher term premiums**.

Monitoring pension fund flows is key. Large funds in Asia and Australia are shifting to safer assets in Europe, **dampening Treasury demand and pushing up yields**.

How Does The Fed Position?

Trade off Between Inflation vs Growth

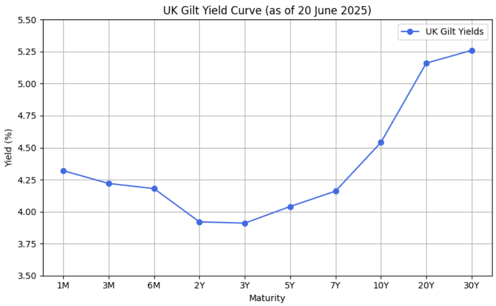
The market is currently pricing in **two cuts by the end of 2025**, but inflationary pressures and uncertainty in the Middle East lead me to believe **only one cut should be priced in**. That said, this view remains **highly dependent on incoming US growth data**. The Fed must also consider how cuts would impact borrowing costs $->$ rate cuts could trigger a spike at the long end due to inflation fears. As such, **upcoming 10y Treasury auctions in July will be key to watch**.



Uncertainty for the UK

Outlook On Inflation

The UK is arguably in a similar position to the US. As mentioned earlier, we've seen a weakening retail sector and signals supporting a potential rate cut in August. The BoE appears squeezed, while the June 18th CPI print showed cooling inflation (**core CPI at 3.5%, down from 3.8%**), underlying pressures remain. Notably, goods inflation jumped from **1.2% to 2%**, partly offset by falling transport costs. We hold the view that persistence of inflation, potential rate cuts and tensions in the middle-east will **push up yields on the long-end of the curve with short-term yields falling**.



Uncertainty for the UK

Descison In August

Slowing growth and a softening labour market add deflationary pressure, but Middle East tensions complicate a potential August cut. We see a **25bps cut in August** as likely, supported by a **78% market-implied probability and swap pricing**. However, this view hinges on upcoming inflation and growth data. Given the high levels of uncertainty surrounding crude prices and the BoE's gradual approach, we believe **two cuts by end-2025** are reasonable. The 6/3 dovish split suggests a shift in mandate, possibly prioritising growth over inflation. If the Fed holds while the BoE cuts, a weaker pound could follow, raising the question: will the BoE align its cut with the Fed?

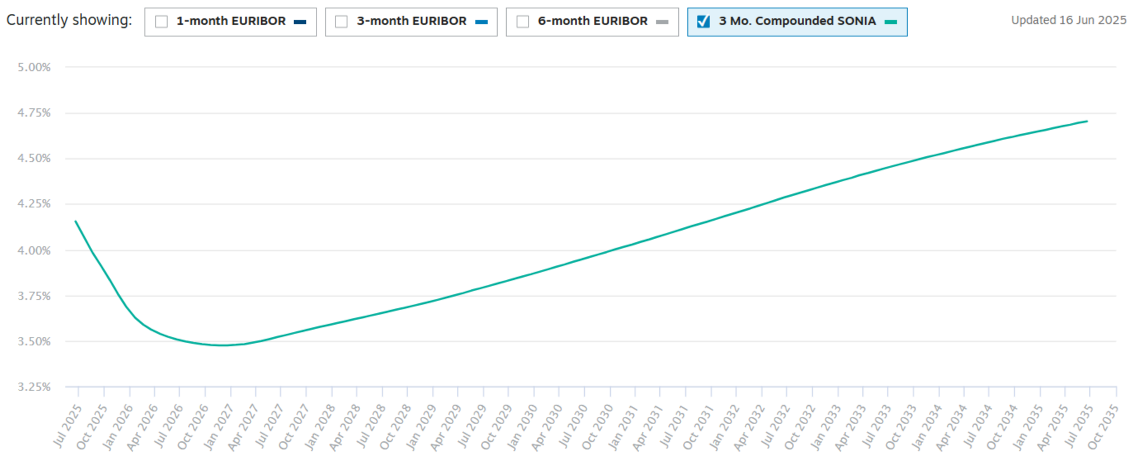
Outlook On The ECB

Decision in July

The Eurozone arguably holds a more predictable stance, the ECB has **cut rates 8 consecutive times to 2%**, signaling it is near the end of a dovish cycle. With inflation **close to the 2% target** and a **strong euro**, the ECB is well-positioned to manage sudden shifts in the economic backdrop. Tensions in the Middle East pose upside risks to oil prices, which could weigh on large exporters like Germany. Some ECB officials, such as Centeno, argue that **GDP remains below potential** and the economy is not yet in equilibrium, suggesting room for one more cut in July. However, we hold the view that **rates will remain steady**, with flattening at the short end (<2Y) and **mild steepening in the long end**, largely driven by strong flows into Europe as a safe haven, **creating heavy demand for 10Y and 20Y bonds**, pushing prices up and yields down.

SFI Z5/Z6 Flattener

- We expect the Bank of England to cut rates by 25bps in August, beginning a gradual easing cycle. To position for this, we propose a **3M SONIA flattener: long Dec 2025 and short Dec 2026 futures**. This reflects our view that the front end will rally more than the back end, **narrowing the spread and generating positive returns** if our rate path materializes.



GBP Receiver Swap Position

- This position hinges on the same fundamentals as the flattener trade but offers a potentially **riskier** way to express the view that the BoE will cut rates in the future. Essentially, we are **receiving a fixed rate** (the rate at which the present value of each leg is equal, close to the current SONIA rate) and **paying the floating rate**, with the expectation that the floating rate will fall relative to the fixed. As a result, our position has **positive carry and generates net positive cash flows**.