

Rates Spark: A consensus US CPI will not relieve the bearish pressure

The US consumer price inflation report due Wednesday is not the type of report that the Fed thought they would see at end-2024. Squint your eyes and you see a 3% inflation rate for December, and month-on-month rates, that when annualised, are in fact point closer to 4%. This, in part, is why the funds rate cut expectations have collapsed, and Treasury yields are knocking on the door of 5%



Not much relief expected from US CPI

Treasuries were happy that we did not get the 0.3% month-on-month that consensus had for the ex-food and energy PPI on Tuesday. We got a surprise 0.0% instead! But was that really a surprise? Just based off zero knowledge, the December PPI number is practically always either 0.0% or 0.1% (over the past 15 years). There's been the odd occurrence of 0.2% here and there (but just three in total), and one outsized 0.7% in 2021 (when we really did have big inflation). So we were not that surprised to see Treasury yields react back up again, as we actually got what we usually get (a subdued December core PPI MoM reading). And PPI inflation is still running at above 3% year-on-year, vs a pre-pandemic tendency in the 2% area.

Overall annual rates of well above 3.5% do not look too comforting and some of the travel and hotel accommodation-related components also signal the upside pressure to the key CPI release,

which is up next. Here, consensus figures are looking hardly encouraging, with YoY headline and core rates seen at 2.9% and 3.3% respectively. Such figures are unlikely to relieve the market of bearish pressures. The front-end is already fully discounting only one more Fed cut for this year, but it is especially the back-end of the yield where we see more upside on the back of supply and inflation pressures.

To reverse this trend we'd need to see Wednesday's CPI report surprise to the downside. There is a 0.4% MoM rate discounted on the headline number, which is not great to say the least, and the core MoM rate is expected at 0.3%. If that is realised, that would be the fifth 0.3% MoM reading in a row. That annualises to over 4% inflation; not good. The realised YoY rates are in the 3% area, which in itself is not contained enough for comfort. When the Fed first cut in September 2024, it followed a run of 3-4 months of contained MoM readings in the 0.1% to 0.2% area. We would need to get back there for a few months before another cut is even considered.

Persistent bearish undertone in EUR rates, but some minor relief out of France

The bearish pressure for EUR rates remains persistent for now as well. The European Central Bank's Holzman "hoping" to meet the 2% inflation target by the end of the year did not sound too encouraging, citing the challenges surrounding the energy market. Recall that late last year there were hopes the target could be met as early as the first quarter of this year. Nonetheless, the ECB is in restrictive territory and further cuts are likely. Further upside to front-end rates at a "neutral" terminal rate pricing of 2% should remain more muted, leaving the curve more exposed to steepening in our view.

France's new prime minister Bayrou outlined his policy agenda on Tuesday. This included revisiting the pension reform of 2023 with the aim of broadening the support for his new government. He also proposed an upwardly revised deficit target of 5.4% for this year, but kept the 3% as a goal for 2029. The growth outlook for 2025 was revised down to 0.9% from 1.1% previously.

Overall the market did not seem surprised by the shallower deficit reduction target, but took positively to the prospect of more political stability. The 10y spread of French government bonds versus Bunds narrowed by more than 2bp. At a spread of 82bp we still remain closer to the upper end of recent ranges with markets more generally scrutinising fiscal positions of sovereigns more closely.

Wednesday's events and market view

The US CPI takes centre stage but is unlikely to relieve the bearish pressure. Consensus sees core CPI at 0.3% MoM and headline at 0.4% MoM. In YoY terms both core and headline CPI would thus remain close to 3%. Later in the day the Fed will release its Beige Book.

The UK's CPI figure will put the focus on gilts in the European morning as 10y yields remain close to the highest levels since 2008. From the eurozone we will get industrial production data for the bloc, but the main focus is likely to stay on ECB speakers Vice President de Guindos, France's Villeroy and Croatia's Vujcic lined up.

In primary markets Germany is scheduled to tap two 30y bond lines. After Tuesday's syndicated deals from the EU and Greece, the focus today is on smaller SSA issuers.

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