Rates Spark: A hawkish set-up to today's US CPI

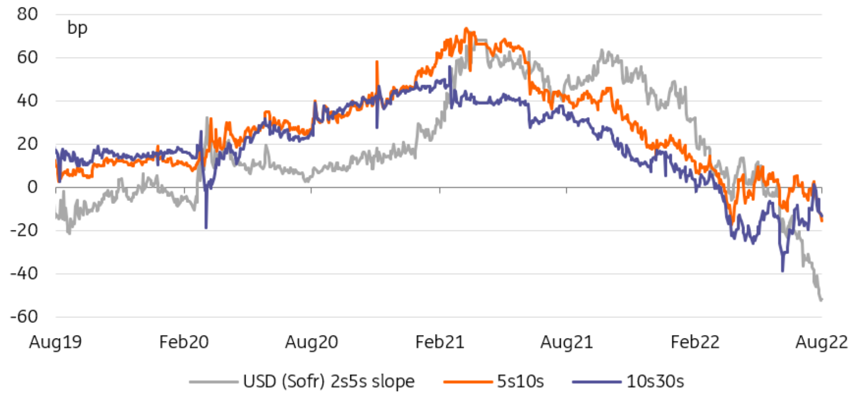
Treasuries go into today's CPI release with a distinctly hawkish tone. This dents the potential move in case of a higher number, but reaction should be concentrated at the front-end. Quantitative Tightening (QT) adds to an already fraught market environment

The US Fed is expected to deliver a 50 basis point rate hike

A hawkish set-up to today's US CPI

On balance, the set up into today's US CPI release is hawkish. The Treasury curve started the week by flattening, both in phases of bond market strength and weakness. This is while the Treasury auctions bonds in the 3Y, 10Y, and 30Y sectors, which one would expect to steepen the curve as the duration of the long-end auction is greater. This does not mean markets have a predicting power on today's release, but the move is likely to blunt the reaction to a greater-than-expected print.

The flattening of the US curve is symptomatic of a more hawkish Fed



Source: Refinitiv, ING

It is easy to reach the same conclusion about the market's mood being hawkish in light of recent Fed comments. The notable pushbacks against a dovish interpretation of last week's meeting has borne fruits, with the curve now pricing a third consecutive 75bp hike from the Fed at its September meeting with a probability over 90%. The hikes priced for subsequent meetings decline fast: less than 50bp for November, and less than 25bp for December. This goes to show that these comments have more influence on how long the Fed will be able to ignore a slowing economy, rather than the economic direction of travel.

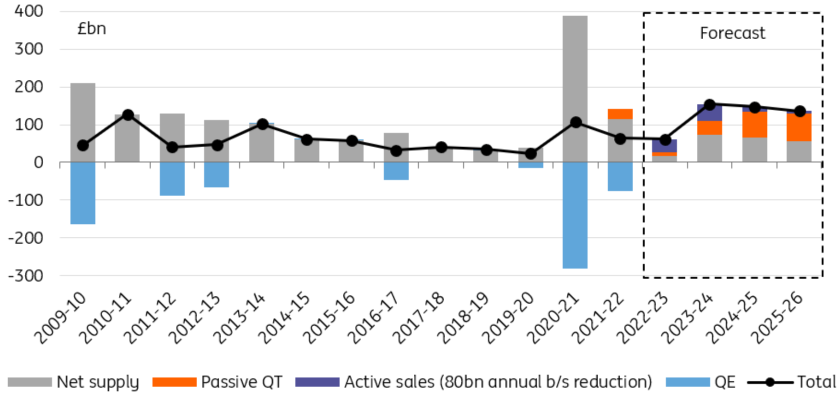
> *Fed comments have more influence on how long the Fed will be able to ignore a slowing economy, rather than the economic direction of travel*

Still bond markets are on the backfoot, even if the pain is mostly concentrated at the front-end. Treasury auctions today (10Y) and tomorrow (30Y) probably add to the upward pressure felt by yields, but we think data continuing to point south will achieve to cap long-term rates. Today's CPI report could indeed push against that trend but, investors will likely remember that inflation tends to be a lagging indicator, even with a backward-looking Fed.

QT adds to an already risky market environment

Of course, an accident in central banks' tightening process cannot be excluded. Dave Ramsden repeated the recent Bank of England messaging that the bar is high to stop gilt sales, once they begin in September. While we agree that the annual rate of £40bn of sales, and £80bn of total balance sheet reduction, does not sound insurmountable when compared to the pace of QE, one would do well to remember that they will add to supply from the debt management office in requiring a record increase in private investment in gilts.

QT and supply set to add a record amount of gilts to the market



Source: Refinitiv, ING

As Ramsden readily admits, the effect of QE and QT is state-dependent. This means that, in normal times, private investors may well be able to absorb this amount of extra debt without flinching. Our concern is that they may prove too much in periods of market stress. This argues in favour of a nimble implementation of sales, with the explicit acknowledgement that they could be put on hold. In a period of rising interest rates, and heading into a recession, this would seem like a prudent course of action.

The effect of QE and QT is state-dependent

If this sounds like another upside risk to government bond yields, it isn't. The risk of an accident when central banks tighten policy via QE does indeed threaten market functioning, but the effect should be sharpest in risk assets, and ultimately draw investors back to the safety of government bonds. Firstly because they will prove to be, once again, the best of a bad bunch, and secondly because any accident would expose the risk of running QT as rates rise, and as a recession looms.

Today’s events and market view

Germany will sell €1.5bn in 30Y debt.

The July US CPI report looms large on today’s event calendar. On an annual basis, headline is due to slow down to a still eye-watering 8.7%, while core should accelerate to 6% according to our US economist. Monthly readings will prove more encouraging, with both core and headline cooling down from June’s red-hot numbers. We read the bond market set-up into today’s release as hawkish (see above), denting the potential reaction to a higher-than-expected number.

The US Treasury will auction $35bn in 10Y T-notes.

The two Fed speakers on today’s schedule, Charles Evans and Neel Kashkari, have already made recent comments but the strong US job report in July, and still hot inflation, might add punch to any hawkish comment.

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