Rates Spark: A US CPI shocker – yields up!

It had been coming. A slow grind, but then a pop – US inflation is suddenly an issue again. Chair Powell says it's not. But it is, and Treasuries know it. Rate cut ambitions have been hit in consequence. Poor fiscal data for January doesn't help. In Europe, the spread between gilt and swap rates to see widening pressure under disappointing growth numbers

US inflation pops, and no rest from the January fiscal deficit data either

A messy Wednesday. CPI inflation has been trending up in recent months, but within zones of tolerance. The January report, however, presented a clear red alert to the Fed. Chair Powell broadly brushed it off as just one number. But in fact a whole series of inflation readings have been trending up of late. Not in a dramatic post-pandemic way. But still, in a frustrating stubborn edge away from the holy grail of the sub-2.5% area. The CPI report itself confirmed inflation is running in the area of 3%, continues to edge up, and the month-on-month readings annualise to the 4%+ area. No wonder the entire Treasury curve shifted up in consequence.

On the front end, the 2yr yield is back up near the 4.4% area (just under). That's now above the effective Fed funds rate (4.33%). It's telling us that if the Fed does manage to nudge the funds rate down later in 2025, it won't be by much, if at all. Indeed the funds rate strip is now sitting at above 4% out to mid-2026. Further out the curve, the 10yr yield shot back up above 4.6%, and was briefly above 4.65%. That's just 15bp below the high seen at 4.8% in mid-January. Another nudge was provided by the fiscal deficit numbers for January, which show the deficit running at 25% above the cumulative 2024 run-rate through October-January (first third of the current fiscal year). DOGE clearly has some work to do!

Meanwhile, the 10yr auction tailed, by about a basis point. Not a huge surprise given the circumstances. In the end though the market is left digesting the inflation story. PPI is up next, and the trend there has also been a slow but steady edge higher in recent months. It's also worth reminding ourselves of the University of Michigan 1yr inflation reading that flashed across our screens last week – it shot up to 4.3%. Now that was a great forward indicator, as it happens.

UK growth numbers could impact the spread between gilts and swaps

Gilt yields were also dragged higher by the move in USTs, but the preliminary GDP estimates for fourth quarter 2024 on Thursday could give some pushback against the bearish sentiment. Consensus sees growth declining on the quarter, and although we see some upside on the back of government spending, the outlook for 2025 remains one of moderation. As we also see inflation numbers come down, we see plenty of room for the Bank of England to keep cutting the policy rate at 25bp per quarter. The short end of the swap curve therefore has room to move lower.

Weak growth numbers could also have a widening impact on the spread between gilts and swap rates, given that supply concerns moved to the forefront last October. The current spending plans of the government rely on a 2% GDP forecast, which is well above our own projections and broader market consensus. If growth dynamics deteriorate further, then expected gilt issuance would likely increase. So far the government has shown reluctance to cut spending or hike taxes to address any spending gaps.

Thursday’s events and market view

Thursday morning will see the release of the UK’s preliminary fourth quarter GDP data. Thereafter the European calendar has only the industrial production data of note, before the attention then turns to the US. The weekly initial jobless claims data is followed by PPI data for January which might get more attention following the CPI upward surprise.

In primary markets Italy will auction 3y, 6y and 7y bonds for up to €5.75bn. The European Stability Mechanism (ESM) has sent out a Request for Proposal for an upcoming transaction – the issuer has not yet been active this year and plans to issue €7bn in total.

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