Rates Spark: All about inflation

The rates rally found its confirmation in German and Spanish inflation data ahead of today's eurozone release, but finally seemed to pause after more hawkish Fed comments. A reassesment of inflation has been the main driver of the EUR rally since rates peaked in October, but the real component still played a larger role in the US

Bull steepening on inflation data, but finally running into some resistance

The bond rally in EUR rates found confirmation in the softer German and Spanish inflation estimates for November. They point to a larger-than-expected drop in today's eurozone flash estimate. For the European Central Bank that means 2024 could bring a first rate cut. Whether this will be as early as the market currently prices remains questionable though. A first rate cut is close to being fully discounted now for April. Overall some 110bp in cuts are discounted for the year as a whole.

The ECB's Stournaras of Greece, one of the more dovish ECB members, told Politico yesterday that he thought markets betting on April were too optimistic in his view. But he did see a cut in mid-2024 as possible. Early rate cut hopes for now ignore the ECB's more cautious approach to inflation having vastly underestimated price pressures in the past.

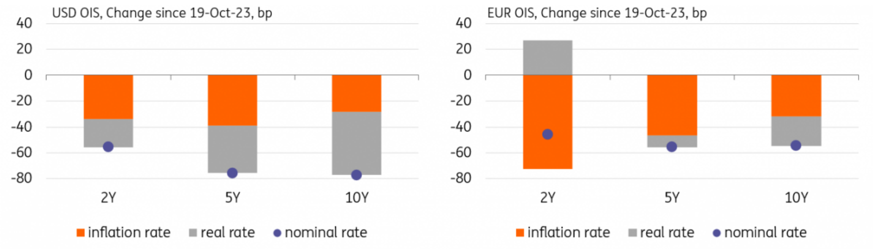
US rates stabilised with 10Y UST yields failing to move past the 4.26% mark, but the front end continued to slide lower with the 2Y yield coming close to touching 4.6%. It was only after hawkish comments from the Fed's Barkin that rates moved higher when he argued it was premature to be talking about rate cuts. The market still begs to disagree and already discounts a 50% probability for a cut in March and more than fully prices a cut in May. US markets discount 117bp in cuts over 2024.

Dissecting the past month's rally in rates

When decomposing the rally of nominal OIS rates since their peak on 19 October into their real and inflation components we find confirmation that the reassessment of inflation has been the main driver of the EUR market, especially at the front end. That should give ECB officials some comfort as the market is rallying for the right reasons, even if the central bank is more cautious on inflation.

In the US inflation expectations have come down notably as well, but the real interest rate component has played a larger role in driving nominal rates lower, especially at the long end where the market had previously been more concerned about the high US deficits.

The inflation reassessment has played a bigger role in EUR markets than in the US



Source: Refinitiv, ING

Today's events and market view

Today's session will still be all about inflation. In the eurozone markets are eyeing the flash CPI for November. The consensus is for a 2.7% year-on-year reading for the headline after 2.9% in October. But following the German and Spanish inflation data yesterday, the actual figure could come in lower. Core is expected at 3.9% after 4.2% last month.

We will also be watching ECB commentary. The usually very dovish Panetta speaks for the first time in his role as the head of the Bank of Italy today. Bundesbank's Nagel is scheduled to speak early in the evening, but we have heard from him already earlier this week.

In the US the focus is on the PCE data, the Fed's favoured inflation measure. Here the market is looking for a 3.0% year-on-year figure for the headline and 3.5% for the core. We will also get initial jobless claims data, which markets have been relying to a greater degree on lately to gauge the temperature in the jobs market.

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