Rates Spark: Energy and food inflation is ringing more alarm bells

Suddenly some inflation alarms are ringing again: energy and food prices are under rising pressure, as are market inflation expectations. We'll get US CPI today, which will paint a picture for July. What's beyond that is becoming a little more nuanced and troubling for bonds

US inflation ahead is key, but so also are the wider impulses which can trouble bonds

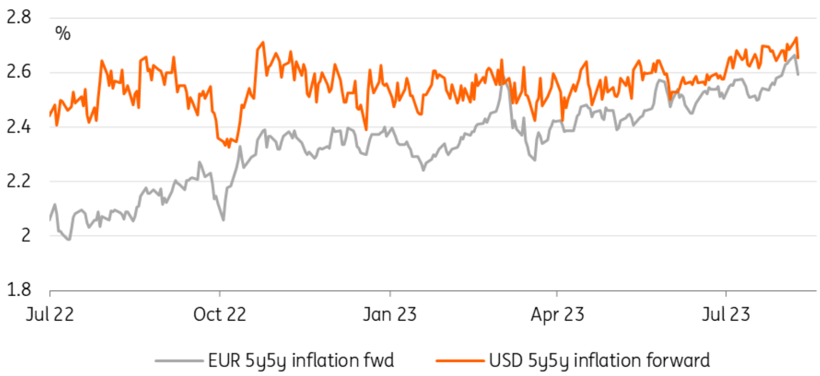
There is heightened discussion on where we are with inflation. While the US CPI reading is key for the near term, there is also an acknowledgement that inflation expectations coming from the market discount have become a little less anchored than they had been.

The 5yr * 5yr inflation rate has returned to the 2.5% area, and the inflation swaps measure of the same has it up in the 2.7% area. These are not awful levels when you consider where inflation was, and at least these expectations are still comfortably below 3%. But it's the path they've been on that creates the issue, as that path has been pointing upwards. At the same time, there is an ongoing rise in food and energy prices in play, which risks adding to headline pressure down the line.

Given this backdrop, the US 10yr has managed to remain above 4%, and we think it should continue to do so. And remember, once we get through tomorrow's US inflation report, we'll likely see headline US inflation closer to 3.5% than 3% and core US inflation closer to 5% than 4%. There's been progress made to the downside, but the burning issue for bonds is whether the inflation threat has actually been dealt a death blow. Based on the market expectations for inflation, it hasn't.

For that reason, we stick to our cautious approach to bonds, eyeing higher yields. We also remain under considerable supply pressure this week. Decent US 10yr auction yesterday. Minor tail, virtually none. High indirect bid, and reasonable cover. Not as good as the 3yr. But it did not tail, as some had feared. The 30yr auction is up next.

Market's long term inflation expectations still trended higher



Source: Refinitiv, ING

Risk to inflation outlook also sets floor to EUR rates

In the eurozone, the upward leg in the longer-term inflation swaps over the past weeks up until the latest correction has been even more striking. Although other measures, such as the European Central Bank surveyed consumer inflation expectations, have displayed further moves in the right direction earlier this week, the recent swings in the price for natural gas also highlight the lingering risk of supply disruptions to the more benign inflation dynamics of late.

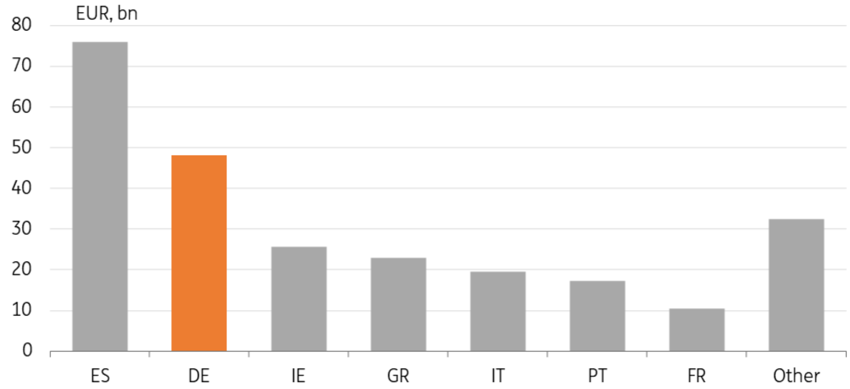
The ECB may have sounded less determined at the last meeting, not having pre-committed to a hike in September. But one should not underestimate the ECB's resolve and persistence. Markets are still seeing a 70% chance for one more hike, even if a bit later than September. Further out, though, there is already a full discount of three 25bp cuts over 2024, which suggests not too much room for pricing in more.

Collateral scarcity remains a sensitive topic

Bunds moderately cheapened relative to swaps on the back of an ICMA official's opinion that the ECB would not follow the Bundesbank's lead in cutting the remuneration of government deposits at the central bank to 0%. That would mean starting in October, only the roughly €50bn sitting at the Bundesbank would be impacted, but not the remaining around €200bn with other national central banks.

Until October, the actual impact of the Bundesbank's changes will remain a source of uncertainty and likely keep Bunds asset swap spreads elevated, but countering collateral scarcity fears are the ECB's ongoing quantitative tightening, which was accelerated last month and the prospect of higher-than-anticipated issuance from Germany itself. Headlines to that end came from the government which announced yesterday that it was ramping up its climate fund from €30bn to €212bn from 2024 to 2027.

Bundesbank's government deposits are not the largest



Source: ECB, ING

Today's events and market view

US CPI is key today. Expected are an increase to 3.3% in the headline and only a marginal decrease to 4.7% in the core year-on-year rates. This still means that the Fed's inflation target is some distance away, although month-on-month readings of 0.2% for both headline and core point to more encouraging dynamics recently.

The other release that has seen larger market reactions in the recent past is the initial jobless claims. Especially since the last official jobs data was a mixed bag, a more contemporaneous reading might get more weight to gauge the state of the jobs market. That said, consensus is looking for little change with 230k this week compared to last week's 227k figure.

Fed speakers Bostic and Harker are scheduled to speak on the topic of employment later today.

In supply, the US Treasury caps off this week's supply slate by auctioning US$23bn in a new 30Y bond.

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