Rates Spark: Competing narratives

The easing inflation narrative has gained traction, but we have not seen that much pushback yet. Central bank hawks might take comfort in real rates still signalling a relatively tight effective policy stance. In any case, data today should shift the macro backdrop into focus. It is the 'landing' that is more relevant for longer rates

ECB Governing Council member Ignazio Visco said this morning that inflation may come down quicker than the central bank projected

Keeping a firm grip on inflation

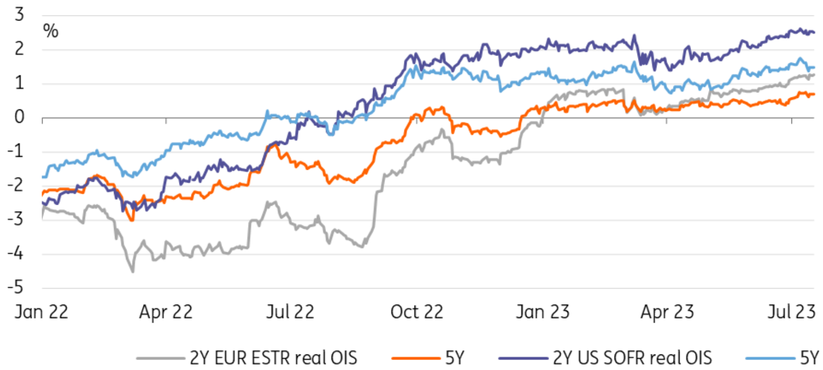
The market has seen a remarkable shift from trading inflation risks on the back of a resilient labour market, toward an easing inflation narrative on the back of one CPI print. The market was quick to extrapolate the surprise, but as of now it's only one CPI print and that hardly constitutes a trend. But a trend is what central banks will need to see before they decide not to change their hawkish bias.

But it is also worth noting that when the effective policy stance as measured by real OIS rates is considered, we are actually close to the tightest levels of the cycle in 2Y or 5Y rates, for instance, both in the US and eurozone. This is especially the case in the eurozone, where there are still a couple of days left to manage expectations ahead of the next European Central Bank policy-setting meeting. This is something the more hawkish governing council members may take comfort in when they see their dovish colleagues becoming more vocal of late. Bank of Italy Governor Ignazio Visco this morning suggested that inflation could fall faster than forecast.

Bundesbank's Joachim Nagel was on the wires yesterday saying that he expects a 25bp hike next week, but that data would decide the September move. Coming from a prominent policy hawk, that sounds slightly more cautious, although he still called for patience saying it is too early to declare victory over inflation. Still, for a market that has another hike after July more than fully priced by the end of the year, it suggests the balance of risks is to the downside for those short rates.

However, longer EUR rates are currently more driven by where the ECB is seen landing after it has tackled inflation rather than by the fine-tuning of the terminal rate. Since late March, for instance, 1-month rates 3 years forward had the highest explanatory power for 10Y swap rates, and that skewed further out the curve increased when considering only the past month.

Despite shifting narratives, the effective policy stance remains relatively tight



Source: Refinitiv, ING

Today's events and market view

There is little in the calendar today to feed the easing inflation narrative, but we should get more hints of a softening growth story.

The main data points to come out of the US are the release of retail sales and industrial production data. Regarding the latter, our economists point out that the ISM manufacturing survey has been indicating contraction for eight consecutive months, while lower energy prices have resulted in a fall in oil and gas drilling rigs operating in the US. Retail sales will be lifted by rebounding auto sales numbers and higher gasoline station sales, but outside of these components, our economist expects sales to struggle.

Incrementally that might push yields lower, but we also caution that the Fed has basically entered the black-out period with the view that one CPI print does not constitute a trend and will not cause a strategy rethink. That would imply that the yield curve might absorb more of the price action with near-term flattening.

In the eurozone, the ECB's Klaas Knot and Francois Villeroy are scheduled to speak. Villeroy recently also pointed out the good news on inflation that was starting to emerge.

Supply will come from Germany in the form of a new 2Y Schatz. The UK will sell 30Y linkers.

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