

## Rates Spark: CPI improvements

The tension between markets eyeing a change in the rating cycle discount and central banks pushing back should raise volatility. Today's US CPI can provide the next directional impulse, with the rates rally having stalled. The US outlook change by Moody's highlighted the upside to rates, but Italy's upcoming review may be more consequential



### The US CPI may be the next directional impulse, after the rates rally has stalled

Pressure on rates starting into this week was on the upside and coming from the longer end of curves. That may well have come on a busier corporate supply slate this week, but without reading too much into a single day's move, we do note that overall the strong rally in rates is fading with the 10Y yield probing levels closer to 4.7% again.

The Fed for one has pushed back on any notion of earlier rate cuts, instead trying to retain a tightening bias. But at the back end of curves, markets are also weighing the weak 30Y auction and news that Moody's attached a negative outlook to the US's top rating at the end of last week. To be sure, other major rating agencies have already stripped the US of its triple-A rating, but the Moody's assessment came as a timely reminder that the structural issues behind rising bond

supply have not been addressed yet.

All eyes are now on the US CPI data to provide the next directional impulse. The headline inflation is seen dropping towards 3%, although the core rate is expected to stay elevated at 4.1%. But against the backdrop of intensifying disinflationary pressures building in the economy recall that our [economist thinks 2% in the second quarter of next year looks](#) possible.

Also of note is that the surprising rise of consumer inflation expectations in the University of Michigan survey, which had spooked markets at the end of last week was not confirmed by the NY Fed's own survey. This saw 1Y inflation expectations nudging to 3.6% from 3.7% while the 3Y ahead held at 3% and 5Y ahead came in at 2.7% from 2.8%.

## Italy's review by Moody's may be more consequential than the US outlook change

While Moody's took action on the US last week, a potentially more consequential decision looms this Friday when Italy's rating is scheduled for review – it stands just one notch above junk and has been coming with a negative outlook since August last year.

The developments on the government's fiscal policy have only since then as has been highlighted also by other rating agencies. A downgrade to junk would send a very bad signal and could push Italian sovereign bond spreads over Bunds wider above recent peaks of just above 200bp. From around 250bp onwards we would get to a slippery slope that could spiral into greater turmoil if the market is not getting reassurance from elsewhere.

For now that latter reassurance would have to come from the European Central Bank. The delay of the discussion to also shrink the pandemic emergency purchase programme's portfolio and hints that the central bank wants to retain some of the flexibility to intervene in bond markets that it gets out of reinvestments also in the longer run has helped calm nerves.

Helpful was also that both Fitch and S&P rate Italy one notch higher, with stable outlooks, and have chosen not to change their assessment over the past weeks when they had the possibility. Yes Moody's acted on the US, but there it was only catching up. On Italy, Moody's is considerably more aggressive than its peers, and it might not want to be seen as the one precipitating market turmoil by charging further ahead.

Getting this final rating risk event out of the way may lead to calmer waters for Italian spreads, though we do not yet see reasons for a broader rally much tighter. The discussions for a new set of fiscal rules to replace the old Stability and Growth Pact are ongoing and bond markets still face the prospect of potentially faster quantitative tightening next year amid still overall elevated issuance.

### Today's events and market view

In an environment where the market starts to play with the change of the rate cycle discount while central banks are still pushing back against any notion of rate cuts, more rates volatility is to be expected. But also against the backdrop of the high-deficit narrative we think there is still a chance, especially for longer rates, to push higher from here.

The data this week could actually be more supportive for lower rates. That includes today's headline US CPI falling to 3.3%, although core will still be in the 4% area. Ahead of the CPI

we will get the National Federation of Independent Business small business optimism index. There is also another busy slate of scheduled Fed speakers, including Williams, Jefferson and Barkin.

In Europe the main highlight will be the ZEW survey and appearances of ECB's Lane and Villeroy. In primary markets eyes are on the new 5Y bond sale and 25Y green bond tap mandated by the EU yesterday. Germany will reopen its 2Y benchmark for €5bn.

## Authors

### **Padhraic Garvey, CFA**

Regional Head of Research, Americas

[padhraic.garvey@ing.com](mailto:padhraic.garvey@ing.com)

### **Benjamin Schroeder**

Senior Rates Strategist

[benjamin.schroeder@ing.com](mailto:benjamin.schroeder@ing.com)

## Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.