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

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

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