Rates Spark: Don’t expect the relief to last long

The US CPI number was okay, as it was better than expected. But it was not a good report. US CPI inflation is still running at around 3%. It is, however, providing Treasuries with an excuse to do some downside testing for yields. We doubt it goes too far, as there is not the ammunition for it. But the bond bulls are overdue a period of positivity

Room for a downward test in yields, even if just to assess how lower yields feel

The market has now seen two better-than-expected month-on-month inflation numbers in a row now, on core PPI on Tuesday and now core CPI on Wednesday. Not that 0.2% is super low. But it it tolerable. If we were to keep getting those, we'd not be far off a 2.5% inflation environment. The year-on-year rate is still running at above 3% though!

Still we saw a big move in the 10yr yield lower, down by c.10bp. And in fact back to where we were before the big payrolls number last Friday. We think this looks a bit overdone, but at the same time the market may well just test lower for a bit here as it has been one-way traffic to the upside for quite some time now.

The Fed funds strip has also dipped back below 4%. It feels like the beginning of a mild retracement tendency till we get the next good excuse to move higher in yields again.

Some relief for EUR rates and especially gilts

The downside surprise in the US CPIs also saw European rates drop noticeably, illustrating the broader influence of US dynamics. EUR rates dropped by up to 10bp led by the belly, while the front end is more firmly seeing the European Central Bank landing at 2%. Previously the market was having some doubts whether a fourth cut this year would happen.

However, this is still up from expectations that rates would go to 1.75% only a few weeks ago. Markets are still grappling with sticky inflation domestically and the challenges posed by energy prices being on the rise again. On Thursday the ECB minutes might reveal to what extent the Governing Council was concerned. Rates were cut by 25bp last December, but the tone of the press conference was less dovish than markets had anticipated.

The outperformer of the day were gilts where long-end rates dropped up to 20bp. This was of course not only the result of the US data but also the encouraging UK CPI earlier in the morning. This already saw 10y gilt yields open 8bp lower on the day. UK CPI had slowed more than expected. Especially the important Services CPI that the Bank of England follows more closely came in noticeably lower than the consensus – 4.4% versus of 4.8%.

Our economist has been calling for a 25bp cut from the BoE in February and the market is now also seeing an increasing likelihood for this outcome. 22bp are now discounted for the meeting versus around 17bp in the days prior. Overall the markets remain more cautious though with the next 25bp not fully discounted before August/September. We still continue to see the BoE cutting more, especially considering that the rise in market rates has contributed to a considerable tightening of financial conditions. But the market may want to see more evidence from the data before buying into such a scenario.

Thursday's events and market view

Following the monthly UK GDP data for November in the morning the first focus of the day are the ECB minutes of the December meeting. Attention will then turn back to the US for initial jobless claims data, import prices and retail sales. The latter should be lifted by firm car sales, but outside of this component, we look for signs of softness, particularly given the weakness seen in recent consumer credit numbers.

In primary markets Ireland is slated for the launch of a new 30y benchmark for which it mandated banks on Wednesday. Scheduled auction supply come from Spain with 5y, 13y and 26y bond taps.

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