Rates Spark: Don't get carried away

Easing US inflation remains the key theme of the week, and we'll see more of that today as trade price data remains negative. This theme is currently dominating the direction for rates – but economic resilience is also having an impact, upping the market discount for how low the funds rate can get. That in turn limits how far the 10yr yield can fall

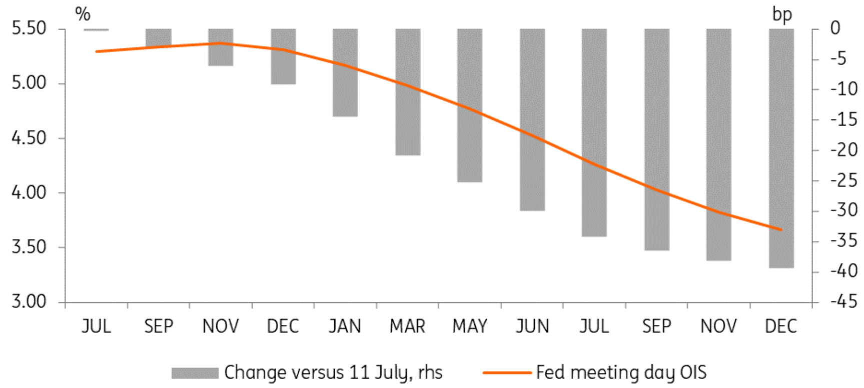
Falling inflation helping to bring rates down, but a firm labour market limits how far they can fall

June data continues to produce some remarkable outcomes. Most of the activity readings have been good, while inflation readings have been subdued. Following on the heels of a taming in consumer price inflation, yesterday's producer price inflation report had more good news. For June, PPI was running at a very subdued 0.1% on the month and at around a tame 2.5% year-on-year. Market rates are really latching on to the deceleration in the inflation theme, especially with data coming in better than expected.

With respect to activity data, the latest jobless claims fell to 237k, showing the labour market still holding up quite well. It's been clear in the past few days that the market has been more willing to believe in the lower inflation risk coming from realised falls in key readings than the higher inflation risk coming from the tightness of the labour market. Yesterday's 30yr bond auction tailed, just as the 10yr did, indicative of poor reception. But tailing into falling yields is no disgrace. In fact, there has been decent underlying demand.

At the same time, note that the market has also priced in a much higher terminal rate for Fed funds when you look out a few years. That's in the sub-4% area, but not that far below the 4% mark. If you take this, and then look at the 10yr yield at 3.8%, there is no glaring value in the latter. We think that's a reason not to get too carried away with the downside for the yields story – at least not just yet, anyway. We've clearly moved back below 4%, but breaking down to prior lows at sub-3.5% is not entirely probable. The firm labour market data is acting to keep rate cut cycle terminal rates relatively high. That's the important counter to the falling yields narrative coming from realised falls in inflation.

Fed pricing has shifted significantly lower with the CPI release



Source: Refinitiv, ING

Calmer waters in the week ahead, with some exceptions

Tomorrow, the Fed will enter into its blackout period ahead of the July meeting. In US data the highlights are retail sales and industrial production, which can shed more light on the resilience of the economy. At least for industrial data, the ISM manufacturing survey does not bode well. We will also see a slate of housing-related data.

The greater focus is likely to be on European Central Bank (ECB) communication with one more week to go before the blackout period. Yesterday's ECB minutes of the June meeting underscored the bank's determination to extend the hiking cycle beyond its upcoming meeting. At the same time, there are signs that the discussion about how much more is actually needed was already picking up. Yesterday saw Governor of the Bank of Greece's Yannis Stournaras even put a small question mark behind the July hike pointing to weaker data, but the September hike should not be taken as a given in his view.

Relevant for Sterling rates will be next week's UK CPI figures, which could be pivotal for the size of the next interest rate hike. For now, the Bank of England is still seen more likely than not to hike by 50bp in August, although terminal rate pricing which had seen rate expectations go up to 6.5% in the wake of the wage data has now eased back towards 6%.

Today's events and market view

The 10Y US Treasury yield has now come off more than 30bp from its recent peak, which takes it well into to the trading range that held until late June.

We'll also see US import prices and the University of Michigan consumer sentiment survey, which could feed the narrative of easing inflation, although we don't see these releases adding any kind of new spin to the narrative.

The only data to note for today in the eurozone is the trade balance for May.

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