Rates Spark: Feeding the doves

ECB President Lagarde's lack of pushback bull steepened euro curves as markets pencil in a high probability of early rate cuts. There may be less dovish sounds in coming days as other ECB speakers take the stage. Thursday's US data had something for all, but were net bullish for bonds. However, the March cut expectation still has some unwind to get done

We think an ECB rate cut is less obvious than the market

US data on Thursday is bond supportive, but we're still not getting a March rate cut. That still needs to be unwound

The strong US fourth quarter 2023 GDP number makes it more likely that first quarter 2024 will be weaker, according to our economist James Knightley. Inventories are going to be making a negative contribution and trade is likely to also swing back to becoming a headwind while consumer momentum is also slowing somewhat. Early days, but we are pencilling in a 1-1.5% figure for the first quarter – the current consensus is for GDP growth of just 0.6%. Also, the Fed's favoured measure of inflation – the core personal consumer expenditure deflator – has come in at 2% annualised for the second quarter in a row. Inflation on these measures has tamed, but growth has not, or at least not yet.

We saw yery jumpy price action. But there is nothing here to accelerate a rate cut in March in any meaningful way, and that's been the biggest driver of the 10yr yield since the beginning of the year. So, it does not surprise to see yields tempted lower on a temporary basis as the price data is indeed good. But the activity data is enough to result in the reaction into next week being one of a further edge higher in the 10yr yield. These are fine lines though as we don't anticipate a big bear market. Far from it, as we see yields lower by mid-year, and well ahead of that. But the stars have not yet aligned to take a second leg lower in yields just yet.

Also an interesting side impression can be taken from the Fed's now likely decision to end the Bank Term Funding Facility when it runs to its natural course in March. We think it's a mistake to end it just now (better to extend for six months), but ending it exudes a sense of Fed comfort on the system. This is important, as if there is no stress to the system, there is no mad need to get a cut in early and run the risk that it's too early. Remember we still have both headline and core CPI rate running with an uncomfortable 3% + handle. The job is almost done, but still not done yet on those measures.

So we see the 10yr yield edging net lower, and we're not surprised by it. But we'd fade the move on a one week view.

Curves bull steepen as markets expected more pushback from the ECB

Thursday's highlight in Europe was the European Central Bank's monetary policy meeting. The main message was as predicted: unchanged. But an immediate 10bp drop of the 2-year Bund yield suggests that markets expected more pushback between the lines against an early rate cut. Lagarde explicitly standing by her December comments about the possibility of summer cuts was probably enough to feed the doves. And while reiterating the importance of wage growth data, she continued by stating that a rate cut decision would be based on a range of data inputs, including the inflation figures from January and February and the March projections. This comment could have had the dovish interpretation that the ECB can start cutting without April's wage data if the other price data comes in low enough.

Despite the dovish interpretation by markets, our economist maintains the view that rate cuts will have to wait until June. Inflation remains closer to 3% than 2% and geopolitical risks have also become more apparent in the ECB's assessment. Only a severe recession scenario would warrant earlier cuts. The bull steepening on the back of the press conference could unwind again in coming days as the more hawkish voices of the Governing Council return to the public.

Friday's events and market view

Friday's main data release is the US PCE deflator for December, although the quarterly data provided alongside the GDP release confirmed expectations of a reading in line with the Fed's 2% target. In the eurozone we will get M3 data as well as the Survey of Professional Forecasters, but the main attention will fall on ECB speakers given the markets' dovish reaction to the press conference. Next to a dovish Panetta, there will also be appearances of the hawks Vujcic and Kazaks.

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