

Rates Spark: Hitting 0.2% is huge

The US 10yr has returned to the 3.5% area, 75bp below the high hit in October. We think the 0.2% reading on core PCE helps to rationalise the move. But we need a consistent run of these, and we doubt that's in the works, at least not in the coming quarter. Given that, this move feels like a mid-cycle overshoot to the downside for yields



Core PCE at 0.2% month-on-month at least helps to validate the fall in market rates

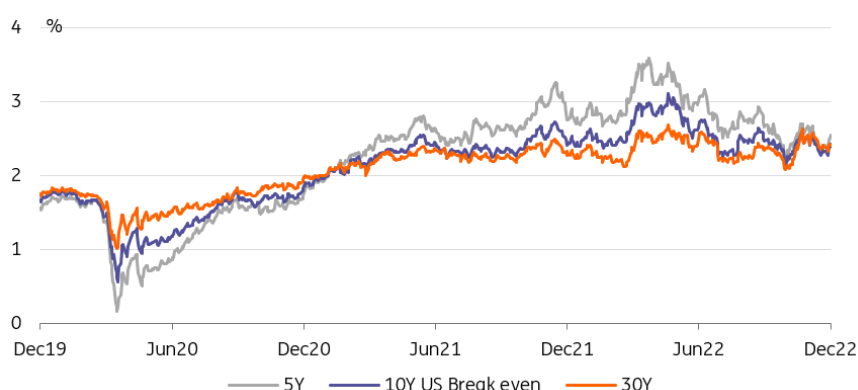
Yesterday's magical hit of 0.2% on core PCE for the US is enough to solidify the move lower we've seen in market rates. Why? The reading of 0.2% annualises to 2.7%. It's fine margins, but that's worlds apart from one notch up to 0.3%, as that annualises to 4.3%. And 0.4% gives 6%, etc. The 0.2% outcome is low enough to secure an annualised inflation reading with a 2% handle. OK, it's still closer to 3% than 2%, but it is something that the Federal Reserve would feel quite good about given where annual inflation currently is.

The fall in market rates started well before we had the November 10th CPI number. That was really a base-effect impacted fall in the year-on-year CPI inflation rate, but took the 10yr yield crashing back below 4%. The subsequent core PCE month-on-month outcome is arguably more significant. The big question now is whether we see this from other inflation readings, or indeed whether we see a repeat from the core PCE number next month.

To really justify the move lower in rates, the Fed needs to be practically done in December

But to really justify the move lower in rates, the Fed needs to be practically done in December. We don't think so, and more importantly, the Fed does not think so (at least not yet anyway). But the market is looking at things through that kind of prism, pulling the terminal fund rate down to 4.9%. While 4.9% technically discounts that the Fed is not done in December and continues to hike in February, the bulk of the volumes are in the first three contracts, which brings the funds rate to 4.7% in February (and falling).

US inflation break-evens rose in the wake of Powell's supposedly hawkish speech



Source: Refinitiv, ING

No more than a mid-cycle overshoot to the downside, pain deferred to 1Q23

Also, it must be noted that players will have a tendency to square up some of the duration and credit shorts set in 2022, in what has been the biggest bear market of modern times. This risk-on mode could sustain if the labour market cools, which is where today's payrolls come in. But it also likely pushes pain into the first quarter of 2023, the pain of resumed upward pressure on market rates and wider spreads.

Anomalously, inflation breakevens actually rose after Chair Jerome Powell's speech on Wednesday, in what is supposed to be an inflation-topping bond rally. The big move lower in rates came from a virtual collapse in real rates; from 1.5% to 1.25% in the 10yr – a massive move! That discounts macro pain ahead and suggests worries about defaults and growth ahead. That appears to be the dominant market reaction post-Powell's speech.

We doubt the 10yr gets below 3% in the rate-cutting cycle ahead

The bottom line is, we think that a 0.2% outcome is significant. It brings us to 3.5% for the 10yr. Note that's a low yield level. We doubt the 10yr gets below 3% in the rate-cutting cycle ahead, so 3.5% is pricing a lot already. From here it really should drift higher, up towards 3.75%. And if it comes to pass that the 0.2% was a one-off (for now), then a return to the 4% area can't be ruled out by the first quarter of 2023. In fact, that remains our central call if the Fed goes ahead and feels the need to hike to 5% at the 1st February FOMC meeting.

We need more than a single 0.2% monthly inflation print to justify Treasuries at 3.5%



Source: Refinitiv, ING

Today's events and market views

The focus is squarely on today's US jobs data. There have been signs already of the labour market starting to cool. This week saw job openings falling, although from still very high levels, while yesterday's weaker ISM manufacturing index saw its employment component dropping 1.6 points to 48.4. There have also been announcements of substantial layoffs, particularly in the technology sector over the past months, which have added to the concerns about the resilience of the labour market.

That said, the consensus is looking for a payrolls growth of 200k this month, down from last month's 261k. That may be still high enough for the Fed to see the need for further action, but low enough for markets to sustain their current risk-on mode. While a 10Y US Treasury yield arguably looks stretched already, we would be cautious to call an end to the rally in the current environment going into year-end.

Of course, further comments from Fed officials will also be followed given this is probably the last opportunity to steer expectations ahead of the pre-meeting black-out period. The Fed's Williams has been out yesterday underscoring that it will take a couple of years to get inflation back to target. Today's scheduled appearances are by the Fed's Barkin and Evans.

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