

Rates Spark: Bonds braced for another inflation pop

A higher-than-expected US inflation print yesterday is likely to be followed by another one today. The FOMC meets next week, and had they not been intimating a cut, a hike could have been a discussion point. No change expected though. Markets remain convinced about a June ECB cut, but are now having slightly less conviction about a total of three cuts for 2024



The US 10yr at 4.7% does not look mispriced

The US 10-year has just touched 4.7%, and there is no sense that it looks mispriced. The 10-year term premium is still close to zero. Back in October, it was 40bp. Add that back on and we have a 5% handle in a flash. The GDP report on Thursday was all about the inflation component, which, again, was hotter than expected. And the prior expectation was hot in itself. Further evidence that the Fed can't cut here. The FOMC meets next week, and if they were to do anything, it would be a hike! (but they will do nothing). If we get 0.4% from the PCE deflator tomorrow we will have further confirmation of an "inflation problem". Some will point to the weak PMIs earlier this week and the headline slowdown in growth from the GDP report as reasons for downward pressure on market rates. But they are not the drivers. It's all about inflation.

With the Federal Reserve a tad slavish to upcoming inflation data, the focal point of the curve is the 10-year rather than a stable funds rate-bullied front end. That makes the curve quite directional, meaning that the shape of the curve is coming from longer tenors. Without a new impulse from the Fed, and with inflation continuing to tick firmer than comfortable, the 10-year Treasury yield is liable to continue to trek towards the 5% area, steepening the curve from the back end. That said, should the Fed surprise us and get ahead of this with some hawkish commentary next week, and even go as far as threatening a hike, then we could see the 10-year yield come off highs on a theory of more Fed inflation protection.

US dynamics showing more spillovers into EUR

On the back of the higher core PCE deflator that came with US GDP data, the Bund curve shifted higher up to 5bp yesterday with a slight underperformance of the 5-year belly. The 10-year Bund yield is now safely above 2.6% with the spread to US Treasury yields widening slightly to 207bp.

EUR rates had looked more prone to being dragged higher after the recently better survey data and also remarks from the ECB hawks becoming more focused on the rates outlook beyond June. A cut in June seems to be a settled case, but beyond that is more uncertain. The ECB's Madis Muller, for instance, argued this week against back-to-back cuts, underscoring the more cautionary tone of late.

Market pricing seems to have taken heed with the OIS forwards now showing less than 70bp of easing priced for the year. That still reflects a bias for a base case of three cuts this year, but the position on a third cut is clearly becoming less firm. Markets' longer-run inflation expectations have also started to drift higher since February with the 5y5y inflation forward testing the 2.4% level this week. The level itself is perhaps not that worrying, but the ECB may eye the trend with some concern. Today, we will get the ECB consumer survey on 1Y and 3Y inflation.

Friday's events and market view

The US PCE deflator will draw the markets' attention. Although much can already be backed out from Thursday's GDP data, the revisions could add some nuance to the number. Alongside this, we have personal spending and income for the month of March.

From the ECB, we expect the outcomes from the CPI expectations survey. The 3-year expectation has remained rangebound around 2.5% over the past few months and is expected to remain anchored. Also from the ECB, the Portuguese central banker Mario Centeno is scheduled to speak, and markets will listen carefully as to whether his strongly dovish stance of recent is reiterated.

The sovereign ratings updates tonight should get some attention with France on the review schedule today for both Fitch (AA-/Stable) and Moody's (Aa2/Stable). With a high expected fiscal gap in coming years, markets see a considerable chance of a downgrade.

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