Rates Spark: Inflation is the theme of the week

ECB rate cut expectations have rebounded at the start of the week on the back of more dovish ECB comments. Friday's flash CPI may not change plans for June, but determine the guidance beyond. In the US, a beat in consumer confidence helped lift rates, underscoring that prospects of one 0.2% PCE print alone are unlikely to rein in a bearish undertone

Eyes on German readings ahead of the flash CPI while ECB comments turn slightly more dovish

EUR rates are looking ahead to the CPI estimate on Friday, the final key data point before the European Central Bank's June meeting. Not that it would change the prospects of a cut then, but rather the communication surrounding it. The wage data last week came in hotter than hoped but was downplayed in an ECB blog post as a one-off. Still, it's not a good look for the ECB, and if we get a negative surprise in the CPI, that could still result in more hawkish communication next week.

In the run-up to Friday's estimate for the bloc, country data will be released over the next few days. Today will see German individual state readings trickle in and then the country reading.

Tomorrow sees Spanish inflation and Friday morning French inflation estimates. In our view, it would take very large surprises to move the needle for June.

But closing in on the next ECB meeting also means final efforts at steering market expectations. Already on Monday, with US and UK markets off, EUR front-end rates repriced lower on the back of dovish comments from the ECB's Philip Lane and Francois Villeroy, the latter not ruling out a second ECB cut in July following the first one in June, which currently looks like a done deal. Arch-hawk Robert Holzmann followed up yesterday remarking that two or three cuts could happen if the ECB projections prove right, but this would not be automatic.

As far as markets are concerned they appear to be leaning towards a 'hawkish' cut already, with only 62bp discounted for the year as a whole. That is up 5bp compared to the end of last week, but still implies that a third cut this year is currently seen roughly as a 50:50 affair.

US data still underpins upside risks to rates in the near term

US markets are also looking forward to Friday's PCE release, but have started the week focusing on US Treasury supply where new 2Y and 5Y notes were sold yesterday. The 2Y yield had moved back closer to 5%, which had already acted as a ceiling for the front end in April as odds of hikes remain low even as they are still not ruled out by officials. On the other end, we think it should stay in this area unless there is a bigger downside surprise in macro data. Consumer confidence yesterday was the main release to watch – and it delivered a positive surprise beating all expectations. For the curve – 2s10s – that means it could turn out more directional from the long end again after the front end retook the driving seat for a brief period over the past week, bear flattening the curve.

As for Friday's inflation figure, the market is looking for a 0.2% month-on-month reading in the core PCE, but it's a close call with the average forecast at 0.25%. And even if we got a 0.2% we think the Federal Reserve would need to see a series of prints at 0.2% or lower before considering a cut, leaving ample time for uncertainty and an upside bias in rates to be maintained (other things equal) until we get the next inflation prints.

Today's events and market view

The eurozone will see the release of money supply data. Markets will focus on the German May inflation estimates as a first glimpse of what Friday's CPI estimate for the eurozone could hold. ECB speakers may use the final opportunity ahead of the pre-meeting blackout period to guide market expectations.

It is a quieter day in terms of US data. The main focus today is the Fed's Beige Book, which provides anecdotal evidence about economic conditions from the Fed districts and also sheds some light on where the Fed's current focus lies.

In primary markets, Germany taps two bonds in the 15Y maturity bucket for €2bn. The highlight is Spain, which mandated a new 10Y benchmark yesterday. The UK will tap a 15Y inflation-linked gilt for £1bn.

The US Treasury sells new 7Y notes after Tuesday's 2Y and 5Y sales.

Author

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Michiel Tukker
Senior European Rates Strategist
michiel.tukker@ing.com

Disclaimer