Rates Spark: Losing buoyancy

Weaker data is eroding the US narrative that has helped push yields higher over the past week. A lower landing zone for the Fed also means a lower floor to long-end rates. There is still more data and volatility in store this week, with the US jobs data looming large. EUR markets will look to the inflation data key input for the upcoming ECB meeting

The Fed discount is eroding and so is the floor for the 10Y yield

Recent data is eroding the narrative of US resilience that had supported the rise of 10Y yields to above 4.3% over the past weeks. Poor job openings data and dipping consumer confidence yesterday saw the 10y falling through 4.2% and then briefly further towards 4.1% overnight. Interestingly the move was largely in real rates, and it reversed all of the gains that they had managed after dipping on the weaker PMIs last week.

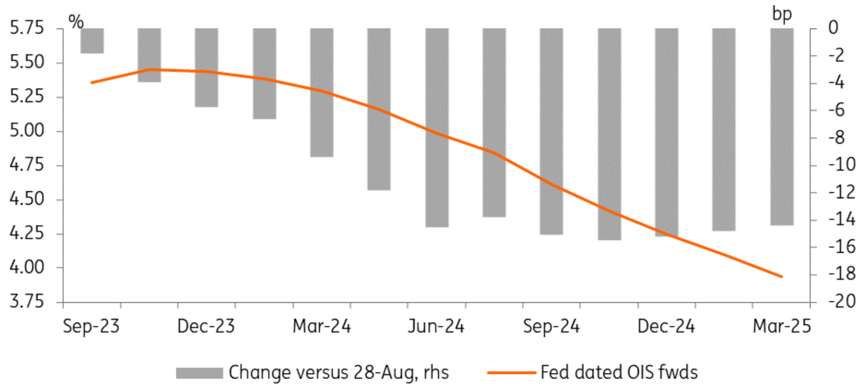
We had suspected that an elevated Fed discount would draw a floor under longer rates. But just as data had shifted this floor higher, data is now hacking away at that discount. The curve bull-steepened with 2Y SOFR swap rates dropping more than 12bp while the 10Y still dropped close to 10bp.

Data this week holds more candidates to push yields around, especially with US jobs data out on

Friday. The consensus is already looking for further cooling with the payroll increase decelerating to 170K, but the unemployment rate is seen steady at 3.5%. Keep in mind that the Federal Reserve itself – in comments and its June projections – has pointed to an unemployment rate of 4% and above as being necessary to cool inflation towards the target rate. The indications it got yesterday are going in the right direction.

A pause in September is widely seen as the base case, with markets firming their view as the discounted probability of a pause moves towards 90%. One final hike is still possible this year, but the discounted chances for that to happen have slipped from close to 70% to a coin toss. Our economist believes the Fed has already reached its peak.

Assessing the Fed's landing zone remains crucial to overall rates



Source: Refinitiv, ING

Aiding the ECB decision process, first August CPI indicators from Spain and Germany

European Central Bank President Lagarde did not provide any further guidance in Jackson Hole with regard to the upcoming meeting in September. From recent comments, it is clear that the hawks on the governing council would still like to see higher rates. Austria's Holzmann had been quite explicit, saying he saw the case for a hike if there were negative surprises until then. Latvia's Martins Kazaks also wants to err on the side of raising rates, while Bundesbank's Joachim Nagel also says it is too early to consider a pause. In later comments, he seemed to soften his tone, suggesting to wait for the data.

Following the dip in the wake of the PMIs, the market has slowly priced the probability of a hike back into the forwards, but still just below 50%. But further out, markets are back to seeing a 75% chance that a 25bp rate hike comes before the end of the year to take the ECB's depo rate to 4%.

We would focus more on the upcoming meeting, however. We also think a September hike at this stage could be more of a coin toss, but more importantly, we sense that the hawks will see it as a last chance to hike one final time. If there is no hike in September, rates will probably not rise any further. One key input to arrive at a final assessment is the inflation data this week, starting today with the preliminary readings from Spain and Germany.

Today's events and market view

It appears that the tide has turned again for rates now that data is eroding the resilience narrative. The latest auction metrics, such as the strong 7Y UST sale last night, also suggest that levels had been pushed sufficiently high to attract demand again.

But the key remains in the data, with the US jobs report looming large on Friday. Today, we will get the ADP payrolls estimate, with a consensus for a weaker 195K after 324K last month. The value of the ADP as a predictor for the official data is questionable, however, as was also evidenced early this month – a large upside surprise in the ADP was followed by a disappointing official payrolls figure. But today's data and anecdotal evidence from the release can still offer insight into the health of the labour market where more signs of cooling have come to light. In other US data today, we will get the pending home sales and the second reading of second-quarter GDP growth.

The main highlight for the EUR markets will be Spanish and German regional CPI data. The consensus is for Spanish headline inflation to tick higher from 2.1% to 2.4% year-on-year. For Germany, the headline is seen falling somewhat from 6.5% to 6.3% year-on-year, but the state of NRW numbers already came in slightly hotter this morning.

Yesterday, supply had initially helped push yields higher before the US data turned the market. Today, we will see Germany tapping a 4Y green OBL for €1.5bn. Italy's bond sales today include a new 10Y benchmark and will amount to up to €10bn in total.

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