Rates Spark: Mean reversion to 4% can't last forever

In a way the path for inflation is convincingly lower, and bullish for rate cuts and bonds. In another, there is ample evidence of inflation being stuck at above 3% (in both the US and eurozone). Bonds are in trading ranges on the back of that, tight ones. In the background risk assets are down YTD, but in a cheerful mood. Anything can happen on Friday really...

We have a view, a firm one. But the bond market is bring quite cryptic; trading a tight range and feeling all bulled up. Not our (tactical) view

Thursday was a day that requires quite some unpacking. US CPI came in at 0.3% month-on-month. That was broadly as expected, but it was clear that the whisper ahead of the number was for a softer outcome; mostly centered on 0.2%. It leaves us with US CPI inflation running in the 3.5% to 4% area (headline and core).

There are better readings for inflation out there. For example, the PCE deflator is running at 2.6%.

Also, inflation breakevens are significantly closer to 2% (e.g. the 10yr breakeven is 2.25%). The latter in particular are more palatable with Fed hike ambitions than the consumer price inflation data released on Thursday. But still, the consumer price inflation report was not as good as it could have been. The US 10yr reacted by nudging back above 4%. But not by much. It was never convincing, as it dipped back down towards 4%, and upped and downed in the 4% to 4.05% area.

Then, a few hours later, we had the US 30yr auction. It was very fine. No tail, like the ones that had caused consternation in two out of the last three 30yr auctions. It was helped by steady market conditions into auction. The pricing was balanced versus secondary. And there was a strong indirect bid, which helped to minimize pressure on dealers to do any forced takedown. Overall a sigh of relief. The market thought about that for about an hour, and then decided it deserved lower market rates. The US 10yr yield fell back below 4%.

So here we are again dipping above and below 4%, symptomatic of the price action seen since the beginning of the year. It does, however, feel like this market does not want to push too much higher in yield. It seems that the rate cut story has been muted, but remains a dominant driver. At the same time, there is no mad dash for market rates to break materially lower from where they are either.

At the same time there are a couple of geo-political factors that are pushing things around too. First, Thursday saw preparation for strikes on Iran-backed Houti rebels in Yemen, the source of the strife in the Red Sea. There are links here to a wider conflict, and many unknowns. Second, we are leading up to key Taiwanese elections over the weekend. As a gut reaction, the thing to do here is buy bonds. The likely duration is short for these events. But then again, difficult to predict. That rather than the 30yr auction has been the catalyst to lower yields on a short-term view.

As we head into Friday, we'll get a smattering of CPI readings out of the eurozone that will show consumer price inflation running in the range 3% to 4% in the likes of Spain and France. That's a reminder of the job that still needs to be done. And then from the US we'll have further confirmation of subdued pipeline pressure as core PPI comes in at around 2.5%, and the various month-on-month readings in the 0.1% to 0.2% range, where annualisations paint a tolerably subdued picture for producer price inflation.

Markets are keen to focus on the positives here. We find ourselves going against the grain, where we see the reasons to be cautious on discounting cuts too soon. We see good reasons to hold off on the next phase of the build of a bigger rate cut discount. This is all being picked up in the US 10yr yield, that dares not stray too far from 4%.

Our directional view is unchanged. Where do we think the US 10yr can get to around the middle of this year? Likely 3.5%. Where do we see it in on a multi-week view from now? Likely 4.25%. The former is not too far from consensus. The latter is non-consensus. The latter is also not discounted in the forwards. This market is primed for falls in market rates and steeper curves. Setting that presents a negative carry problem that can grind away and cause pain. Bond bulls will need the move lower in market rates to happen soon, else they'll be forced to manifest something closer to our non-consensus view. Geo-politics though is the biggest risk to our view, as that can drive a short-term path to the buying of bonds.

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