Rates Spark: More of the same is needed

The FOMC outcome was mixed. Rate cuts are still coming, but on a delayed path from the perspective of the Fed's dots. But nothing happened from the FOMC to negate the now dominant preference to continue to build a rate cut discount. That pitches 4% as a viable target for the 10yr yield. But if the inflation data fails to sit at 0.2% MoM, then 5% still looms as a risk

Treasuries are on a rate cut-build path unless negated by data/events

Post the more subdued 0.2% month-on-month core consumer price inflation reading, Treasuries have been re-cobbling together the string of weaker observations seen in the past few weeks, and downsizing the importance of the firmer ones. We're back to the build of a rate cut bias, as had been seen in the couple of weeks prior to the firm payrolls report. The 10-year is back in the 4.3% area, and the 2-year at 4.7%. The target for both would be 4% should a rate cut theme really build. The only real issue is timing, especially with the Fed dots now down to just one for 2024.

If the stars align and the Federal Reserve does cut by September, the twist is that there is not a whole lot of room for the 10-year to stay below 4% for too long. If the Fed just gets to 4%, that would imply no term premium in the 10-year and a completely flat curve. Add the large fiscal deficit to the equation and we'd ultimately need to see a material term premium in the area of 100-150bp. That easily brings a 5% yield back into the conversation. But 4% first, provided the data behaves and allows for the build in the rate cut discount, in particular for 2024 delivery.

Meanwhile, liquidity conditions remain ample but on a tightening trend. The past couple of months saw volumes going back to the Fed stalling the area of US$400bn. Extrapolate that and bank reserves will shrink, which will tighten liquidity conditions in a wider sense. The Fed continues to voice a broadly agnostic stance on all of this. This is mostly as the central bank is pre-positioned given the tapering in quantitative easing is already in place. As an aside, liquidity in Treasuries has deteriorated, adding another layer of issues that can spike volatility ahead.

Today's events and market views

Markets are likely to remain particularly sensitive to US data, even if more optimism should be baked into the curve following the CPI reading yesterday. Of interest should be the PPI data for May, where also many elements feed into the Fed's preferred inflation measure – the PCE is due on 28 June. The initial jobless claims, also up for release on Thursday, have recently nudged up slightly, adding to the sense of a cooling jobs market even as the latest non-farm payrolls figure surprised to the upside. Calendars are quieter on the European side, with only industrial production data to note.

In primary markets, Italy is scheduled to sell a new 3-year bond alongside reopening of three other bonds out to the 30-year maturity, all in all for up to €9bn. Focus will later turn to the US Treasury re-opening its 30-year note after Tuesday night's strong 10-year auction triggered a notable rally in rates.

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