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Rates Spark: Nervousness ahead of US CPI

Political uncertainty continues to drive Eurozone bond spreads, including a more noticeable nudge wider in Bund asset swap spreads. The key to overall rates direction stil lies in US data and what the Fed makes of it. A US CPI at consensus today, together with a potentially hawkish Fed, would support a bearish bias

Today's US payrolls report will be crucial in determining the direction of markets ahead

Risk-off in eurozone as sentiment turns more wary

Markets seemed to reflect this weekend's election news with a bit more pessimism on Tuesday. Whereas on Monday yields rose across the board, including for Bunds, on Tuesday risk-off sentiment dominated and Bunds saw an increase in bid. The result was a widening in Bund asset swap spreads, later partially reversed, as well as a bit of bull steepening for euro rates, with the 2s10s Bund curve passing the -40bp handle again.

The amount of ECB easing priced in for 2024 nudged up a few basis points, from 31bp to 34bp, despite no notable data releases and few insights shared by ECB speakers. The move seemed also predominantly sentiment-driven. The French elections bring some uncertainty, which will unlikely abate before the first round on 30 June. We think the risk here should be channelled mostly through OAT spreads and not as such a broad market reaction.

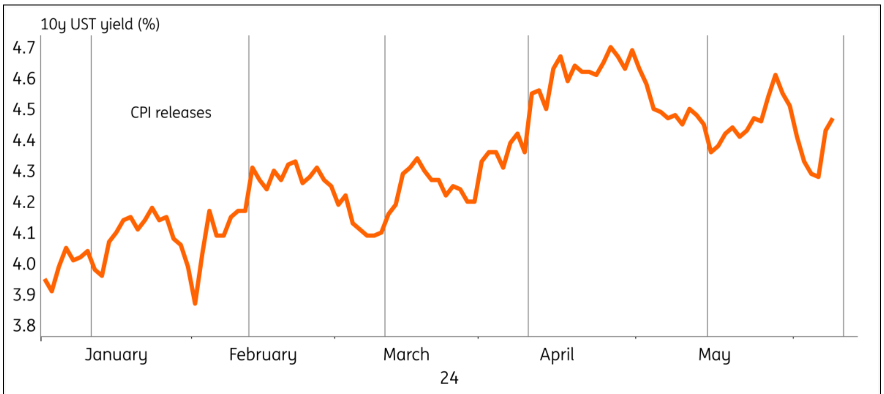
US CPI and the FOMC remain the key drivers of direction

US rates have proved more steady ahead of today's US CPI numbers. Consensus sees the core CPI coming in at 0.3% MoM, with some economists forecasting 0.2% MoM. Releases earlier this year suggest that the US CPI numbers can come with a surprise (see figure below). CPI published in April was also expected to come in at 0.3% MoM, and the 0.4% figure bumped up UST 10y yields by almost 20bp on the day. We also have the FOMC meeting so a lot of data and event risk to digest.

Even if the CPI comes in as expected, we still think the annualised figure is not one that should appease bond markets. The Fed needs at least a series of 0.2% MoM inflation readings to move forward with rate cuts. Previous core PCE – the preferred inflation measure of the Fed – is now at 0.2% but only one such reading is not enough. We maintain an upward bias on UST yields.

With the recently tight correlations between UST and Bund yields, the impact from the US CPI number is set to spillover to euro rates. Even though the independence between the Fed and ECB is stressed again and again, markets seem unconvinced that the ECB can move much further without the Fed starting too. Given the lack of forward guidance offered by ECB speakers and more data being needed for a clearer path forward, we maintain the view that US data will be taking the driver's seat for euro rates.

UST 10y yields have been sensitive to CPI releases this year



Source: ING, Macrobond

Today's events and market views

Markets will first be watching the US CPI numbers and later the FOMC. The Eurozone has little data to offer, but another slate of ECB speakers. The ECB will not want to paint itself into a corner again, and its remarks so far have been very non-commital.

In primary markets Germany will auction €4bn in 10Y Bunds while the UK will sell £0.9bn in 20Y inflation linked gilts.

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