Rates Spark: Not the end of the story

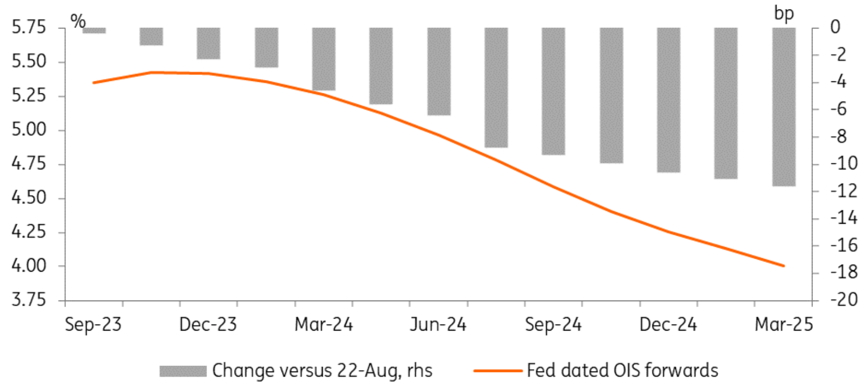
Yields dropped after very weak PMIs. In the US, the narrative of economic resilience that has been the main driver of higher rates over recent months has been challenged. It is but one data point and Fed Chair Powell will also have a word to say at Jackson Hole

Disappointing PMIs upends the resilience narrative

The broader rise in rates had largely been driven by the narrative surrounding a surprisingly resilient US economy. So, when that narrative gets challenged, a large market reaction can be expected. For the US, PMIs would not have been the usual suspect, but when the disappointment in the data is as large as today – and also happening on a global scale – the market takes note.

The UST curve bull flattened with 10Y UST yields falling more than 13bp to below 4.2%. With the data miss as large as it was, the possibility of Fed cuts was priced back in, and the December 2024 SOFR future's implied yield dropped 12bp. The very near-term policy outlook did not change that much – a pause in September is a tad more likely at close to 90% implied probability, with a hike thereafter still being attached to around a 40% probability.

Fed cuts are priced back in, but the trough is still not materially below 4%



Source: Refinitiv, ING

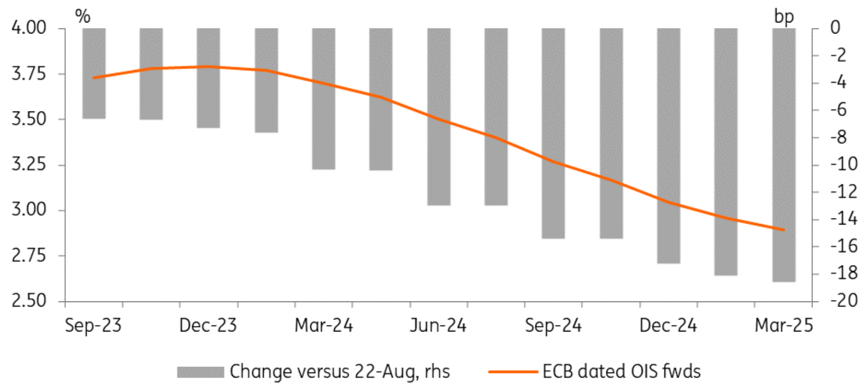
Weak eurozone PMIs but persistent inflation pressures cause ECB headaches

Yesterday's rally, however, began in Europe with the services PMIs coming in a lot weaker than anticipated and falling into contractionary territory. Bunds rallied, pulling USTs alongside, but with the gap widening temporarily to over 170bp in 10Y.

As bleak as the macro outlook that yesterday's PMIs painted appears, inflationary concerns are not going away. The PMI reports indicated an upturn in service sector input cost inflation, i.e. rising wage pressures. Add to this that the market's long-run inflation expectations have also not come down much – 5y5y forward inflation still stands at a historically elevated 2.6% after dropping 3bp yesterday – and it remains an overall uncomfortable situation for the European Central Bank. The ECB hawks may still be tempted to push through a final hike before it is too late.

As for the ECB pricing, markets now see a greater chance for a pause in September. Ahead of yesterday markets were looking for a slightly greater than 50% chance for a hike, now that stands at 30%. it's now the overall probability for a hike before year-end that stands at 50%, having been close to fully priced in the days before.

More ECB tightening is seen as less likely



Source: Refinitiv, ING

Today's events and market view

Should one data point be enough to upend the narrative that has driven the rise in US rates and turn the tide? The 20Y UST auction showed overall yield levels were high enough to attract decent demand again, but a good amount of short covering seems to have been at play in yesterday's reversal as well. When it comes to risk assets, the bad news was good news with equities looking up. In the end, that can also help dampen the bull flattening move.

On the other side, inflation is still residing at elevated levels above the Fed's target. Despite the more encouraging dynamics of late, it is too early to declare victory. With that in mind, we head into the Jackson Hole symposium with the spotlight on Fed Chair Powell's speech tomorrow. The general sentiment appears to be for him to stick to the recent Fed script, if anything with a slightly hawkish risk of more pushback against the pricing of rate cuts.

Today's data slate sees the release of the US initial jobless claims and durable goods orders as the main highlights. After yesterday's data, it seems markets will be more sensitive to any signs of weakness. In primary markets, the US Treasury will sell 30Y inflation-linked bonds.

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