

## Rates Spark: One step in the right direction

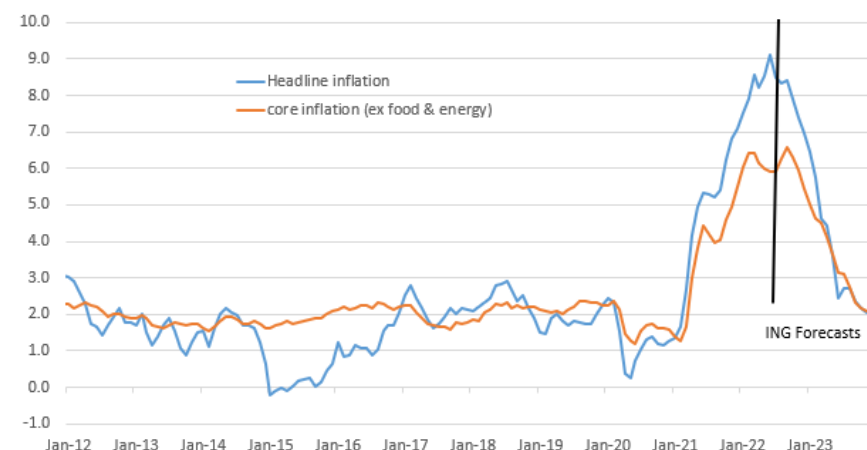
A slowdown in US CPI casts doubt about data, and the Fed's, ability to move long-end rates. Meanwhile, market fundamentals are improving. We see 10Y US yields converging to 2% in 1Q 2023



### US CPI to make the Fed's hawkish communication less effective

A generous helping of caution is necessary when drawing the conclusions of a single economic release, but the July US CPI report suggests that the peak in headline inflation is now behind us. The fall in gasoline prices in particular should ensure that [the August print drops to 8.3% annualised according to our economics team](#), from 8.5% in July, and 9.1% in June. This is all well and good but core could spike again in the coming months before also heading lower. From the point of view of the Fed, in short, it is too early to sound the all clear. More hawkish rhetoric likely lies ahead.

## US inflation should drop over the coming months



Source: Macrobond, ING

---

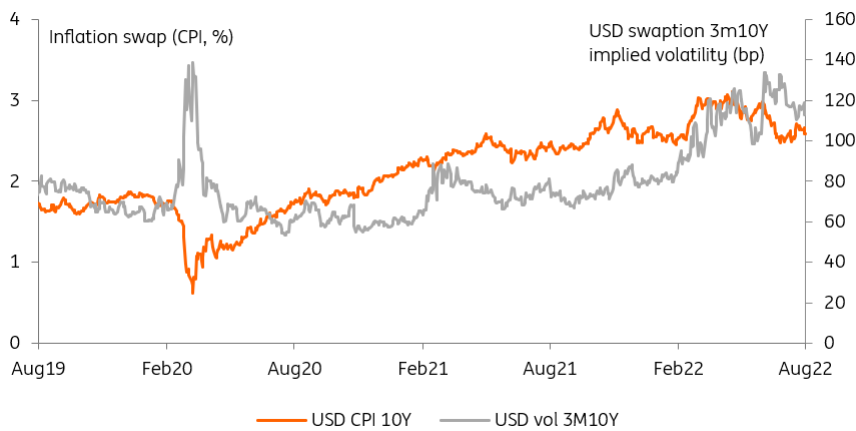
*There is no guarantee that faster QT, if it causes financial stability risk, would push Treasury yields up for long*

---

Of course, the more interesting question for our readers is whether financial markets will listen to another barrage of hawkish comments. Ultimately, the Fed has the ability to push long-end rates however high it wants, but the question is whether it would do so at any cost. For instance, an acceleration of QT beyond the increase already planned for September should in theory push Treasury yields up. The Fed, however, may be reluctant to use anything else than the Fed Funds rate. Firstly because it signalled that it is its marginal tool, and secondly because it would add risks to a QT process already fraught with perils. Finally, there is no guarantee that faster QT, if it causes financial stability risk, would push Treasury yields up for long.

With signals around the Fed Funds rate being its main communication tool, one can reasonably question whether more hawkish comments have the power to move long-term yields much. Even with a Fed signalling that it will rely on backward-looking inflation data (which itself is a lagging indicator of the economic cycle), markets need to price what the Fed's decisions will be months, and even years in advance. Fast forward one year, with much slower economic growth, inflation on its way back to target, and Fed Funds way above neutral, we don't blame the curve from pricing rate cuts. Today's Fed doesn't need to acknowledge that for the curve to price it with a high degree of conviction.

## Inflation swaps are in check and implied volatility is declining, both helping treasury demand

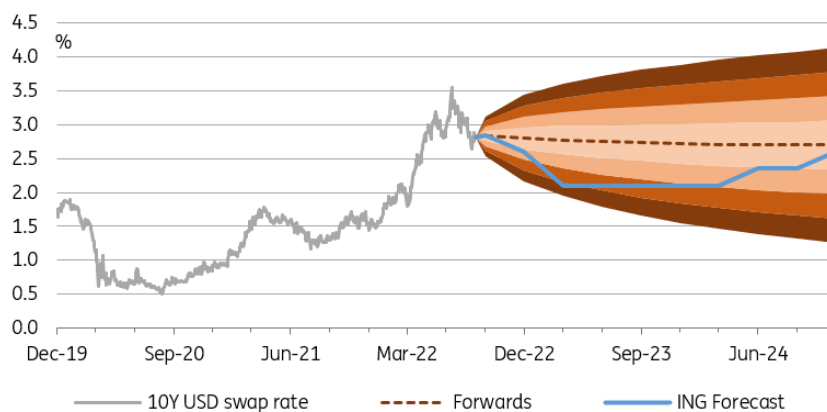


Source: Refinitiv, ING

## 10Y yield set to drop to 2%, as fundamentals are improving

Another unknown in this equation is how demand for Treasuries evolve in the coming months. We have highlighted the fall in inflation expectations removing in recent weeks, one key brake on Treasury demand, but another factor is pointing in the direction of better investors' sentiment towards Treasuries. Implied volatility, and so the perceived riskiness of bonds, is also on the decline. All else being equal, this is an encouraging sign that more investors will be willing to return to this market, and that functioning overall is improving, despite summer trading conditions.

## We expect 10Y US rates to bottom out in 1Q 2023



Source: Refinitiv, ING

*Our forecast for 1Q 2023 is for 10Y yields to converge to 2%*

In summary, 10Y Treasury yields may well test the 3% level in the coming sessions, but this

increasingly feels like a ceiling. Our forecast for 1Q 2023 is for yields to converge to 2%, before climbing back to 2.5% later in the year. A 2% forecast can seem incongruous when inflation is still above 8% but this is backward-looking measure if there ever was one. Swaps suggest inflation will return to similar levels, and temporarily negative Treasury real yields shouldn't surprise anyone if the US finds itself in the midst of a recession.

## Today's events and market view

Hot on the heels of yesterday's US CPI, US PPI is also expected to cool both on the annual headline and ex-food and energy measures. Given that this slowdown is already expected by consensus, and that yesterday's release saw a significant re-steepening of the US yield curve, we think PPI will prove less momentous than CPI. This is all the more true if the barrage of hawkish Fed speakers continues, although today sees no scheduled appearances.

In that regard post-CPI Fed speakers seemed to sing from the same hymn sheet. Neel Kashkari and Mary Daly both repeated that it is too early for the Fed to declare victory after an encouraging inflation report. Although the former pushed back against the idea of rate cuts next year if inflation is still elevated, the latter said a slowdown to a 50bp hike in September is her base case, subject to data published until then.

The Treasury concludes this week's supply slate with a 30Y auction worth \$21bn.

## Author

### Antoine Bouvet

Head of European Rates Strategy

[antoine.bouvet@ing.com](mailto:antoine.bouvet@ing.com)

### Benjamin Schroeder

Senior Rates Strategist

[benjamin.schroeder@ing.com](mailto:benjamin.schroeder@ing.com)

### Padhraic Garvey, CFA

Regional Head of Research, Americas

[padhraic.garvey@ing.com](mailto:padhraic.garvey@ing.com)

## Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit [www.ing.com](http://www.ing.com).