

Rates Spark: setting the stage for the Fed

The US November CPI report released today will skew the way markets deal with the Fed's communication tomorrow. A higher print would be most market-moving.



Source: Shutterstock

US CPI to skew the way the market reacts to the Fed tomorrow

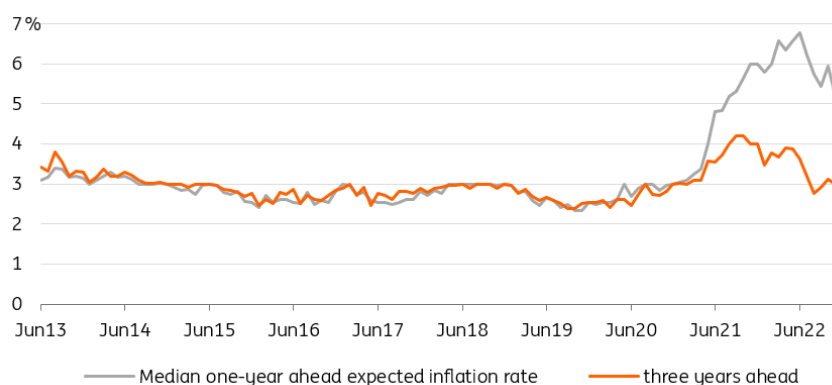
The upside to yields we expected into this week's US CPI release and central bank meetings is materialising, but it is still limited and unlikely to amount to much of a change in market narrative. The predominant view, judging by market moves in recent weeks, remains that inflation is on its way down and should allow the Fed to slow, and eventually stop, its hiking cycle at the coming meetings. Data on that front is encouraging. Consumer inflation expectations in the University of Michigan and New York Fed surveys is, globally, on its way down, and the price components of surveys such as the ISM are also suggesting the direction of travel is lower.

There is no guarantee that inflation continues to converge on a linear path towards the Fed's target

The problem of course is that there is no guarantee that inflation continues to converge on a linear path towards the Fed's target. One key worry, for instance, is that after an initial drop, inflation upside resumes. In that context most, including us, expect the Fed to continue striking a cautious tone at this and subsequent meetings. Since the summer, this has resulted in the Fed pushing back against instances of easing of financial conditions. Lately, that pushback has been less effective, due to more encouraging data. Today's CPI release should be no exception. A core monthly print at 0.3% could take the edge off Powell's hawkish tone, but we think it is a higher reading that would have the most market impact, as it would wrong-foot almost two months' worth of bond rally.

It is still too early to talk about a change in the market's economic outlook. Most telling market moves, the richening of 5Y on the curve and the flattening of the 2s10s slope, have merely stopped, rather than reversed. In addition to the uncertainty about the sign of the inflation surprise today, and about the strength of the Fed's pushback, one needs to add uncertainty about the market's reaction. The speed of the moves since October make a retracement most likely, before rates converge lower and before the curve re-steepens in the course of 2023.

Consumer inflation expectations support the current dovish narrative



Source: New York Fed, ING

Today's events and market view

Italian industrial production and Germany's Zew surveys are the two main releases in the European morning. Consensus is for the expectations component of the latter to continue its bounce back from very depressed levels.

Italy will auction 2Y, 3Y and 7Y debt. The US Treasury will sell 30Y T-bonds.

Both headline and core US CPI are expected at 0.3% MoM which is an improvement on the 2021 and 2022 average but still too high to be consistent with inflation at 2% annualised. Any deviation to consensus is likely to skew market expectations ahead of tomorrow's Fed meeting but the bar is high for market to price a 75bp hike in our view. NFIB small business activity completes the list of releases for today.

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