Rates Spark: Still adjusting to stickier inflation

Rates continued to move higher as Tuesday's core CPI reading reverberates and markets rethink the risks surrounding their Fed outlooks. The ECB presented a framework largely in line with market expectations and thus with little immediate market impact. Few details were provided for the planned structural bond portfolio and liquidity operations

Yields move higher as markets readjust to stickier inflation

Market rates continued to edge higher with the 10Y US Treasury yield moving above 4.18%. While there are other factors such as supply and the risk-on backdrop adding to the push higher, it is also markets still adjusting to the reality of somewhat stickier inflation after Tuesday's core CPI reading.

This also means reassessing one's expectations for Fed easing. The discount for a first Fed rate cut in June has notched back towards 18bp, implying a roughly 70% probability. We have argued that it can go back as far as 50% given what we currently know in terms of inflation readings and jobs data. Ahead of the FOMC meeting next week markets are also contemplating the repercussions from the hotter data for the Fed's dot plot, since not many of the individual dots have to move to shift the median projection away from the currently 75bp of easing flagged for this year. Market expectations for easing over this year have been pared back to less than 80bp – at the end of last week the market was still looking at more than 90bp.

Wednesday's US 30yr auction saw firm pricing, coming at some 2bp through the when issued yield. Yields were rising into the auction, which helps. The indirect bid was also decent, and of course the issue was well covered. But the dominant tone through much of the day pre and post auction was a reverberation theme post Tuesday's 0.4% month-on-month reading on core CPI. There was not much to push things around through Wednesday, leaving the path of least resistance one of a re-edge higher in yields. We think there is still legs in this move, at least until negated. A lower PPI print would certainly help, and especially if in components that can help to contain core PCE deflator due at the end of the month. Barring that, there is room between 4.2% and 4.35% on the 10Y yield.

The ECB new framework is in line with expectations and with little immediate impact

On Wednesday the ECB presented the outcome of its operational framework review. The market impact was very limited given that expectations were already geared towards a demand-driven floor system and many changes will affect the market only after a further balance sheet normalisation. The ECB also decided to leave the minimum reserve requirement unchanged, though previously flagged by news reports it was still a relief for banks.

Liquidity will be provided through a mix of instruments. The ECB foresees a more prominent role for the shorter dated weekly liquidity operations. Alongside the 3m operations these will continue to be conducted via fixed rate full allotment tenders. In order to reduce the current stigma attached to participating in the liquidity tenders, the pricing of the weekly operations will be reduced to 15bp above the deposit facility rate starting 18 September. For now though, the banking system is still flooded with €3.5tn of excess reserves, meaning demand for the liquidity operations could still be muted.

More telling is perhaps what has not been detailed. At a later stage structural longer term operations and a structural bond portfolio will complement the liquidity provision. No indications were given about the pricing or tenors for the operations, and with regards to the portfolio, no indications about composition and maturities. What we do know is that the new portfolio will be separate from Asset Purchase Programme and Pandemic Emergency Purchase Programme, which will continue to be run down. The outlined principle of efficiency, respecting "proportionality" and "net side effects" does hint at a shorter maturity focus as suggested by earlier press reports.

Thursday's events an market view

US data on retail sales and jobless claims will help markets challenge the continued resilience of the US economy. The stickiness of inflation of late should raise the sensitivity towards the US PPI numbers.

In the eurozone we have no notable data releases, but this is more than offset by the significant number of seven ECB speakers, including the influential Schnabel who will speak at the Money Market Contact Group. That should be of particular interest now that the ECB has announced the operational framework.

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