Rates Spark: Not enough to justify any material fall in market rates

Lots and lots of liquidity still washing around, risk being bought on an ongoing basis and a pop in January inflation are all combining to a combination that should not gel with a collapse in market rates. We remain tactically bearish on bonds, looking for market rates to re-edge higher. It won't last, but it's still the way to go from here

Still tactically bearish for choice on Treasuries

We got 0.4% month-on-month for the core PCE deflator for January 2024. In each January of the past three years – the 'inflation years' – we've had either 0.4% or 0.5% MoM. So getting another 0.4% keeps us in the inflationary prone period. Prior to the inflation spurt of recent years, the last time we had a 0.4% reading for January was all the way back in 2007. In all probability the latest 0.4% reading is a one-off, as recent previous readings have been comfortably below 0.4% (and indeed the December 2023 reading was revised down to 0.1% MoM). We'll have to wait till the February readings for core CPI, core PPI and the core PCE deflator to get to back on the notion that the 'inflation years' are behind us.

For now though, this all places ongoing upwards pressure on market rates. Yes market rates fell post the core PCE deflator release, but as noted we really need to wait for the next installments before we can conclude that the only way for market rates is down. At this juncture we're not quite there. The other issue in the background is the extreme risk-on mood that has dominated so far this year. That's an indication of excess, and does not gel with a need for the Fed to cut rates. The same can be said of the excess of liquidity in the system that is, in part, placing downward pressure on repo rates. That liquidity excess, again, is something that makes an imminent collapse in rates unlikely.

Something will change here. Most likely, the inflation pop subsides. Ongoing, liquidity should continue to leak as the Fed's QT continues. And quite possibly, risk comes off as the economy ultimately slows. The last bit is the tough one to sell as it has proven to be quite illusive. It's also why we remain tactically bearish on Treasuries. We're fading the move between 4.25% to 4.5% on the 10yr Treasury yield. We're back to the bottom of that range, but we think we'll maintain it. No change in view given what we know.

Country data already point to mixed signals from the flash eurozone CPI

Markets already have a good idea of what to expect after the first country inflation readings were released yesterday by Germany, France and Spain. While the year-on-year rates dropped, they provided mixed signals with one worrying development being the trend in monthly price increases.

This was enough to push 10Y yields briefly above 2.5% before they were dragged lower again towards 2.42% by the US PCE data. In money markets we observe that the conviction for a first rate cut at the June meeting was pared back a bit. It was more than fully priced going into the day, but now the market seems to take a more cautious view. Front-end rates were thus stickier than the longer rates seeing the spill-over from the US, flattening the yield curve as a result.

Month end may have played a part in exacerbating the move back down, but a 10bp trading range for the 10Y Bunds on Thursday, while larger, is not out of the ordinary when looking over the past month. However, with the ECB in the black-out period there are few events in the Eurozone after today's CPI to change the picture ahead of next week's ECB meeting. More likely is that EUR rates get shown back into the passenger seat by US rates, given the upcoming ISMs and US jobs data next week.

Friday's events and market view

The publication of the eurozone February CPI estimate takes center stage on Friday. The headline year-on-year rate is anticipated to drop to 2.5% from 2.6%, the core rate is seen slowing to 2.9% from 3.3%. We will also get the final manufacturing PMIs with readings for Italy and Spain.

Finally, in the US the ISM manufacturing index should continue to grind higher but remain below the 50 break-even level. As such, the index will have been in contraction territory for 16 consecutive months.

Primary markets are quiet apart from a small reverse inquiry auction conducted by Belgium. Italy enters the final day of its BTP Valore sale wit books now tracking around €17bn after the first four days.

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