Rates Spark: Still worlds apart

The lower-than-expected CPI pushed US rates back into the driving seat, taking Bunds for a ride. But we are also watching hawkish ECB risks that could potentially narrow the UST-Bund spread. We think such tightening is more likely to be temporary and is more inclined to follow the ECB's dovish lead into December, setting inflation risks aside for now

US rates return to the driving seat

US rates markets moved back into the driving seat as the post-CPI rally pushed the 10Y UST yield down 6bp towards 1.28%.

The rationale for a test lower in yields yesterday could centre on an extrapolation of lower US inflation prints ahead. The impact reaction has been a fall in breakevens and a rise in real yields, with the lower breakeven dominating, resulting in mildly lower yields (all referencing the 10yr). At the same time, let’s not forget that even on a lower core CPI number, it still leaves core CPI inflation running at 4%, which remains some 140bp above where the front end of the breakeven curve sits (right out to 5yrs). Not much room here for a big and sustained fall in breakevens; they are still quite low versus where inflation currently prints.

In that sense, market rates still have a valid reason to rise, even on a fall in core inflation. Bouts of risk-off are also preventing a test higher in yields for now. Big picture, the 10yr yield has not deviated too far from 1.3% in several weeks now. Breaks below 1.3% make it technically vulnerable to the downside, but it still feels like yields can drift higher.

It still feels like yields can drift higher

Our economists put yesterday's lower than expected inflation figures down to a moderation in the re-opening hotspots of the past months. However, they struggle to see headline inflation moving sustainably below 5% before the end of 1Q 2022. Core inflation should also struggle to get below 3.5% before 2Q 2022. While those arguing for the transitory nature of high inflation will see their view confirmed, other data released yesterday also offered more hints that inflation could be more persistent.

The National Federation of Independent Business survey showed a net 49% of small businesses raising prices and a net 44% expecting to raise them further in the coming months - both series are now at 40+ year highs.

UST-Bund convergence masks more fundamental drift apart

Bunds rallied in sympathy with the US, but the 10Y UST Bund spread still narrowed almost 4bp towards 160bp. However, we still believe that the two jurisdictions are on different trajectories, even if some of that is muddied by the ECB putting more emphasis on the upside risks to the inflation outlook.

Vigilant without being worried

But Banque de France's Villeroy has aptly described the ECB's stance as 'vigilant without being worried' yesterday. And the ECB has thus laid the basis for a benign rates environment at least in the next couple of months. Any of the upside risks also flagged by the ECB will not show up in the data before then, and given the dovish tone, the market is for now still free to hope for more ECB buying further down the road. This is particularly well reflected in the outperformance of periphery spreads where the 10Y Italy/Bund spread has tightened to cross the 100bp threshold for the first time since June. Yesterday's Italian bond auction also saw decent demand, although at slightly smaller than usual sizes.

The flip side of that rise in optimism is a greater risk of disappointment. Today sees public appearances of the ECB's Schnabel and ECB Chief Economist Lane. The former's position is known from her speech earlier this week, and Lane is a dove. Any hint from him that may weaken the ECB's latest inflation forecasts could also dampen the market's expectations for more asset purchases.

Today's events and market view

10Y UST Bund saw a decent tightening yesterday, but ultimately we believe the two jurisdictions remain on diverging trajectories. Tightening of said spread, especially on hawkish surprises from the ECB, should prove temporary, we think.

In Europe, the focus is on the ECB speakers and how they continue to manage the balancing act of sticking to a resolutely dovish stance amid rising inflation risks. Data sees the release of Eurozone industrial production. The US sees releases of the Empire manufacturing index and industrial production data.

Supply money markets will watch the EU's inaugural bills auction, a 3m and 6m tranche combined for up to €5bn. Yesterday the EU had launched a new 7Y bond raising €9bn and thus leaving another €26bn to fund in bonds before year end.

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