Rates Spark: The inflation story steals the show

As central banks fine-tune their final doses of policy tightening, data such as today's US payrolls remain key. Despite a resilient jobs market, the recent rates rally is more focused on the easing inflation story

More evidence of an easing inflation story

Market rates continue to rally – even if more moderately – as more signs of disinflationary trends gaining traction emerge. Not just in Europe where the flash estimate for eurozone inflation in May showed a larger-than-anticipated drop in core inflation, but also in the US where the first quarter unit labour costs were revised down by a good deal.

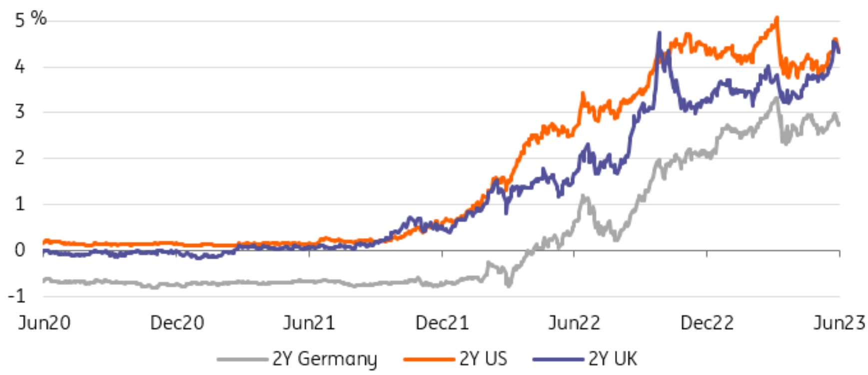
US jobs market data takes centre stage with the Fed at a crucial turning point in its tightening cycle

The US jobs market data usually takes centre stage for markets, especially now that the Fed is seen at a crucial turning point in its tightening cycle. While today's jobs data look set to still show a tight labour market – the ADP estimate yesterday pointed to a 278k increase in payrolls versus an expected 170k – the underlying labour cost story is looking a little less threatening as our economists note. The ADP release itself came with a commentary that pay growth was slowing substantially.

And looking further ahead, the indications we get from the Challenger data on falling hiring – but quickly rising job layoff announcements – point to further cooling of the market. The layoff announcements usually have a long lead on the weekly initial jobless claims data, which so far have maintained levels still consistent with a resilient jobs market.

Recent Fed comments making the case for skipping a hike at the upcoming June meeting might have taken the edge off of today's data release, especially when paired with the mixed bag of other data on the jobs market. In the end, the largest factor for markets to pare their hike expectations is the inflation story. And here the ISM manufacturing index with a substantial drop in the prices paid sub-component provided the market with further evidence of easing pressure yesterday.

Good news on the inflation front had front-end yields retreat from their peak this week



Source: Refinitiv, ING

Fine-tuning the final dose of tightening

The eurozone CPI flash estimate showed core inflation falling. It was the second drop from its peak in March, but in absolute terms a 5.3% reading remains uncomfortably high. Speaking after the release, ECB President Christine Lagarde still stated there was "no clear evidence" that it had peaked and pointed to further interest rate hikes. The market is still close to discounting two more 25bp rate hikes over the next meetings from the ECB.

> *The May ECB meeting accounts showed a bank still preoccupied with the persistence of inflation*

The accounts of the May ECB meeting showed a central bank still preoccupied with the persistence of inflation, pointing out that “developments in underlying inflation had become more worrisome”. Wage dynamics, especially, were becoming a greater concern, but there was also a discussion around rising measures of longer-term inflation expectations and their risk of becoming unanchored.

The accounts also showed a bank calibrating its policies amid increasing uncertainties not only about the outlook but also about the transmission of the substantial tightening delivered so far. This was an argument to slow the pace of hikes to 25bp, with policymakers adamant not to convey any impression that a pause of the tightening cycle was imminent.

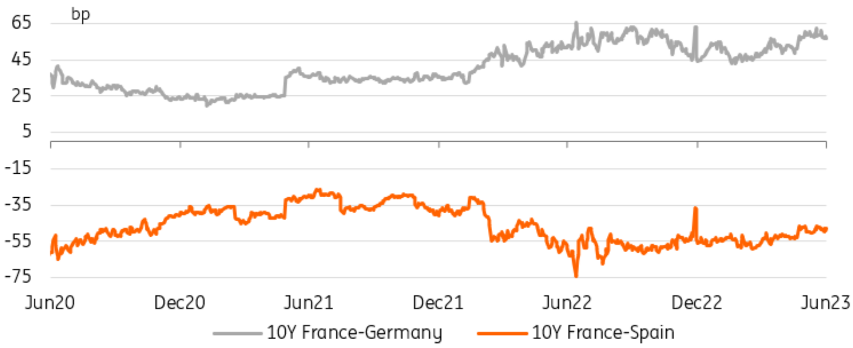
Next week: more on the global backdrop

ECB officials still have a couple of days until Thursday next week to steer market expectations before entering the blackout period ahead of the next meeting.

The Fed will enter its pre-meeting blackout period already this weekend, leaving the focus on the ISM services at the start of the week. The price component should attract the most interest given the strong reading that was seen in April.

With regards to the more general risk sentiment backdrop, Chinese data could shift into the focus again after data this week dashed some hopes for a stronger post-Covid rebound. We will get trade data, CPI and PPI readings as well as credit data for May.

French bonds are trading on the backfoot ahead of tonight's rating review



Today’s events and market view

The US jobs data takes centre stage. Consensus is looking for 195k in non-farm payrolls growth with unemployment ticking up to 3.5% from 3.4% and average hourly earnings rising 0.3% month-on-month versus 0.5% in April.

The market seems more focused on the easing inflation story, and recent Fed commentary making the case for skipping the June meeting has already shifted market hike speculation to July. Only around a 25% chance for a June hike is still discounted, but a larger upside surprise to the tune of 250k and above and higher wage growth could rebuild these expectations.

After the European market closes, eyes are on S&P's rating review of France.

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