

## Rates Spark: The last piece of the jigsaw

There is no doubt concern about First Republic. But it remains an idiosyncratic issue, marshalled as junior to the bigger issue of elevated inflation. Yesterday's US core PCE of 4.9% confirms there is still a job for the Fed to do. In the eurozone, country inflation should give the market a pretty good clue of whether a 50bp hike is likely at next week's meeting



### US core PCE pressure will remind the Fed it still has a job to do on inflation

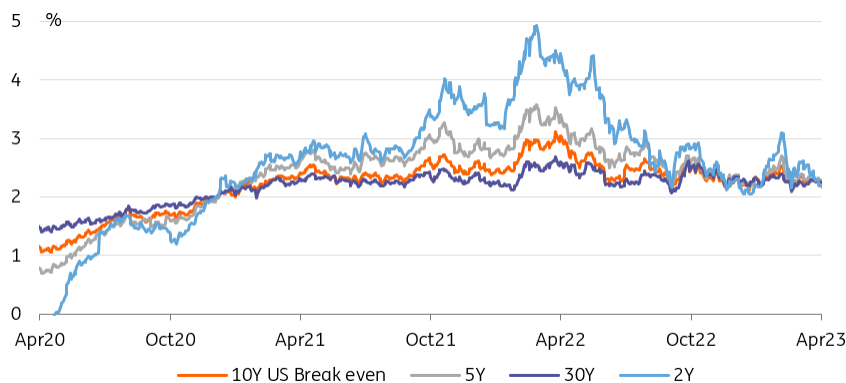
The nudge higher in market rates yesterday reflected the move higher in core PCE to 4.9% for the first quarter of 2023. It's clearly not great, and supports the view that the US remains a 5% inflation economy. Core PCE has, in fact, been in the "5%" area since mid-2021! The market discount from inflation breakevens points to the US becoming a 2% to 2.5% inflation economy in the quarters ahead, but it's taking time. The 2yr breakeven inflation rate is now 2.2%, up a tad post the number. This is still a breakeven that the Fed should like, and to realise this, inflation must be expected to fall below it (in order to average at 2.2% over the coming two years).

## The biggest driver of growth in 1Q was the consumer

But what looks like sticky contemporaneous inflation remains an issue, preventing the market from getting too carried away on the rate-cutting phase to come in subsequent quarters. This is why the market paid little heed to the below-consensus GDP growth numbers. But then again, at 1.1%, while technically in recession territory, growth has certainly not collapsed. And, importantly, the biggest driver of growth in 1Q was the consumer. That said, the tightening in financial conditions should see the balance tip towards greater weakness in the months and quarters ahead, and that will be a catalyst for the 10yr Treasury yield to finally make its way down toward 3%.

We've been clear on one thing in recent months. At 3%, the 10yr Treasury yield would be very low. Think beyond the hikes, to cuts, and to where the Fed is likely to cut to. The market thinks that's around 3%, or slightly lower. We don't disagree. But if that is indeed the case, there would need to be a curve in pace at that point. Having the Fed bottom out on cuts and not to have a curve worth 100s of basis points at that point would be unprecedented. Really the 10yr should be pitched at least at 4% if the Fed bottoms at 3%. Hence, any break below 3% for the 10yr in the quarters ahead should be fleeting. That is unless the expectation builds for bigger cuts; emergency-style ones. Not our view given what we know.

## Inflation has to fall sharply for breakevens to be right



Source: Refinitiv, ING

## Today's inflation prints should seal the deal between 25bp or 50bp ECB hike

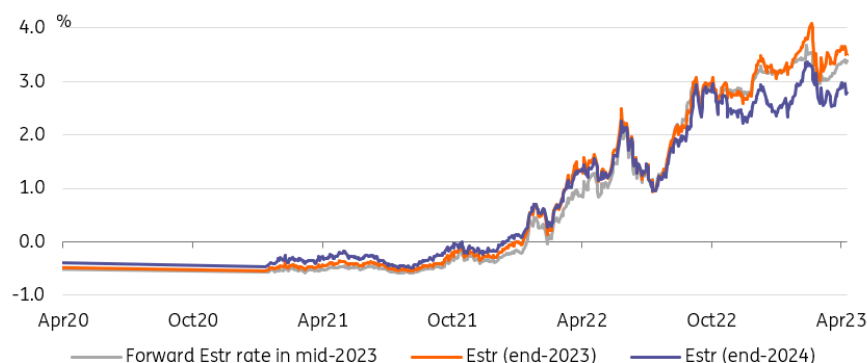
We would argue that, as far as rates are concerned, April inflation is the last piece of the jigsaw missing for markets to make up their mind about next week's European Central Bank meeting. The debate is currently between a 25bp and a 50bp hike, [the former being our and the market's base case](#). In our opinion, only a significant upside surprise could lead the market to think the hawks have enough of a case to convince their colleagues to vote for a 50bp hike. Eurozone inflation will only be published next Tuesday, two days before the ECB meeting. By this afternoon, however, we think markets will have a pretty good idea, as inflation for countries worth around 60% of the eurozone-wide print will be published today.

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The other important piece of information will be the ECB's Bank Lending Survey (BLS). [The minutes of the March meeting](#) were rife with uncertainty about the speed and extent of the transmission of monetary tightening into the real economy. Bank lending is a key channel of policy transmission, and data on that topic is sparse. The reason we think the BLS, also due to be updated on Tuesday, doesn't rank as highly as inflation in investors' minds is that we think the bar is high for it to be used as an argument by the hawks for a 50bp hike. [The last release in January](#) already noted declining demand for loans and tighter lending standards and recent stress in the financial sector means that even an improvement wouldn't allow the ECB to sound the all-clear.

As financial fears recede, hopefully permanently, markets are pricing a one in five probability of a 50bp hike at the April ECB meeting. This probability is unlikely to go all the way down to zero before Tuesday but the odds of it rising would be reduced if today's eurozone member state inflation doesn't accelerate.

## Today's inflation will go a long way to shaping ECB hike expectations



Source: Refinitiv, ING

### Today's events and market view

French, Spanish and German CPI releases today, worth together almost 60% of the eurozone HICP index, will give markets a fairly good idea of what the eurozone-wide inflation number due on Tuesday will look like. We think April inflation is the most important data publication before next week's ECB meeting, but this is not all. Today will also see the release of the advance eurozone 1Q GDP, German unemployment, and Italian industrial sales.

The economic calendar is no less crowded in the US with most of the attention being understandably on the Fed's preferred inflation measure, the core PCE for the month of March. The 1Q advance GDP report published yesterday suggested an upside surprise might be in store for March PCE, and Treasuries reacted accordingly. Other releases include

personal income and spending, and the employment cost index for 4Q 2022, a well-regarded but not very timely measure of wage pressure.

At today's policy meeting, the Bank of Japan left policy unchanged but chose to remove its rates forward guidance, which contained an implicit easing bias. The step, although tentative, could be seen by markets as a sign the bank is edging towards a modification of its yield curve control policy - effectively a 0.5% cap on 10Y JGB yields - possibly as soon as its June meeting. However, the length of the policy review announced by the BoJ today - 18 months - suggests Governor Kazuo Ueda and his team will think of policy changes over longer time frames. The subsequent rally in JGBs is another factor supporting European bonds at the open.

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