Rates Spark: There is still a job to get done

Market expectations of policy easing for the next year are about to get tested tonight with the Federal Reserve likely to signal that there is still a job to get done. Yesterday's CPI was largely in line with forecasts, but with residual strength in some corners of the services sector, the Fed is likely to remain nervous

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The mere 0.1% increase in headline prices seen in the past two months paints a subdued picture for US inflation. Then again, 4% core and 3% headline inflation readings remain elevated and far too deviant from the preferred 2% rate. There is still a job to get done here. If you combine a 4% core inflation environment and a 200k jobs increase (as we saw in Friday's payrolls), there is a valid argument against material falls in market rates.

Following Monday's tailed US 10yr auction, the 30yr auction on Tuesday went better. Or at least pricing was tidier, which proved a relief for a market that was fearful of another larger tail. Events like those have had a material negative impact on Treasuries. But this auction was followed by a downward move in market rates. That's the auction test complete, which leaves the market focus now on the FOMC ahead.

The Fed last raised rates in July and we think that marked the peak. If, as we expect, the Fed sticks to the hawkish tilt and does not give the market too much to get excited about, then expect minimal impact. As it is, the structure of the curve, as telegraphed by the richness of the 5yr, is telling us that a rate cut is not yet in the six-month countdown window. That will slowly change, and we'll morph towards a point where we are three months out from a cut and the 2yr yield really collapses lower.

The ongoing deepening inversion theme is in part a result of the Fed's success in telegraphing the outlook for official rates. The 2yr yield does not yet have the green light to really break lower and drastically steepen the curve from the front end. We need to see either material falls in inflation (and we've not yet had enough of this) and/or a heightened sense of labour market vulnerability. And we're still waiting.

One of the issues that the market is looking at is the stress in commercial real estate. While nothing material has come to the fore, we run the risk every day with the funds rate at 5.5% that at some point, something gives. Emerging stories of growing angst in the multifamily residential rental sector are also having an impact, as is the ongoing monitoring of private credit and its nature of leveraged floating financing.

The market thought process here is a rate cut could not come fast enough. If it doesn't, something could well break. Over to Fed policymakers to hear what they have to say.

Today's events and market view

The market is discounting around 110bp of policy easing from the Fed over 2024 with a first rate cut fully priced by May. Pricing has eased off its most aggressive levels but it will likely still remain in stark contrast to the FOMC's own median policy rate estimate as reflected in the new dot plot. Here we expect the Fed to retain the same 50bp of rate cuts in 2024 that it signalled in the September forecasts, albeit from a lower level given the final 25bp December hike forecast last time is not going to happen.

In today's primary markets, Italy will tap 3Y and 7Y bonds. This will also mark the final supply for the current year.

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