Rates Spark: Those long rates are looking up

There is a rising longer tenor rates narrative building. Japanese and German long yields are on the move higher. Long Treasury yields behave as if they want to go lower, but continue to be frustrated by domestic resilience. It's an interesting combination for the Fed to interpret next week, and ahead of that, we get the impactful PCE report

It's remarkable how US data continues to show material pockets of resilience

Inflation sets the floor for rates, and that floor is currently elevated

The inflation environment should set a floor for market rates on the theory that positive real rates are the norm, and higher real rates are typical as we move out the curve to longer tenors. The only debate is how far above inflation rates need to be. The contrary argument is for inflation to fall ahead. We're okay with that, eventually (pulled lower by a weak housing sector). But for the coming few months, we find it tough to imagine that there is no sting in the tail to come from tariffs, manifesting in higher aggregate prices.

These thoughts will all play out as we examine the PCE report on Friday, and the market will then have a growing focus on next week's FOMC meeting. A 25bp cut is anticipated. Fine for the front end. But the back end has shown a tendency to ignore rate cuts and do its own thing, and price more in line with the pure inflation story, rather than on growing macro vulnerability. Also, the ongoing move higher in German, and especially Japanese, 10yr yields cannot be ignored as it impacts Treasuries from a relative value perspective.

What we're seeing here is a mapping of long tenor rates to inflation environments, and it makes absolute sense. Inflation in Japan is at 3%. In the eurozone it's at 2%. In the US, it's 3%. Build curves on top of those numbers and there is nothing untoward going on when we see, say, the 10yr JGB yield showing an ambition to head for 2%. And when it gets there, it should sail on above.

Pockets of macro resilience a feature for Treasuries

It's remarkable how US data continues to show material pockets of resilience, despite the dominant acceptance that the labour market is under a degree of pressure. The Challenger Jobs report saw another month of sizeable lay-offs, but at the same time, the jobless claims data remains indicative of a relatively firm labour market. The latest orders data was also reasonably upbeat, in particular durable orders. In fact, the probability of a rate cut has taken a bit of a dip in consequence, still really elevated, but now down to 90% (having been at 100% a week ago). And the US 10yr yield is right up at that 4.1% level, as well as clear of 4%.

The Federal Reserve will feel a bit more comfortable on its rate-cutting agenda if Friday's PCE reading for September were to come in at 0.1% MoM on the core measure. The dominant expectation is for it to come at 0.2% MoM, but there is a chance for 0.1% MoM given the benign PPI reading for the same month (there is always an element of rounding involved). At 0.2% MoM, the core PCE number would be 2.8% YoY. That's still too close to 3% for comfort, and that's where core CPI is running. From a rates perspective, this is all very important (as explained above).

Friday's events and market view

The eurozone will release French and Spanish industrial production data as well as the final eurozone GDP data for the third quarter. The ECB's Lane attends a panel session at the CEPR Paris symposium, where Villeroy will give a keynote speech on monetary policy.

In the US, the main focus will be on personal income and spending data, as well as the PCE price index, although both data sets are for September. The more timely indicators of consumer health will come from the University of Michigan's consumer sentiment indicator, which is expected to recover slightly, and the overall change in US consumer credit volumes in October.

After markets close, the rating reviews scheduled for this day are Germany (AAA/Stable) by S&P, as well as Austria (AA/Stable) and Belgium (A+/Stable) by Fitch.

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