Rates Spark: Will tariffs show up in US CPI?

Markets are not fazed by Trump's trade escalation, so far, it seems. Japanese yields keep rising on fiscal and inflation concerns, whilst European government bonds are now looking more attractive on an FX-hedged basis. The big one coming is the US CPI report for June, and to what extent we see the beginnings of tariff-inspired price rises

Brace for a US CPI report that has the capacity to have a big impact

The US consumer price inflation report for June is the big one for Tuesday. The 0.3%'s expected on the month are in part tariff impacted, but the bulk of the tariff impact will be felt from July onwards, where 0.4%'s month-on-month are a risk. These type of data have the capacity to push core CPI inflation up to the 3.5% to 4% range in the third quarter.

There's been a lot of talk of exporters and importers and retailers choosing to take a chunk of the tariff pain, and if we were to get a 0.2% MoM for the June report, such talk would amplify. That is an angle for a more bullish outcome.

It's not our central view though as the balance of the evidence we are seeing suggests at least some material evidence of tariffs in consumer prices. If we get the 0.3% MoM outcomes as predicted, the market likely won't do too much on that. But it would consolidate the 10yr at above 4.4%.

If we were to get a surprise 0.4% MoM, it would really put the cat amongst the pigeons, as the narrative that tariffs are not going to impact consumer prices is rubbished. It would also add credibility to Chair Powell's stance on rates.

This is going to be an impactful report either way.

Markets looking for economic signals among the (headline) noise

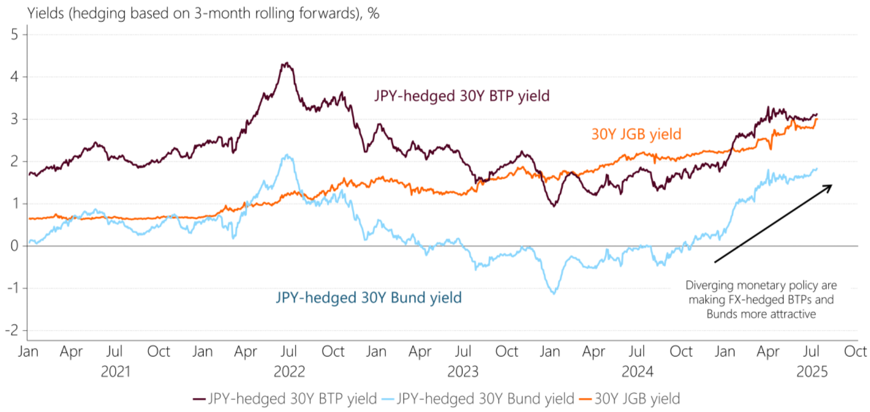
Trump's threat to increase tariffs to 30% on the EU does not seem to faze markets, reflecting the continued wait-and-see approach. Markets will likely be more interested in the impact from Trump's trade tantrums on the underlying economic data. But for any of the upcoming data releases the interpretation will be difficult. Businesses frontloaded their activity before 'Liberation Day', which meant that the eurozone's export and industrial production data for April showed a worsening. We are now getting that data for May, but here we could go in different paths. Either we have more frontloading on the back of the announced tariff delays, or the impact from tariffs will start to materialise. In practice we think it will be a mix of both, making the outcome of such data points a noisy signal for markets.

Japanese investors may look at EGBs as JGBs underperform

The yield curve of Japanese government bonds (JGBs) steepened further from the back-end, pulling global 30Y yields close to new highs. This latest move was driven by a potential upward revision of the Bank of Japan's inflation forecast. The 30Y Bund yield hit 3.25%, on par with the top recorded in 2023. The next move up would bring it to the highest yield since 2011. The global lift of the long end of the curve is not just a JGB story, it reflects the broader fiscal concerns lurking in the US, the UK and to some extent the eurozone.

The fiscal concerns in Japan may chase domestic investors to look elsewhere, whereby FX-hedging costs are moving in their favour. Japanese institutional investors are known to rely on FX hedges to manage their currency exposure. Policy rate hikes by the Bank of Japan and cuts by the European Central Bank reduce these FX hedging costs. Since the beginning of this year, a 30Y Italian government bond (BTP) offers a higher yield on an FX-hedged basis (assuming 3-month rolling FX forwards). As we see more cuts from the ECB and hikes from the BoJ, the 30Y JGBs could remain under pressure as investors seek alternatives.

BTPs now offer a higher yield on an FX-hedged basis than JGBs



Source: Macrobond, ING estimates

Tuesday's events and market view

From the eurozone we have the industrial production figures for May, which consensus sees recovering from a -2.4% month-on-month in April to 1.0%. The ZEW survey from Germany is expected to improve notably. The US will publish the CPI numbers from June, whereby the expectation is for a core CPI of 0.3% MoM, too hot for the Fed's liking.

In terms of supply, we have the UK auctioning £1bn of 7Y gilts. Germany will auction €5bn of 2Y Schatz.

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