Rates Spark: US CPI is key for rates ahead

The 10Y is back in the 4.25% to 4.30% area, and looking for an excuse to dip lower. The CPI report will decide, and the expectation is it will provide a route for lower yields (but watch services prices). In contrast to the US, eurozone markets do not see a rate-cutting cycle building. The 2s10s Gilt curve disinverted, but this may revert again in the near term

US CPI should be supportive, but pay attention to services price inflation which needs to calm more

The 10Y is back in the 4.25% to 4.30% area, and looking for an excuse to dip lower. The rationale for doing so can come from Thursday's CPI report for June. The May report had enough there for us to pivot from being bearish on Treasuries to positioning for a more definite rate-cutting tendency ahead. Our view having seen that report was that it was repeatable in June, and beyond. If that is the case, the rate cut discount for September can harden further.

The June CPI inflation report will be followed by the June PPI report and then in a couple of weeks we'll get the PCE deflator. As it is we're shaping up for bond-friendly outcomes, and on that assumption, Treasuries can continue to perform.

One thing we should pay close attention to is services sector inflation though. It continues to run a tad too hot for comfort. It's the calming in goods price inflation that has really done the disinflation job. Further calming in services prices, and especially in the housing sector would really make for a better CPI outcome, but also has the capacity to have a sting in the tail should the report turn out to be less friendly than expected.

Narrowing spread between short ends reflects diverging policy outlook

The 2Y UST-Bund spread touched the lowest point since March this week, underlining the contrasting directions in policy outlook. Markets in the eurozone struggle to build towards a rate-cutting cycle and the European Central Bank is not giving direction either. As long as economic data doesn't signal significant recession risk, the ECB cannot commit to more cuts. This means that a significant steepening of EUR curves may have to wait till later this year.

Gilts curve vulnerable to inverting again

The GBP OIS curve repriced the probability of an August rate cut lower as the Bank of England's chief economist Pill highlighted persistent inflation, bringing the probability close to 50-50. Nevertheless, the 2Y Gilt has been coming down since the beginning of July, disinverting the 2s10s Gilt curve, which contrasts with the still inverted curves for Bunds and USTs. Having said that, we do think the 10y yield is on the high side at 4.1% considering USTs yields are only just a nudge higher at 4.3%.

In the near term this may mean that the steepening has gone too far, potentially bull flattening the curve. If the US CPI figure comes out favourable, the spillovers from USTs to Gilts will help the back end down. The front end needs a more solid cutting narrative to really come down, which so far hasn't been convincing enough for markets based on the data and could take more time.

Thursday's events and market view

Key data point for the day is the US CPI release for June. Consensus is looking for a 0.2% month-on-month in the crucial monthly core CPI reading. This view seems relatively firm with only 11 out of 66 forecasters looking for a higher 0.3% reading. The other releases to follow are the initial and continuous jobless claims which have displayed a small updrift of late pointing to a cooling jobs market. There will be a few Fed speakers to watch with Cook, Bostic and Musalem speaking.

In primary markets Italy is selling bonds from 3Y to 20Y for up to €7.5bn. The UK sells £3.75bn in 7Y Gilts and the US Treasury will tap the 30Y bond for US$22bn.

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