Rates Spark: Dip in US inflation keeps rates looking down

US CPI has settled down to rate-cut territory. First May, now June. Ahead July, and if that's in the same vein, Treasuries can continue to anticipate cuts from the Fed. The ECB will unlikely commit to a September cut next week, but will also not push back against market pricing of a +80% probability

US CPI is in line for cutting for the second month running

We predicted lower yields and steeper curves for 2024 at end-2023, but we pivoted to a more bond-bearish stance early in 2024 as the US inflation data popped higher. We then switched back to a more bond bullish stance about a month ago, based off the subdued May inflation reading. Since then, we're back on the lower yields and steeper curve view.

The US CPI number for June was even better than May's (lower). The 10yr Treasury yield is now at sub 4.2% and the 2yr touching 4.5%. The 10yr has a target of 4%, and the 2yr has the same target, as the curve should dis-invert completely in the coming couple of months. We've got to get through the July CPI report of course, but looking good so far.

The 2yr yield is now more than 80bp through the effective funds rate. That was in excess of 100bp at the beginning of the year when the rate cut story went into overdrive. This time it feels more real, and so there is scope for 2's to trade lower still. The 2/10yr at -32bp should really continue a material dis-inversion on the back of this, although it typically takes an actual cut to get some material steepening here.

One the other end of the curve, there was a hiccup Thursday as the 30yr auction tailed. It actually tailed badly, by almost 2bp. No significant implications, as on the day the inflation report dominated. As we progress through the next few months, we should note that rate cutting is a curve steepening impulse (from the front end), but so too is the elevated fiscal deficit (from the back end). We get to the same place, a steeper curve (dis-inversion process first).

ECB September cut likely, but this time without precommitment

The European Central Bank's July meeting is already next week, and while no rate cut is expected, this meeting should pave the way towards a September cut. Whereas the cut in June was cemented by ECB comments in the months leading to the cut, this time is different. No commitment will be made, yet at the same time the ECB will also not want to push back too hard against market pricing. Dutch central banker Knot just this week even suggested that he is fine with current market pricing, which includes more than an 80% probability of a September cut.

The ECB will probably reiterate their data dependent approach and is thus unlikely to move the front end of the EUR curve by much. Markets will continue to closely follow US rates as the forward guidance in the eurozone remains open-ended. The ECB may, however, decide to push back against the narrative of a full easing cycle, which would suggest that even after a September cut we could see a pause. If that were the case, then the market pricing of ECB cuts into 2025 may see some reduction.

Friday's events and market view

Following on the heels of the cooler-than-expected CPI print, economists will dissect Friday's PPI print for June to get a better handle on the PCE inflation measure, the one that the Fed is really focused on. The PPI is also expected to look relatively benign, though expectations are still for a slight uptick in the month-on-month print from 0.0% to 0.1% in the headline and 0% to 0.2% in the 'ex food and energy' reading. The other release to watch is the preliminary University of Michigan consumer sentiment survey where a slight uptick is expected.

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