Rates Spark: Bearish on bonds still, but the time for a fade is approaching

US yields remain under upward pressure post CPI, but consider fading the move to come. The overall impact on euro rates remained relatively limited, resulting in wider Treasury-Bund spreads. That's a move that should be faded too in the weeks ahead

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For players that are over-fixed, or feel they've missed the boat on receiving higher rates, consider some swap to floating strategies between here and 4.5% on the 10yr Treasury yield (or approximately 4.25% on 10yr SOFR). And here's why.

Tuesday's US CPI report continues to reverberate through markets. The single standout number was the 0.4% increase in core prices for January. That's a month-on-month outcome; one that annualises to 6% inflation – clearly not what the Federal Reserve wants to see. It's also the highest month-on-month number for seven months, and reminiscent of the run of 0.4% and 0.5% outcomes that we saw for most months over the first half of 2023. Even if we were to regard this 0.4% number as a rogue reading, the 0.3% outcome that the market was expecting was not good enough either, as that would have annualised to 4.2% inflation. And we've had 0.3% MoM outcomes over the previous two months. Bottom line, core consumer price inflation is running with at least a 4% handle on a 3mth annualised basis, and the year-on-year rate of 3.9% is also too high for comfort.

We can of course point to other measures of inflation that are running less hot, but it's the core CPI one that has tended to correlate best with 10yr Treasury yields when a long time frame is taken. It's far better than the headline number, and also better than the Fed's favoured measure (core PCE) that's now trending at closer to 2%. As much as we'd like to, we can't ignore core CPI. We can point to elevation in implied rents as an element that is frustratingly not doing (yet) what it should be doing (easing lower), but until it actually does Treasuries can't be comfortable. Just look at the absolute levels. The 10yr Treasury yield has just hit 4.3%. That implies a very low real yield to the year-on-year core CPI rate, and a large enough negative real yield to the annualized 3mth core CPI inflation rate.

The previous run down to 3.8% for the 10yr yield was all about a mad expectation that the Fed was about to cut next month. Tuesday's number now brings even a May cut into question. Some weaker activity is due this week which can dampen the rise in yields, or even reverse them. But if so, it's likely to be only temporary. Given these inflation data, we'd have to have some very weak number to reverse this move in any meaningful way, at least not for now. The 4.25% to 4.5% range is the one that we have identified as a likely area for a turning point. Post this CPI report, it's now more likely for the turn to be closer to 4.5%. But we stick with the 4.25% to 4.5% range as one within which players should begin to fade into positions that begin to think about getting long the market. No rush on this as we can see yields rising some more first. But now's the time to at start to consider fading the up-move in yields.

UST-Bund spreads widened on US inflation surprise

Trading in the eurozone was also all about the US CPI figure. The 2-year yield led the immediate increase, bear flattening the curve overall. But the total impact throughout the day was not that impressive given that 10-year yields closed just 3bp above opening. Overall this meant that the pricing in of European Central Bank rate cuts nudged outwards only slightly, with markets now seeing around a 45% probability that the first rate cut will have taken place by April.

The muted reaction from Bund yields means that the 2-year spread with USTs has started increasing again, back to the highs just after the strong US payroll figures earlier this month. If markets start aligning spreads more closely with the differences in growth outlook between the US and eurozone, we could see some more widening in the short term. The US economy has remained surprisingly resilient whereas eurozone growth remains in stagnation territory.

Wednesday's events and market view

Wednesday is the UK’s turn to release inflation numbers, which remain significantly above the US and eurozone. Month-on-month headline inflation is expected to come in at -0.3%, down from previous month’s 0.4%, but consensus still sees year-on-year inflation at 4.1%. Core inflation is expected to remain even higher at 5.2%.

For the eurozone we have preliminary fourth quarter 2023 GDP figures coming. Growth will likely stick around 0.0% on both a quarter-on-quarter and year-on-year basis.

Plenty of ECB speakers scheduled, including Vujcic, Guindos and Nagel. From the Fed we have Goolsbee and Barr, and, in addition, BoE governor Bailey is to speak at the Lords.

In terms of auctions, we have 10y JGBs in total of JPY 800 bn. Germany will auction 30y Bunds for a total of EUR 2bn. Portugal has three auctions (6y, 15y and 29y) totaling EUR 1.75bn. Lastly, the UK will auction GBP 3.75 bn of 10y Gilts.

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