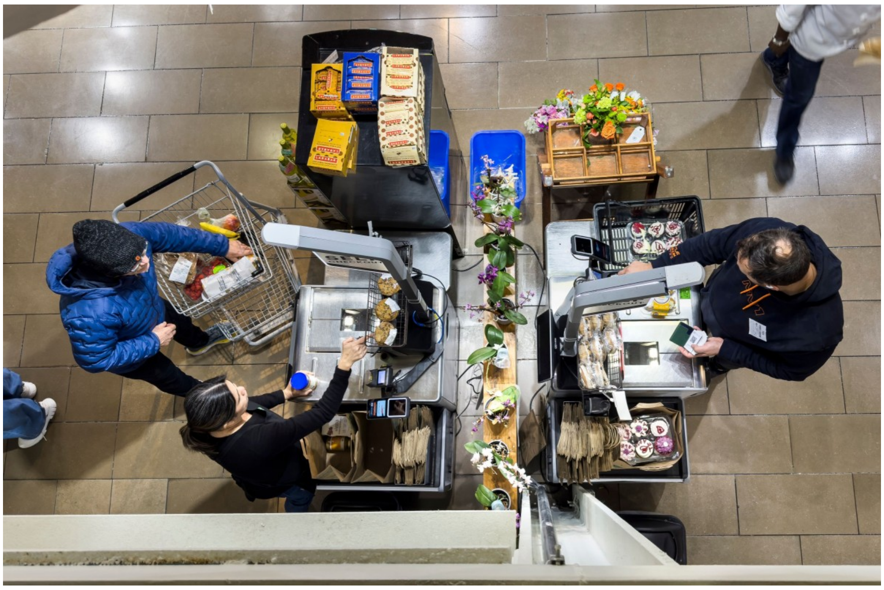
Rates: Worried about stubborn inflation

Delivered inflation with a handle of 3% presents a problem for both US and eurozone bonds. The market is discounting a return to 2% inflation on both sides of the Atlantic, but that needs to be confirmed by realised inflation. We think that will happen, but progress has slowed. That's why market rates can remain under upward pressure for the coming month



We think that sticky inflation on both sides of the Atlantic is likely to keep upward pressure on market yields over the coming month

Market rates are on the rise, mostly as delivered inflation is still too high

So far in 2024, the rate cut narrative has been battered by a selection of events. These include a 353k non-farm payrolls outcome, a core inflation reading of 0.4% month-on-month, and even a nudge up in some eurozone confidence indicators. They have been interlaced by survey evidence pointing to pockets of weakness, and we do believe there is a material slowdown brewing, but the big hitting data is still not where it needs to be to make an imminent rate cut a no-brainer.

As a result, market rates are under rising pressure as the carrot of imminent rate cuts remains frustratingly out of immediate reach. The Euribor 10yr almost touched 4% last week, while the US 10yr Treasury yield briefly topped 4.3%. These levels are up from where they were, but in fact, don’t look particularly high when we consider US core consumer price inflation (CPI) running at

3.9% and core eurozone CPI at 3.3%. These are still well above the desired 2% area, and proving a tad stubborn.

Actual inflation needs to fall towards market implied inflation, or else rates don't fall

Based off market yields versus delivered inflation, real rates are, in consequence, very low. Just 40bp in the US (10yr) and 70bp for the eurozone. Based on this stand-alone metric, there is room for US yields to rise relative to eurozone rates. A theoretical fair value 10yr real rate for the US would be in the 1.5% to 2% area. Adding a 2% to 2.5% inflation expectation on to that would deliver a fair value 10yr yield of 3.5% to 4.5%. Adding a 50bp term premium would see approximately 4% as a neutral 10yr yield.

However, that's based off an inflation expectation of around 2%, whereas actual inflation (core CPI) is closer to 4%. If core inflation were to remain at around 4%, it *must* then place upward pressure on Treasury yields. That's the issue that markets are dealing with currently. The 10yr breakeven inflation rate as backed out from the difference between real yields and nominal yields is 2.3%, based off a market real yield of around 2%. That needs to be justified by falls in delivered inflation, and we're still waiting.

The eurozone shares the same themes, but the issue is bigger in the US

There is a similar dynamic ongoing in the eurozone. The 10yr market breakeven inflation rate is around 2.2%, yet core CPI inflation is running at over 3%. Therein lies pressure for nominal market rates to rise. To prevent that from happening, realised inflation needs to start to move much closer to the implied market rates. We think that will happen, which ultimately results in a resumed rate cut alert mode, and drives market yields back down.

> For now, the market is troubled by the stickiness of inflation at around (or above) 3% on both sides of the Atlantic. That will maintain upward pressure on market yields in the coming month.

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