Rates: Focus on CPI, not activity

US Treasury yields have seen a significant 30bp rise. Retracement risks are there, unless counteracted by higher CPI inflation.

2.3%

10yr Treasury yield

move from 2.05% has been relatively abrupt

The move from 2.05% back to 2.3% for the 10yr Treasury yield in the past month has been relatively abrupt, but also moves the yield back to a level that we view as appropriate. Factors that could tempt a retracement from here include:

Geo-politics (Korea)

Hurricane impacted data

Euro stress coming from Catalonia (and potentially Italy)

Pitted against that is a pure macro focus centred on the prognosis for CPI inflation to edge higher in the coming quarters, forcing nominal rates higher with it.

The Fed's rate hike credibility

On the front end markets continue to refuse to place much credibility in Fed rate-hike ambitions. There are many ways to measure this; one that we like is the positioning of the 5yr on the curve. Before Donald Trump was elected president, a moderate richness was attached to the 5yr which equates to rate hike rejection by the markets.

This quickly changed as Trump was elected. The re-cheapening of the 5yr to the curve correlated with the marketplace inputting more belief that Fed hikes could be delivered. That said, once the Fed delivered the first hike, the market had to be bullied into discounting further hikes. The Fed has delivered two hikes since, but at the same time the 5yr has re-richened to the curve. As a measure of market psychology this shows that the market is pricing in a very benign interest rate prognosis again.

> There are two factors that risk disrupting this balmy backdrop. First, we are of the opinion that US CPI inflation will head into the 2% to 2.25% area in the coming quarters – which is important as to hit a zero real Fed funds rate the nominal rate would have to be hiked by another 100bp (currently 1.00% to 1.25%). Second, while balance sheet unwind eases in with just US$10bn a month, within a year that will be up at between US$30-50bn per month. That equates to between one-quarter to one-third of net issuance. The combination of the two has the capacity to disrupt core markets, to the tune of 10yr rates rising by 25-50bp.

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