

Rates Spark: Inflation is still too high for comfort

We will certainly know more after Thursday's US inflation report. But even if it's good, the US economy will still be a 3% to 4% inflation economy. On top of that the 10yr auction tailed, and the 10yr term premium is negative. We maintain the view that the US 10yr stays above 4%. We'll need a great CPI number to change that



Whatever way the US CPI report due on Thursday swings, we will come out the other side with one remaining reality – the US is still a 3% to 4% inflation economy. That's great compared with the near double-digit measures seen in mid-2023. But it's still nowhere near 2%. Most of the falls from 9% towards 3% have come from base effects. The last bit, the bit to come, is tougher.

Our economists have good and solid views on this, where inflation continues to fall, and we do trend in the direction of 2%. But we are not there yet, and the most worrying aspect is the 0.3% month-on-month expectation for core inflation – annualise that and you get inflation at quite close to 4%. Don't get us wrong. We're not saying that inflation won't fall. In fact, on a conviction view, we expect it will. But we need to be shown the money, as does the market. The Fed will need that too. Hence the rationale for the market to pare back the rate cut expectations that had built through the fourth quarter of 2023.

That in turn rationalises the 10yr Treasury yield fretting about getting too far below 4%. In fact we maintain our view that it should stay above 4%, and has room to lift higher in the weeks ahead. It won't get to 5%, but it could get to 4.25%. The fact that the 10yr auction tailed on Wednesday is not dispositive on this point, but it does push in the same direction. Ahead we have a US 30yr auction, and that has had a habit of tailing in the past few auction events, and has resulted in some material upward pressure. So even if CPI is good, watch the 30yr auction too.

It's at times like these that things like a negative term premium in long tenor rates gets dragged into the conversation, as this as a standalone is also an argument that market rates have room to rise. In the 10yr, the term premium is now -20bp; actually a term 'discount'. Hard to justify this as we evolve towards a rate cutting tendency (and a steeper curve) plus deficit-related pressure that typically correlates with a positive term premium.

The US Treasury has of course been offsetting some of this pressure by morphing issuance to the front end, and away from the back end, and may do so again at the next refunding announcement. But it still remains an issue. We remain tactically wary to play this bond market from the long side until we get evidence that the Fed does in fact have the all clear to contemplate rate cuts.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.