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.

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