US CPI brings volatility to FX markets as real yields yo-yo

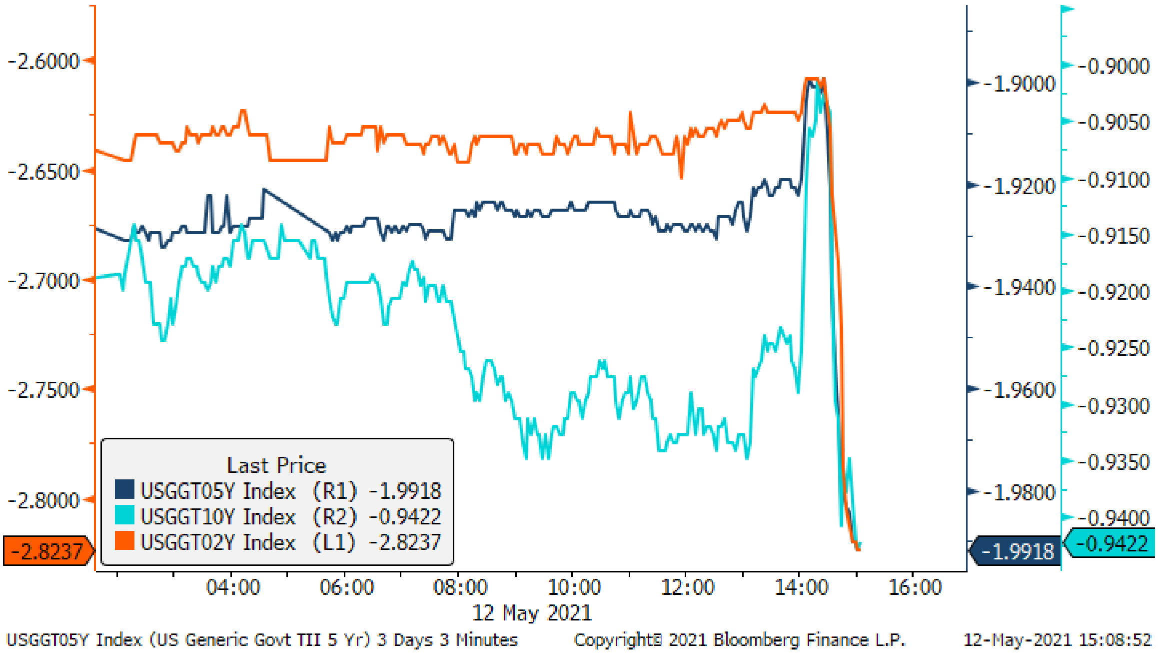
12th May 2021

April's US Consumer Price Index figure was set to be the first large inflation print significantly above 2% as a low base from last year and surging commodity prices this year set a high bar.

The 4.2% YoY increase in the headline print did not disappoint and comfortably exceeded market expectations which were set at 3.6%.

Meanwhile, core CPI rose by 3%, a print 0.7% higher than expectations, while month-on-month rates, which strip out the base effects, also showed strong inflationary pressures in April. Real rates rose on the back of the release, which prompted a bounceback in the US dollar as well as the US Treasury curve steepening, but subsequently collapsed. This suggests that fixed income markets are taking the one data point with a pinch of salt and continue to buy the Fed's stance that the uptick in inflation will be transitory.

US real yields climbed and collapsed as markets didn't deem CPI significant enough to alter policy expectations



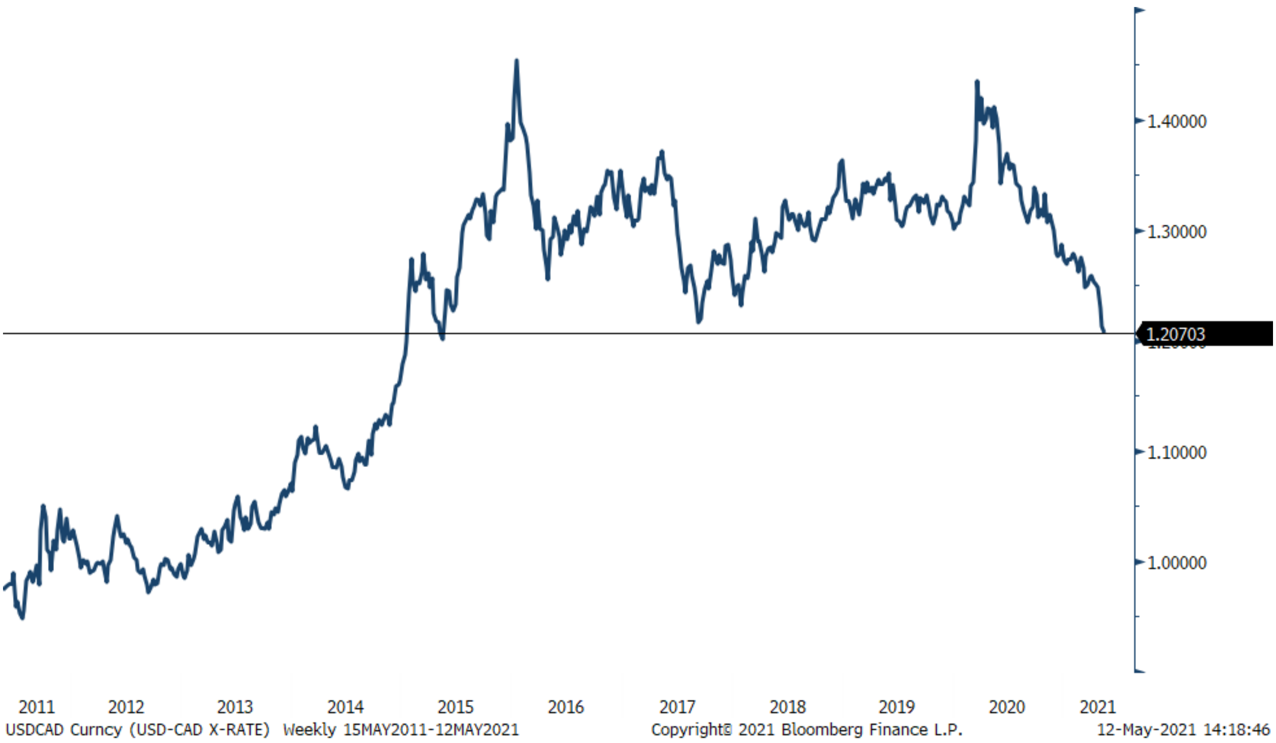
Souce: Bloomberg

Going into today's US CPI release, the question was going to be at what point inflation expectations would trigger markets to believe the reading would move the needle for the Fed to adjust policy. Or, in other words, at what point inflation expectations would spill over to policy expectations. In the initial aftermath of the data print, it looked like today would be the day, however, real yields subsequently dropped across the 2-10 year tenure, while inflation breakevens absorbed the upwards pressure from the CPI release. While one release isn't enough for markets to rethink their previous stance, it adds to an underlying dynamic of increasing inflation expectations, that if left unattended to, will at some point snap real rates back into life. Over the last week, 5-year inflation expectations steadily climbed to their highest point since 2005. Data on US job openings, Chinese PPI, higher commodity prices, and wage pressures from Friday's Nonfarm payrolls release all contributed to this rise in inflation expectations, which have now found another boost from the April CPI release.

> The dollar initially found another wave of support in the aftermath of the release as real yields climbed. But, the greenback quickly reversed its course as markets digested the information and didn't deem it significant enough to alter expectations of policy normalisation. The Canadian dollar was arguably the biggest beneficiary of today's CPI release.

We highlighted in today's morning report that US CPI data could provide the catalyst for the loonie to break through 2017's highs, and this eventually played out as rising price pressures in the US are seen to filter through into Canada, with the Bank of Canada's reaction function being much more sensitive to inflation than the Fed's.

USDCAD breaks 2017 low as loonie continues to climb towards its 6-year high (sub-1.20)



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Author: Simon Harvey, Senior FX Market Analyst

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