

October's ECB cheat sheet: Reluctant mark-to-market

The ECB is widely expected to cut by 25bp this week after the recent inflation slowdown. We explore how a market positioned for a predictable outcome could react to a surprise hold or more dovish guidance. We retain a bias for higher front-end EUR rates, and further pressure on EUR/USD would probably need to come with some defensive pre-election positioning

Scenario analysis: How to position for Lagarde's alternatives

	Inflation outlook	Growth outlook	Interest rates	EUR/USD (1.090)	10Y Bund (2.25%)
Current stance	Inflation to fluctuate this year, decline towards target in 2H25	Economic activity to be supported by real income rising. Risks to the downside	Depo at 3.50%. Data-dependent, meeting-by-meeting approach		
Dovish	Risks of inflation undershooting target in 2025 and beyond	Recessionary risks have increased. No longer expecting a recovery	25bp cut. Larger rate cut was discussed	1.080	2.20%
Moderately dovish	Greater confidence of hitting inflation target in 2025	Balance of risks for growth has shifted further to the downside	25bp cut. Commitment for cuts in December and beyond	1.085	2.20%
Neutral ING base-case	Inflation risks remain balanced. More data required; upside risks persist	Still expecting a recovery, but downside risks linger	25bp cut. Hints at more rate cuts to come without pre-commitment	1.090	2.25%
Hawkish	Downplaying latest CPI slowdown. Risk that oil prices lead to higher inflation	Slow activity narrative comes from potentially unreliable surveys	Hold. Data dependence but hints rates can be cut in December	1.105	2.20%

Source: ING

This note is part of our preview for the October ECB rate decision. Our economics team preview can be found here: [Why an ECB rate cut next week is less obvious than markets think](#)

Retaining bias for higher front-end rates

A slate of weaker survey data and a cooler September CPI prompted officials at the European Central Bank to open the door to a cut in October. Markets took the hint and have since firmly priced in an October cut as the base case. In fact, markets firmly see at least four back-to-back 25bp cuts as the baseline scenario at the moment. With such strong conviction about this cut and

future cuts, the risk of disappointment is high, and thus we maintain a bias towards higher front-end rates.

Our economists believe that the ECB will find enough reason to cut this week and not disrupt markets. But the case for a cut and then a follow-up in December is not straightforward. September's cooler CPI has already been flagged by ECB President Christine Lagarde and inflation is expected to nudge higher again over the remainder of the year. Geopolitical risks and potential knock-on effects to energy prices could also make the ECB more wary about hinting too much at further easing. As our economists note, the ECB has become increasingly concerned about the growth outlook but is still very reluctant to give the all-clear on inflation.

Holding rates could be read as policy error

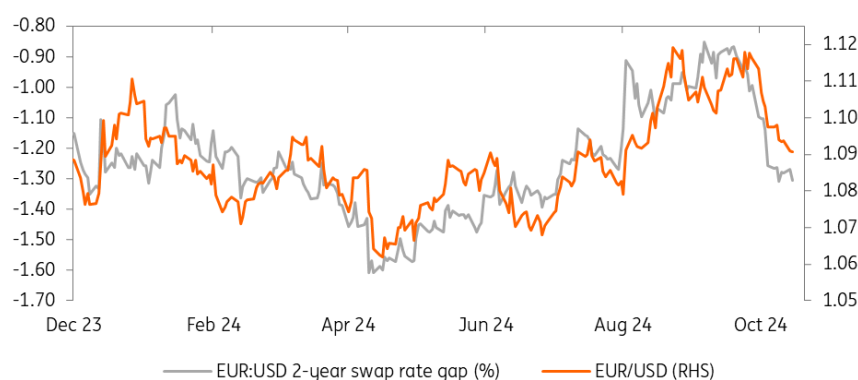
Some members of the ECB, including Peter Kazimir and Pierre Wunsch, have been critical about a rate cut. So what are the implications if the Bank decides against it? Skipping the October cut would be a blow to the conviction of back-to-back cuts, shifting implied rates for front months higher. If the ECB turns out to be more hawkish than thought and is still more focused on inflation, the market could even judge this as a policy error in the making. The ECB would be seen as falling behind the curve and growth concerns could mount, requiring the ECB to deliver even more easing at a later stage by potentially cutting even below the estimated neutral range of 2-2.25%.

Fewer cuts now translate into more cuts later, and this would flatten the curve. Given how firmly the market is priced for this baseline, this is clearly the risk scenario for this week's meeting. However, it is not our base case. If the ECB delivers as expected, the market will very likely feel more conviction in its pricing of faster-paced ECB easing ahead.

FX: ECB negatives largely priced in

The huge rewidening in the USD:EUR short-term rate gap has been the key driver for the recent EUR/USD decline. As markets stayed on the hawkish side of the USD curve at the start of this week, and are now pricing in fewer than two Federal Reserve rate cuts (44bp in total) by year-end, the USD:EUR 2-year rate spread is now at 130bp, 45bp wider than a month ago. If we plot that against EUR/USD, we struggle to come up with a bullish argument for the pair (chart below).

EUR/USD and its associated short-term rate gap



Source: ING, Refinitiv

At the same time, that short-term rate rewidening has probably little room to widen further. The Fed guidance is still two cuts this year, meaning another blowout jobs print is probably required to have the November or December cut priced out. On the other side, the EUR OIS curve is close to pricing in back-to-back ECB cuts at each of the next four meetings. We doubt this week's ECB guidance (or lack thereof) will trigger much further dovish rerating. In other words, the rates picture is bad for the EUR, but we don't see it getting much worse.

That means that EUR/USD bears will need to look for other negative drivers soon. Some positioning ahead of the US election favours USD inflows due to the somewhat higher perceived chances of Trump winning in the past couple of weeks (at least according to betting markets), but that would mean the 5 November event will be an even more binary one for EUR/USD. Meanwhile, the decline in oil prices suggests less risk associated with Middle East tensions.

All in all, we don't think this ECB meeting will introduce any new negatives to EUR/USD, but we could still see a move into 1.07-1.08 if markets take on Trump hedges. Ultimately, the election result will determine whether the pair trades at or below 1.05 or at or above 1.10.

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