Article | 24 November 2023

EUR direction and curve

The ECB is likely already at its interest rate peak, putting the focus on the timing of a first rate cut. As cuts approach in the summer of 2024, the curve should start to disinvert via the front end. But a prospective landing zone of the depo rate at 2.75% in 2025 limits the scope of steepening and how far longer rates can rally from here

Central banks, including the European Central Bank, are now likely at the top of their tightening cycles

Timing the turn in the ECB rate cycle

As 2024 approaches, central banks, including the European Central Bank, are likely at the end of their tightening cycles. Usually, this should also mark shifting dynamics in fixed income markets, as the focus then turns to the timing of rate cuts.

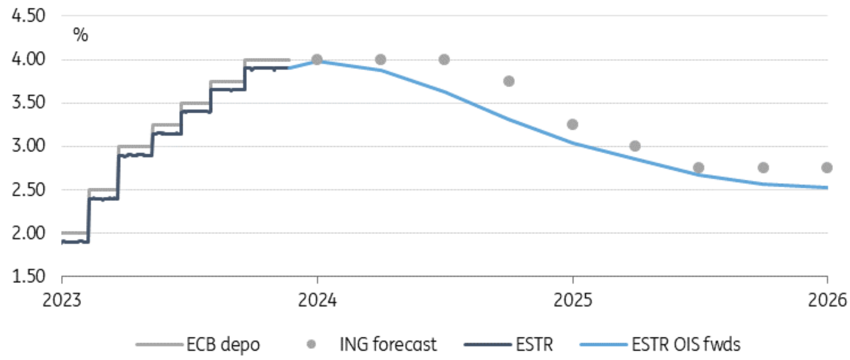
But the the inflation challenge is not yet over with a core inflation rate that is still above 4%. While not explicitly taking further hikes off the table, the ECB determined in September that rates had reached a level high enough, if held there sufficiently long, to make a substantial contribution towards bringing inflation back to the 2% target over the medium term.

We are seeing progress being made on the inflation front but the going is likely to get slower as inflation drivers become more domestic. Inflation expectations, especially, are still seen as fragile given the potential for renewed energy shocks or weather-related food price inflation. Before any victory over inflation can be declared, the ECB wants to wait out the wage negotiation rounds through the first half of next year.

This means the ECB is still looking in the rearview mirror, although it is now starting to acknowledge that it might have been too optimistic on the growth backdrop. That is an important shift, albeit a slow one. Eurozone GDP growth turned negative in the third quarter (-0.1% quarter-on-quarter) and the latest sentiment indicators suggest that growth over the winter quarters is also likely to hover around 0%. The economy itself is not seen falling into a deeper recession but rather a broad stagnation. Our economists expect very weak GDP growth for both 2023 (0.4%) and 2024 (0.2%).

However, with progress on inflation, the ECB will eventually be in a position to cut rates next summer. Our economists expect the ECB to cut rates by 75bp over the course of the second half of 2024 to end the year with a deposit facility rate of 3.25%, and we think it will extend the easing cycle by another 50bp in the early part of 2025.

Rate cut speculation could get some pushback at first



Source: Refinitiv, ING

The factors keeping long-end rates more elevated

Our economists are looking for a 125bp reduction in ECB policy rates before mid-2025. That should also pull longer rates lower, but considering the levels we currently see in 10Y swaps – around 3.05% – and the prospective landing zone for the ECB deposit facility rate at 2.75%, the potential for longer rates to rally looks modest in our base case scenario. It is still likely that the 10Y swap rate undershoots the 3% mark into the middle of next year, but we would also expect rates to come off these lower levels again soon afterwards when markets have a better view of the ECB's shallower trajectory.

The ECB may well be on track to reach its inflation target, perhaps even hit it somewhat earlier than indicated in its own forecasts. But at the same time, there are structural factors that can keep inflation more elevated compared to pre-pandemic times which were marked by a low interest rate environment. Demographics, deglobalisation and decarbonisation argue in favour of upward pressure on price levels.

Closer at hand, fiscal policies could also be comparatively more expansive, assuming that the EU can compromise on a new set of fiscal rules that allow for more leeway than the old Stability and Growth Pact. And one important factor that could add to the term premium of longer rates and is in the hands of the ECB, is the continued roll-off of its bond portfolios. The roll-off could even be accelerated if the ECB decides on an early end to the reinvestments of the portfolio accumulated under the Pandemic Emergency Purchase Programme.

The ECB's Chief Economist Philip Lane has suggested that the long-run nominal neutral rate should be around 2%. Our economists would side with some of the more hawkish governing council members who have put that value closer to 2.5%. That would put fair value on the long-end rate at 3%, including an OIS-based term premium of around 0.5%, as estimated by the ECB.

Steepening via the front end, but don't get carried away

Initially, there may well be a period when the ECB holds out against pressure to cut rates as it wants to see more evidence of stabilising wage dynamics. This period could pose a re-flattening risk for the curve as other macro weakness materialises either domestically or abroad, especially when US growth starts to falter, as our economists expect and Treasuries begin to rally.

Eventually, the curve should start to disinvert from the front end once the potential for rate cuts moves into view. But the steepening potential is limited by the degree to which the ECB can and will cut – also considering the aforementioned structural factors keeping inflation higher. Only towards the end of next year do we see the 2s10s curve becoming upward-sloping again. If the backdrop were to deteriorate more than we anticipate, then markets might be tempted to see the post-pandemic situation in the eurozone as not so different to pre-pandemic times after all. That could imply more rate cuts, but with the old ailments still plaguing the bloc, it would also mean longer rates could fall further.

Further curve steepening should come via the front end

Source: Refinitiv, ING

Author

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com