Rates Spark: A break from geopolitics

While US curves continue to re-flatten as geopolitical tensions abate and risk sentiment recovers, the 10y Bund yield remains closer to 2.9%, the upper end of its range. The flash PMIs will likely justify the picture of macro resilience, which itself argues for ongoing curve normalisation with the ECB firmly on hold

The flash PMIs in the eurozone are likely to confirm the ongoing resilience of the gradual recovery despite geopolitical headwinds

Attention shifts away from geopolitics with the eurozone PMIs in focus today

Risk sentiment has regained its footing as a diplomatic solution to Trump's Greenland ambitions looks likely and tariffs are off the table. Attention can turn to the data again with a focus on flash PMIs in the eurozone. And they are likely to confirm the ongoing resilience of the eurozone's gradual recovery despite geopolitical headwinds.

With the European Central Bank staying on hold, that would support the prospect of further curve normalisation in the medium to long run. This means long-end rates can be gradually pressured higher as the recovery evolves, but also as fiscal and supply pressures rise, which remains a more global theme as recent market events have shown. Meanwhile, Dutch pension reforms may leave their mark on the very long end of the euro curve, although predicting the flows and market impact continues to be a challenge.

The ECB minutes of the December meeting have confirmed the Council's assessment that it finds itself in a 'good place', keeping rates on hold. However, as my colleague also explains, the minutes revealed an ongoing divide within the Council on the upside or downward risks around the inflation outlook.

We would add that there is an important time dimension to these risks, meaning that in the near term, if we consider just the upcoming months and quarters, the risks are probably still skewed toward the ECB cutting rates again, even though that is not our base case. Even the past week has shown how the market's perception of rate cut probabilities can quickly shift again – heading into Trump's Davos speech, prospects for another cut this year had briefly risen to around 20%.

Clearly, rate cuts are not our base case, but any cut speculation can add to a steepening dynamism in the near term as long as the prospects of, for example, the German fiscal story, as one driver of the ongoing recovery, don't take a hit.

Friday's events and market view

The focus turns to the eurozone with the release of the flash PMIs for January. The consensus is for a slight improvement, with the manufacturing index expected to remain in contractionary territory.

In the US, the PMIs carry less relevance for markets, though an improvement is also seen here. The University of Michigan releases the final sentiment index for January.

Primary markets take a breather with no sovereign bond supply scheduled for the day.

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