

Rates Spark: A fourth ECB cut incoming

While we don't entirely exclude 50bp, the European Central Bank is likely to decide on another 25bp cut. If the communication turns more dovish, then markets may going forward be even keener to price in a lower landing zone on the back of weaker economic data. After a 0.3% MoM US core CPI reading, rates will be carefully watching the PCE numbers next week



ECB President Christine Lagarde

We'll be listening for a more dovish tone from the ECB

The market is going into the European Central Bank meeting with the baseline expectation of a 25bp cut and only a very small tail risk of a bigger 50bp cut. We would not entirely exclude it, but the focus of the market should be more on the communication. An updated staff forecast that would see the inflation target being reached sooner next year would allow the ECB to pair the smaller cut with a more dovish tone. The ECB could, for instance, soften the prior wording around keeping sufficiently restrictive policy for as long as necessary now that the goal is moving closer into view.

With a terminal rate pricing of 1.75% the market is already geared towards the central bank taking interest rates into accommodative territory next year. But a dovish stance this meeting would probably allow the market to further undershoot this level if the outlook were to worsen, sensing

that the ECB could be even more inclined to supporting growth.

More relevant for the long end could be the US dynamic where rates have backed up over the past few sessions. Clearly, another core CPI of 0.3% month-on-month even if matching consensus was not a good look for the Fed. But on Thursday the focus is now on the PPI and its implications for the core PCE reading next week, the Fed's preferred measure. This should still be on track for a 0.2% MoM core reading, which should also leave the Fed on track to deliver the 25bp cut the market is expecting for next week. What we could see though is the Fed trimming its September projection of four cuts next year to just three cuts. However, the market is already pricing less than three additional cuts for next year.

The US 2yr yield continues to look lower, while the 10yr is less tethered now it seems

There's been various cross winds in play for Treasuries. The detectable net outcome is the 2yr yield wants to ease lower, while the 10yr yield has less inclination to do so. This fits with our medium-term relative value viewpoint. We think the front end is fine where it is, and indeed the 2yr can get down to 4%. But the 10yr is biased to head higher through 2025, as it is likely to end up well above the neutral area that we identify as around 4.5%, or conservatively 4% to 4.5%. We also note the marked selling of longer dates in the past couple of weeks by mutual funds (EPFR data).

Remarkably though, on a 0.3% month-on-month and 3.3% year-on-year core inflation reading the impact effect was for the entire curve to shift lower. Even though there was a subsequent retracement higher for both the 2yr and 10yr, the 2yr managed to remain net down while the 10yr ended up on the day. For many weeks now we've been asserting that market rates can drift lower in the turn of the year. This remains a conviction view for the front end. For the back end, we also have that view, but we can't deny that there is something of a risk for a mood change. On the flip side, the 10yr auction saw some tidy pricing, coming at some 1.5bp through the when issued level (effectively secondary level but with some moderate timing deviation).

Overall, the front end looks and feels stable and lower for yield. The 10yr, less so. But we still think any big move higher won't be a thing till 2025.

Thursday's events and market view

The ECB meeting is the main event and the currently c.26bp priced reflects only a marginal tail risk of a bigger cut. Eyes therefore will be on the communication and staff forecasts. The overall commentary going into the meeting pointed to some unanimity among ECB officials this time around, which of course the pricing is reflecting.

From the US we will get the PPI data for November with consensus looking for a 0.2% increase. Together with the inputs from the CPI it would leave the core PCE deflator on track for a 0.2% reading. The other data point to watch are the jobless claims numbers, where especially the creep higher in continuous claims is signalling some cooling of the jobs market.

In primary markets Italy will sell 3y to 30y BTPs for up to €8.5bn in total. The US Treasury will auction 30y bonds for US\$22bn.

Author

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.