

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.

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