Article | 26 March 2026

Rates Spark: Aggressive central bank discount remains sticky

Markets appreciate the US seeking a deal, but without concrete steps, they will be reluctant to dial back their aggressive central bank discount. The ECB cannot retreat to just watching the data, but also must balance market expectations along the curve

Markets are pricing a more forceful ECB response, even as President Christine Lagarde emphasises caution and data dependence

Central banks balancing the market as tensions linger

Markets are appreciating US efforts to seek a deal, but without concrete steps, the overarching narrative of two to three ECB rate hikes this year remains unchanged. Even for April, market pricing still points to a 60% probability of a hike. The key variable to watch remains the oil price, and that hasn't really moved much since the start of this week. Headlines do bring some movement, but investors are reluctant to trade on every rumour related to a deal. And with Iran clearly feeling confident, the situation is still fragile and can easily escalate again.

Still, market pricing, especially for April, appears aggressive against the backdrop of President Christine Lagarde suggesting on Wednesday morning that the ECB would not act until it had enough information and could look through a short price shock, underscoring the differences to the 2022 situation. Of course, being still in the middle of the turmoil, one can only speculate about the duration of the disruption. A more forceful reaction by the ECB could still follow to nip any price spiral in the bud. This is what the market is pricing – and it gels with the relative stability of longer-dated (forward) inflation swaps. But the market is also looking for a partial reversal as indicated by the hump, e.g. in the Euribor futures strip.

At this stage, the ECB is engaged in a balancing act of managing market expectations and the curve. If it sounds too doveish, the risk is that the long end runs away as inflation expectations become unmoored. If it sounds too hawkish, growth concerns take over. At some point, even meeting market expectations might be required to keep the balance – and buy time.

The strong decline in longer-dated gilt yields might provide an omen for EUR and USD curves. Increased worries about the UK growth outlook are pushing 10Y rates down faster than the short end. Markets are now positioned for at least two hikes this year, which would bring the policy rate to 4.25%, implying a very tight policy stance. In effect, the brake on the economy would eventually force a loosening of policy and could very well push the Bank Rate to below neutral over a longer horizon. If this becomes a more dominant narrative, also outside the UK, then we would expect a bull flattening of curves.

Thursday's events and market view

Markets remain driven by geopolitical headlines, and most data releases for now have been overtaken by events. In the eurozone, there will be some final Q4 GDP releases from the Netherlands and Spain. We will get the ECB's M3 data, while Germany will release a consumer confidence reading which could be more informative in assessing the current turmoil's impact. ECB speakers such as de Guindos and Muller, who are scheduled to speak, should also be more relevant than data for now.

In the US, we will get the usual weekly jobless claims data and manufacturing index from the Kansas Fed. The main focus here, too, will be the Fed speakers scheduled for the day: Cook, Miran, Jefferson and Barr.

From the Bank of England, Breeden, Taylor and Greene are scheduled to speak.

In primary markets, the UK tenders 30y gilts for £0.3bn, while the US Treasury will sell new 7y notes for US$44bn.

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