Rates Spark: An ECB pause, but no relief for longer rates

Markets are widely anticipating the European Central Bank to keep rates on hold today, which might put more focus on balance sheet discussions. Meanwhile, long-end rates are being pulled higher again ahead of today's US GDP numbers and more crucially on prospects of rising US Treasury supply, as the next quarterly refunding draws closer

The eurozone's wage growth drop is firming up expectations of a 25bp cut from the ECB next month

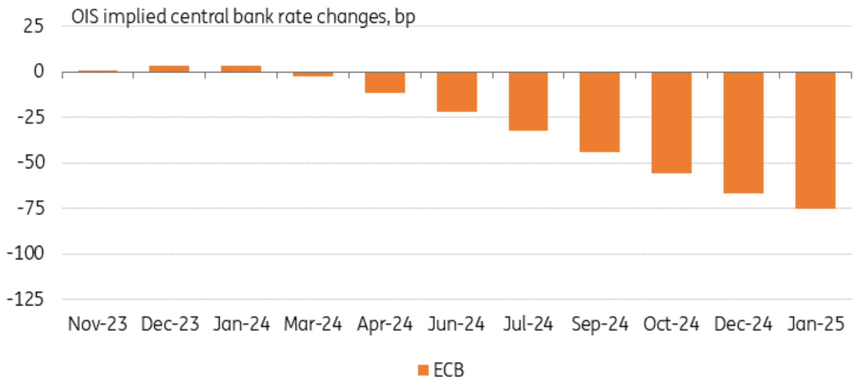
ECB to pause on rates, but may shift focus to the balance sheet

Markets have been firm on their view that the ECB will not hike rates at today's meeting since the ECB indicated in September that rates were high enough to bring down inflation. The latest economic data points only brought further confirmation, with the PMIs pointing to worsening weakness in the economy. The bank lending survey and data also indicate that the transmission of the ECB's policy tightening is working. Overall, a good time to pause, and our economists also agree.

This will put even more focus on the ECB's signalling and how it sees the balance of risks surrounding inflation and growth. Geopolitical tensions in the Middle East and with it, elevated oil prices have brought renewed concerns around the viability of the ECB's plans to reach its inflation target with current policies in a timely manner. Since the end of last week, oil prices have started to ease, though uncertainty still appears elevated surrounding the region. Currently, markets are fully discounting a first 25bp rate cut around the middle of next year. Some hawkish ECB members such as Klaas Knot seem to think this is still too early.

Bringing the focus of discussions back to the ECB's balance sheet might be a possibility to maintain a hawkish posture and prevent markets from pricing cuts too early. However, higher long-term rates, even if more inspired by US rates, might lessen the pressure on the ECB. And any balance sheet discussion will also have to be balanced against the growing concerns surrounding sovereign spreads, and Italy in particular. Spreads of Italian bonds over Bunds had seen some relief following the affirmation of Italy's sovereign rating by S&P last week, but have since moved back above 200bp. This may be indicative of market expectations for the ECB working towards stopping Pandemic Emergency Purchase Programme reinvestments earlier than is currently planned. At the moment, reinvestments are still slated to run until at least the end of 2024.

Markets widely anticipate an ECB pause



Source: Refinitiv, ING

US long-end rates pulled higher again by data and more by crucially supply prospects

US rates had seen a rally at the beginning of the week, but the long end has begun pulling the curve higher and steeper again – the 10Y yield is back above 4.9% and 30Y yields firmly above 5% again. One factor may be today's data where markets are looking for a solid 4.5% third-quarter GDP reading, boosted by strong consumer spending. However, we would note that the front end is proving relatively stable with the 2Y UST yield resisting a rise above this week's highs of around 5.13%. Late last week, the 2Y had reached 5.25%.

The other factor then is of course supply. Not necessarily today's 7Y Treasury auction which follows on the heels of last night's weaker 5Y auction, but the US Treasury Department's next quarterly refunding statement where it lays out issuance plans for the next three months. The detailed announcement will come on 1 November.

Back in August, the higher-than-expected announced issuance volumes were seen as a key factor turning the market bearish on rates and driving the so-called term premium – i.e. the excess yield investors require to commit to holding a long-term bond over the expected path of short-term yields over the same horizon.

Today's events and market view

The ECB operates in an environment with greater spillover effects in markets from a surprisingly resilient US economy and higher supply expectations. The resulting higher long-end rates might give the ECB more room for pause and lessen the pressure to sound hawkish. Still, if the ECB decides to maintain a degree of hawkishness, given the eurozone's less resilient economy, which is also more exposed to geopolitical risks, it could limit the EUR curves steepening potential relative to its US counterpart. Something we are also seeing is the widening of the 10Y UST/Bund spread to around 200bp.

That said, it will be difficult to untangle market drivers today given the quick succession of the day's key events. The ECB releases its press statement at 14:15 CET, although larger changes here seem unlikely this time around. The main slate of US data including the 3Q GDP, durable goods orders and initial jobless claims will follow at 14:30 CET, while the ECB's press conference will begin at 14:45 CET.

In government bond supply, the main focus is the US$38bn new 7Y US Treasury note sold today.

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