Rates Spark: Catching a breath

On the third day of turmoil, markets appear to be catching their breath with risk assets recovering somewhat and oil prices staying below prior peaks. While US yields are still backing up on positive data, Bund yields have declined as ECB hike expectations recede. But inflation fears linger with the geopolitical situation ongoing

Markets seem to catch their breath as Bund yields dip on a lower probability of a European Central Bank rate hike

Markets appear to catch their breath after tumultuous days

After three days of market volatility, it appears markets are catching their breath again. While the situation in the Middle East remains uncertain, oil prices at least are not rising beyond prior peaks.

In bond markets, eurozone government bond spreads have tightened modestly; the German 2s10s curve eked out a steepening for the first time since early February. The pricing of the European Central Bank, which had swung to implying a 50% hike by the end of the year at one stage, has returned to a more cautious 20-25% probability.

That is still a clear hiking bias versus a cutting bias before the turmoil. The inflation scare is still prevalent, and it is not too difficult to construe a scenario where energy supply remains disrupted for longer.

More recent commentary from ECB officials has urged cooler heads, suggesting that policymakers think it's too early to pass any judgement on what the overall fallout will be. But the market still fears that any inkling of the price shock working its way through to other areas of the economy in

a more meaningful way could prompt the ECB to react faster. After all, the not-so-distant experience of 2022 is still ingrained in policymakers' minds.

But central banks' reaction functions will differ, not just given the different exposures to the Middle East energy supply. The Bank of England appears more sensitive to the inflationary impact stemming from Middle East turmoil, as our economists point out. What had looked like an 80% probability of a cut this month from the market's perspective has now been pared back to a 20% probability. Two cuts were fully priced by the end of the year. Now, there is only a slim chance of a second cut being priced this year.

The US economy, of course, is more energy independent than its peers. Nevertheless, coming from a situation where inflation is still on the somewhat hotter side and tariff effects potentially still feed through, the Fed also remains more cautious about stirring dovish hopes. The macro fundamentals, as painted by the recent ISM releases, also suggest a position of strength going into the geopolitical turmoil.

Thursday's events and market view

Most of the focus will remain on headlines related to the Middle East conflict. Regarding data, we have eurozone retail sales figures for January. Consumption growth remains sluggish in the eurozone, but consensus does pencil in an increase from 1.3% to 1.7% year-on-year. In the US, we have Challenger jobs and jobless claims. Both will be watched closely for signs of a further cooling of the labour market. The more important payroll number is scheduled for Friday.

In terms of supply, we have Italy continuing with their 6Y retail Valore issuance, which is estimated to raise €15-18bn this week. Spain will auction 3Y, 7Y and 15Y SPGBs together with an 11Y SPGBei for a total of €6.25bn. From France, we have 10Y, 17Y and 20Y OATs totalling €13.5bn, and the UK will auction a 3Y gilt for €3.5bn.

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