

## Rates Spark: Easing inflation expectations going into the ECB meeting

With the ECB decision on Thursday, markets are comforted by falling oil prices which are helping to ease inflation expectations. We share the market view that the ECB will cut by 25bp, but the pessimism on growth may be overdone. In the meantime, EGB spreads continue to tighten, partly driven by the 10Y Bund swap spread cheapening



### Lower oil prices help to ease inflation expectations

With little in the calendar and the ECB meeting looming ahead, rates markets appear to be tracking the dynamics of oil prices more. Eurozone 5y5y inflation forwards dipped to 2.16%. Alongside inflation expectations, the swap rate dropped 4-5bp led by the 5y belly of the curve, now sitting just below 2.3% after the additional push following the cooler UK CPI data.

Declining oil prices and some sense of stabilisation of the situation in the Middle East would of course make the ECB more comfortable with cutting rates on Thursday. Near-term markets, though, had already been very confident in their pricing of a cut not just on Thursday, but also at the following meetings.

Markets still see the ECB bottoming at 2% if not lower. But market pessimism about the growth outlook might have gone too far. Yesterday's ZEW index saw a somewhat bigger improvement in

the expectations component than anticipated and also the ECB's bank lending survey has shown cautious improvements. At some point, the prospect of faster policy easing should help stabilise the longer outlook and should limit the downside in the forward rates.

## Tighter sovereign spreads as risk sentiment improves

The easing risk sentiment has led to a more notable tightening of sovereign bond spreads in the eurozone. French 10y spreads versus Germany have tightened to 73bp, still at the wider end of the range since the election, but at least their tightest levels since 19 September. More notable is that Italian spreads have moved clearly beyond the previous lows of July and are now approaching the lows of March. Spanish spreads are on the verge of entirely unwinding the premium that had built up when the ECB started to tighten policies in 2022.

Part of the story is the German leg of those sovereign spreads. The 10y Bund swap spread has cheapened further at the start this week taking it below 20bp more lastingly for the first time since 2014, i.e. before the ECB embarked on quantitative easing. The ECB is now continuing to unwind its balance sheet which is further eroding the Bund's scarcity premium.

### Wednesday's events and market views

This morning's UK September CPI report showed services inflation falling more than expected from 5.6% to 4.9%. This was not just below consensus but also well below the Bank of England's projection at 5.5%. This dovish outcome should further open the door to cuts at this year's remaining BoE meetings. Other than that, there is little for European and US markets to digest; perhaps US mortgage applications will be the highlight in terms of data.

For supply, we have the UK with a 7Y Gilt auction for £3.5bn. Germany will auction 26Y & 30Y Bunds totalling €2bn.

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