

Rates Spark: ECB and BoE meet hawkish markets

The ECB and BoE will meet amid a volatile situation in the Middle East, where recent headlines have pushed markets towards pricing more hawkish policy trajectories again. The Fed's own hawkish tinge last night did its part in pushing 10y UST yields above 4.25% and dragging 10y EUR swap to 3% again



We expect the European Central Bank and Bank of England to keep rates on hold

The situation in the Middle East remains highly volatile, as underscored by events over the past day. They turned a day that started on a calmer note into one marked by another spike in energy prices.

The Fed kept rates on hold as expected and continued to project a cut in 2026 and 2027. However, a hawkish tinge came with the revision to higher GDP growth over the forecast horizon and a small lift in the long-run Fed funds rate.

In sum, 2y Treasury yields rose 10bp on the day and 10y yields were lifted above 4.25% by these events, with the market further paring back its expectations for Fed cuts. The first cut is now fully discounted by summer next year.

ECB's Lagarde could sound more hawkish, but can she be more hawkish than the market?

The market is also going into today's European Central Bank meeting with more aggressive rate hike expectations on the back of the latest geopolitical escalation – two hikes are again fully priced in by year-end.

No one expects the ECB to act today, and given that the ECB's new forecast will have been overtaken by events already, the main focus will be on the guidance provided by President Lagarde. Even if good arguments can be made to look through the turmoil, it is very unlikely that hikes will be taken off the table at this stage. So the question will be rather to what degree Lagarde can keep pace with the already hawkish market pricing. In the end, signalling a readiness to act and a data-dependent and meeting-by-meeting approach to assessing the appropriate policy stance will likely mean that energy prices will remain the overriding factor for market rates for now.

As for the negative feedback loop that we think could still rein in too hawkish pricing, we have seen risk markets weakening again yesterday but not really tipping over yet. And long-end real yields were still not signalling longer-term growth concerns. European government bond spreads, like the 10y BTP/Bund remained below the prior week's peaks, with Bund spreads to swaps still showing only muted reaction to the situation.

Watch the BoE vote split as markets guess reaction function

As markets are trying to guess the reaction function of central banks, the vote split for the Bank of England will be even more closely watched than usual. Markets have turned 180 degrees over the past few weeks from pricing in two cuts this year to one hike. We think contemplating a hike is premature, but energy prices will have to move lower to ease markets. The BoE's meeting will make any future move conditional on energy prices, but the vote split could communicate a more nuanced stance. Our economist takes 7-2 in favour of no change as the base case, but be prepared for surprises.

Whilst UK rates have been hit relatively strongly by the surge in energy prices, we don't see a higher risk premium for holding gilts. During last year's periods of market stress, we noticed that gilts often suffered more than Bunds. But whilst the spreads between many European government bonds and the swap curve have widened materially since February, this is not obvious for gilts. The rise in the 10y gilt yield has been a function of a hawkish repricing of the BoE and not by the swap spreads. We would therefore really have to see a repricing of policy rates to see gilt yields ease lower.

Thursday's events and market view

The main focus of the day is the ECB and BoE policy-setting meetings. Although no changes are expected today, the guidance provided will be key in judging the reaction functions amid the geopolitical turmoil. The morning started with the release of the UK unemployment rate and average earnings data for January. US data later in the day covers housing data with building permits and new home sales for January, as well as the jobs market with the usual weekly jobless claims data.

In primary markets, Spain auctions 5y, 7y and 10y bonds for up to €6bn. France taps

short to medium-term bonds as well as inflation-linked bonds for a total of up to €14bn.

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