Rates Spark: ECB outlook getting more complicated

A stronger euro, costs of energy and geopolitical tensions are all adding complexity to the ECB's policy rate outlook. Meanwhile, Dutch pension funds are turning more critical of US developments

FX, energy and geopolitical developments are adding to the complexity of the eurozone's macro outlook

ECB's 'good place' is getting more uncomfortable

The European Central Bank meeting next week is the one that markets will watch after the Fed held rates steady on Wednesday. But while the consensus is that nothing will happen, the 'good place' the ECB sees itself in is looking less comfortable, as our economists note. For now, the underlying story might still look good for the eurozone. But exchange rate dynamics put downward pressure on inflation projections, while at the same time, cold weather and tensions around Iran have pressured energy prices higher. To compound market worries, AI concerns are resurfacing of late, sending US tech stocks lower and the rest with it.

Markets are increasingly starting to question again whether the ECB will be able to hold a steady course amid increasing cross currents. The implied probability of the ECB cutting rates before the year is out has crept over 30%.

Shorter dated inflation swaps are actually still up by more than 10bp since the start of the year, while real rates are sliding further from the peaks we saw then – the 5y real ESTR OIS rate is down

from 0.55% to 0.35% just this month. Admittedly, setting aside December, that is still the upper end of the range since last April.

Even as 10y US Treasury yields are staying largely pat, 10y Bunds yields are falling closer to 2.8% and sagging risk appetite is also reflected in a rewidening of spreads in the eurozone bond market, where French bonds are underperforming as the 10y spread over Bunds climbs closer to 60bp again.

Dutch pensions funds continue to review US exposures

Dutch pension funds are increasingly concerned about the changing geopolitical landscape and are hinting at reducing US exposures. The latest headline came from PME, highlighting that the US is no longer the trusted ally it once was. With €60bn assets under management, the fund is relatively large, but does not represent the entire Dutch pension pot of over €1.5tn. Yet this is not the first time we hear about Dutch pension funds reviewing their US exposures. In the wake of 'Liberation Day', these worries started mounting.

Reducing exposures to the US comes with challenges, as the European market depth is simply not comparable to US markets. In the case of equities, especially, we note that pension funds are heavily exposed to the US and will struggle to allocate large shares closer to home. We therefore shouldn't expect a sudden rotation out of the US towards Europe. Instead, the process would likely take a more gradual shape, where over numerous years the US exposures would slowly be reduced. Even a slow downward trend in US investments would, however, leave a mark given the sheer size of the European pension sector. A more immediate impact channel would be through FX hedging decisions, where Dutch pension funds have more flexibility. Increasing dollar hedging ratios by European pension funds likely already contributed to the dollar depreciation post 'Liberation Day'.

Friday's events and market view

In the data, the focus should turn to the eurozone for a change as we await the first reading for fourth quarter 2025 GDP growth – the consensus is looking for 1.3% year-on-year growth. We will also get the unemployment rate, which is expected to stay at its lows of 6.3%. On the topic of inflation, the ECB releases its consumer inflation survey while Germany and Spain will also release the preliminary CPI data for January.

In the US, producer price inflation is anticipated to cool off marginally with the December YoY core rate coming to 2.9% from 3%.

After markets close, S&P has pencilled in, among others, a possible review of Italy (BBB+/Stable).

Author

Michiel Tukker
Senior UK & Eurozone Rates Strategist
michiel.tukker@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

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