

Rates Spark: Euro rates driven by ECB cut expectations

The divergence between EUR and US rates continues. While the European Central Bank's endpoint is being recalibrated lower, a more hawkish interpretation of Fed Chair Jerome Powell's comments last night pushed US rates higher again, with the market now starting to lean towards seeing the Fed pause in December



More ECB cuts expected, but a 50bp cut in December is far from certain

European Central Bank rate-cutting expectations continue to be the theme driving euro rates, and also at the longer end of the curve. The terminal rate as priced by ESTR swaps was pushed down by some 7bp and is now around 1.75%, in line with our forecast. Interestingly, most movement was in the belly of the curve, whilst the probability of a 50bp cut in December moved little and continues to hover in the range of 20-30%.

In our view, markets are right to recalibrate the ECB's endpoint lower, and we also agree that it's too early to call a 50bp cut for December with certainty. If anything, the remarks by ECB speakers this week highlight the difficulty of the current environment. On the one hand growth seems to

cool, albeit gradually, while inflation is not yet fully conquered.

Having said that, with growth a focal point of both the ECB and markets, we could still see a rapid shift lower in rates on just a few disappointing economic data points. Remember that the October cut was justified by a couple of poor PMI readings. While some ECB speakers are pushing back against current pricing, we know they are also easily persuaded by weaker growth, and the front-end of the curve may therefore find little resistance to move lower in the coming months.

US markets expect little volatility in the coming months

US rates continue in something of a hold-and-see pattern and the slight upside surprise in PPI numbers and better jobless claims did little to change the mood. Implied rates volatilities have also fallen further, with the one-month MOVE index now close to this year's average again. The comparable implied volatility measure for equities, the VIX, is back to its lowest since July, reflecting the general calm returning post-election.

Federal Reserve Chair Powell's speech last night was interpreted more hawkishly by markets, which pared back the chances of a rate cut in December to less than 50%. The economic resilience would allow the Fed to make more careful decisions. While the latest inflation data was a bigger bump than the Fed had anticipated, it clearly appears to be in no rush to cut rates. Powell remained guarded about the implications of the Republican clean sweep. While careful about changing policy until having more certainty, it also means that the Fed will still react should data start to disappoint in the coming months.

Friday's events and market views

On the data front, the highlights are the US retail sales figures for October, where the consensus is still looking for a 0.3% month-on-month increase for the control group after 0.7% in the prior month – note these are nominal growth figures. We also get the releases of industrial production data as well as import/export prices. The eurozone calendar is less exciting, though we should get an update of the EU Commission's economic forecasts.

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