

## Rates Spark: Feeble pushback

Markets are clearly eyeing the turn of the rate cycle, but amid central banks' 'high for longer' messaging and data releases, volatility remains elevated. Add to that the uncertain outlook for the German budget and Bund supply



ECB President Christine Lagarde and Vice-President Luis de Guindos are among those set to make public appearances today

### Feeble ECB pushback amid a broader sense of improving inflation

Markets are still pricing more than three 25bp cuts over the next year, and more than a 50% chance discounted that the first cut will already come in April. By June, it is already fully priced. We have had pushback over the past few days from European Central Bank (ECB) officials, but aggressive pricing shows it has had limited effect. The hawks were signalling again that hikes are not off the table. More centrist members seemed to downplay these chances but still stressed persistence. Francois Villeroy, for instance, stated that rates should plateau for the next few quarters. More interesting were discussions surrounding ending PEPP reinvestments sooner picking up again.

The [minutes of the October ECB meeting](#) confirmed the messaging around the key rate – that hikes are not entirely off the table. But the reality is also that the “disinflation process was proceeding somewhat faster than expected”, while the ECB is not as optimistic about the macro backdrop anymore.

Amid all the central bank messaging, we should also note that financial conditions remain relatively tight, at least when measured by real interest rates. The 2Y real OIS is just 10bp shy of this cycle's highest levels. At the longer end, the 10Y is well off the September spike but still higher than any time before that. This is thanks to the market inflation expectations component having come down notably from its highs over the past two months. Overall, it might lessen the need for officials to push back more aggressively, although some would point out the often-cited fragility of inflation expectations.

Yesterday's flash PMIs remained in contractionary territory but notched up a bit and signalled that the downturn is not worsening. For market interest rates yesterday, that was enough to start turning somewhat higher again.

## German budget woes highlight downside risks across the supply and macro outlook

As we head into the final months and weeks of the year, bond supply prospects move into focus. But this time around, there is increasing uncertainty surrounding the outlook for issuance of German Bunds after the constitutional court derailed the government's budget plans.

The downside risks are obvious, but we still have to get a clearer picture of what the ultimate impact is – not just in terms of supply but also for fiscal stance and the macro outlook as a whole. The political fallout is brewing, too. Members of the Free Democratic Party (FDP), which currently holds the finance ministry within the government coalition, have successfully petitioned to get a vote on whether to leave the coalition. The outcome would be non-binding for party leadership, though.

Yesterday, the finance minister announced that he wants parliament to retroactively declare an “emergency situation” for the current year, which would also allow for a suspension of the debt brake for the 2023 budget. This prospect gave Bund yields an uplift and retightened the Bund asset swap spread. But this plan is largely an after-the-fact legitimisation of 2023 borrowing given few other viable options and does not mean more debt issuance. The more relevant announcement of the 2024 budget has been postponed.

### Today's events and market view

Left to their own US Thanksgiving holidays, 10Y Bund yields climbed over 2.6%, again steepening the curve in the process. Today's calendar mainly features the German Ifo index – seen improving slightly – and public appearances from ECB President Christine Lagarde, Vice President Luis de Guindos and Spain's Pablo Hernández de Cos.

US markets will see an early close today, but we will have data releases from the US in the form of the S&P flash PMIs for November. Both services and manufacturing were just above the 50 threshold that demarks contractionary territory.

Looking into next week, the inflation outlook, which has helped drive the rally, will likely remain the main focus. The eurozone flash CPI could show inflation easing further, with the core rate likely getting into the 3% handle – even if only barely. The easing trend of inflation should also be confirmed in the US by the PCE data, the Fed's preferred inflation measure.

## Author

### **Benjamin Schroeder**

Senior Rates Strategist

[benjamin.schroeder@ing.com](mailto:benjamin.schroeder@ing.com)

### **Padhraic Garvey, CFA**

Regional Head of Research, Americas

[padhraic.garvey@ing.com](mailto:padhraic.garvey@ing.com)

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