Rates Spark: Flatter Bund curve should ECB fail to deliver

ECB cuts for October and December are fully priced in, yet ECB speakers appear to be pushing back against such firm positioning. If the ECB holds next week's meeting against all expectations, we could see some flattening of the Bund curve as policy mistake risk increases. The FOMC meeting notes showed support a 25bp cut in September

The ECB building in Frankfurt

Markets holding firm position on October ECB cut

With the ECB blackout period starting, members of the Governing Council had one last chance to dissuade markets from a cut next week and push back against the 24bp priced in by markets. Kazimir was especially critical about the expectation of a done deal and Wunsch was not yet convinced of an October cut. But markets held their position and even for December another cut remains fully priced in. Whilst October and December cuts are the most likely outcome in our view, we do warrant against excluding a hold scenario entirely.

That begs the question of whether the ECB can deviate from market pricing and what such a bold move would mean for euro rates in general. Forwards are now expecting four back-to-back cuts of 25bp, and thus skipping the October cut could be a bit of a blow to that conviction. On the front end, that would translate to higher rates as the ECB turns out more hawkish than interpreted and seemingly focused more on inflation. Interestingly we'll receive the minutes from September's meeting on Thursday which may shed some light on the balance between perceived inflation and growth risks.

In contrast, not cutting would probably lead to backend yields coming down as the risk of a policy error increases by being behind the curve. Growth concerns would mount and markets would return to the view that the ECB might have to cut below the neutral range of 2-2.25%. In effect, this could result in more rate cuts priced in, just moved further back in time and likely only reaching a low towards the end of 2025. Altogether the curve would flatten.

FOMC meeting notes showed support for 25bp cut in September

Wednesday's FOMC minutes pointed to a more divided Fed than the sole dissent to the 50bp cut decision had suggested. While in the end most supported the decision, some had preferred a smaller cut, which others said they would also have supported.

The market's pricing for the Fed's terminal rate, which should implicitly also provide a floor to rates further out, has in the meantime risen to 3.4%. The 2Y US Treasury yield has topped 4%, albeit just barely and we do not think it should move much higher from here. Rather the path should still be gradually lower as upcoming rate cuts draw closer. The 10Y still faces more persistent upside pressure in our view, having risen to 4.07%.

Thursday's events and market views

The key data release comes out of the US with the CPI data for September. The headline is expected to slow to 2.3% YoY and the core rate to stay at 3.2%. More relevant again is the monthly core rate that is seen reverting to 0.2%, which is needed to keep the annual rate tracking towards the 2% target. As such, the data should leave all options for the Fed on the table, even if the debate in the market seems to have shifted to whether even 25bp is necessary at all.

Unless there is a big (upside) surprise on the CPI data, the initial jobless claims data might be more market-moving in the wake of the payrolls data. It is a more contemporary indicator of job market health and the consensus sees the weekly figure ticking up only slightly.

The only noteworthy release out of the eurozone is the ECB minutes of the September meeting when the ECB cut a second time by 25bp.

Germany will be in the primary market auctioning two bonds in the 15Y maturity area for a combined €1.5bn. The US Treasury auctions are probably more closely followed after the weaker 3Y and 10Y sale earlier this week. Thursday the Treasury will sell 30Y bonds for US$22bn.

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