Rates Spark: FX and rates doing their own thing

A confident Chair Powell declared a hold for rates, and sounded a glass-half-full narrative for the US economy; we sniff some rates upside ahead. In the eurozone, a stronger euro is unlikely to push the ECB towards easing further, especially because our FX strategists note the broken correlation between EUR/USD and rate differentials

Even though the Federal Reserve kept rates on hold, we think US rates can still go higher with euro rates more contained

Market rates smell some more upside, while the plumbing gets the thumbs up (just)

The curve edged higher on the smidgen of reduced negative commentary from the FOMC statement, and the commentary from Chair Powell subsequently copper-fastened the market notion that rate cuts are off the agenda, at least for now. This week, the 10yr yield edged up from the 4.2% area on Monday to 4.25% post the FOMC (and is higher today, pre and post the FOMC). It's been quite the week for dollar products, given the FX intervention talk out of Japan, and then the dollar weakness push from President Trump. Add that vulnerability to a Fed that's standing pat on less macro negatives, likely facilitates an upside test for market rates as a lasting reaction.

In terms of the plumbing, no change to the policy action of buying bills, and out to 3yr Treasuries where required. That *has* been required, as the latest data show renewed net buying in the bond space (in fact dwarfing the roll-off of MBS paper). Repo volatility circumstances have in turn calmed, but the effective funds rate remains elevated. It remains at just a basis point below the rate paid on excess reserves, versus a prior 7bp spread. It's not a drama. But still, the optics aren't great. And those optics were, in fact, the genesis of the decision to re-ignite bills buying in the first place. But, not a whole lot of additional commentary on this from Chair Powell.

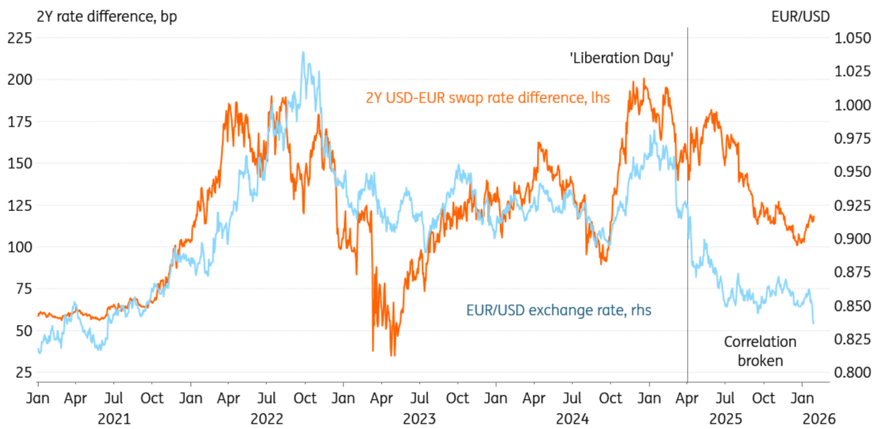
Stronger euro a headache for the ECB but unlikely a game changer

The euro's appreciation on the back of a stronger dollar tilts the balance of risks slightly further towards more European Central Bank cuts, but the rates impact should be limited for now. In normal circumstances, a stronger euro would be linked to improving growth and is therefore often interpreted as a hawkish signal. In this case, however, the euro strengthening is driven by forces external to the eurozone's economy, a scenario which can be a bit of a headache for the ECB. In effect, a stronger euro reduces the price of imports and worsens the competitiveness of exports. Lower inflation and headwinds to growth would then be reasons for the ECB to cut further.

A key question is whether the ECB will actually have to cut rates on the back of a stronger euro. The ECB's own projections from December suggest that a 1.21 EUR/USD exchange rate (vs 1.19 EUR/USD currently) would lower inflation and GDP growth by about 0.1ppt in 2026, not a lot.

Meanwhile, our FX strategists see that the classical correlation between EUR/USD and rate differentials has broken down over the past months. So, even if the ECB cuts once or twice, the broader macro and geopolitical stories may remain a bigger driver than relative policy rates. Already in the past days, we see that comments from Trump and Bessent on the dollar strength are the main FX movers, not relative rates. We therefore see the euro strength as an additional factor in the ECB's decision-making, but not something markets should react dramatically.

ECB rate cuts may not have much impact on the euro strength



Source: ING, Macrobond

Thursday's events and market views

From the eurozone we have final consumer confidence numbers for January, which continue to slowly show some improvement. We also get the M3 growth numbers for

December. From the US we have weekly jobless claims, together with trade balance numbers and factory orders data from November.

In terms of supply, we have Italy with an auction of 5Y and 10Y BTPs together with a 9Y CCTeu, totalling €8.5bn. From the UK we have a 2028 gilt tender for £1.25bn, and the US will auction $44bn of 7Y Notes.

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