

Rates Spark: Good but fragile sentiment as we approach ECB decision

Market sentiment is positive with Chinese and European equities higher. If the ECB fails to deliver on the highly anticipated cut this week, which we think is possible, some sizeable moves are possible as sentiment takes a hit. Don't forget, the ECB's prime objective is inflation, not growth. US markets will open again after Monday's holiday



Risk of sizeable market moves if ECB fails to deliver on cut

Risk sentiment is good in markets as we approach the European Central Bank rate decision on Thursday. Chinese and European equities are all up and the VIX is slowly nudging lower again. The negative outlook by Fitch on France did little to upset OAT investors, with the 10Y Bund-OAT spread trading tighter since. Markets are concerned about European growth, but at the same time seem confident that the ECB will be ahead of the curve and ease another 25bp this week, followed closely by more cuts at each successive meeting.

Such high expectations from the ECB can be risky and markets should be aware that the fight against inflation is not yet over, a battle that remains the prime objective of the ECB. We see

[plenty of arguments](#) for the ECB to stay on hold at this meeting and yet the pricing has hovered around a 95% probability for a cut over the past two weeks. Just last month, the probability was priced at 25%.

An October cut is our baseline, but we would also not be surprised if ECB President Christine Lagarde refrained from cutting. Markets are poorly positioned for such a disappointment and a broader risk-off mode would seem likely in this case. Given market sentiment is quite good currently and even the implied EUR rates volatility is only just below this year's lows, we see a risk of sizeable market moves if the ECB fails to meet expectations.

Tuesday's events and market view

There is not too much in the calendar to go by today after the UK jobs data in the morning. EUR markets will look to Germany's ZEW index where a slight improvement in the expectations component is eyed. Having said that, markets won't be brought out of balance if the German data disappoints again. France and Spain will also release the final CPI data for September. US markets open again after Monday's holiday and the Empire manufacturing index is set to be released. The Federal Reserve speaker to watch is San Francisco's Mary Daly later in the day.

Finland is in the primary market tapping 6y and 10y bonds for up to €1.5bn. The UK sells £2.25bn in 30y Gilt.

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