Rates Spark: Growth disappointments on ECB day

The ECB cut the policy rate to 2.75% as expected, thereby approaching the estimated neutral range of 1.75% to 2.5%. Weak growth numbers helped feed the dovish sentiment and we think the front end of the euro curve can therefore still move lower. In the US we also maintain a bullish bias and will be closely watching PCE data and developments on tariffs closely

Weak growth and a willing ECB can pull front end of euro swap curve lower

The stagnating eurozone growth set a dovish backdrop for the European Central Bank meeting on Thursday. French, German and Italian GDP numbers for the last quarter of 2024 surprised to the downside and also the aggregate eurozone growth number disappointed with a 0% quarter-on-quarter reading. Such numbers pave the way for more easing and indeed the ECB cut the policy rate by another 25bp as was already widely anticipated.

Confidence in reaching the inflation target paired with the expressed notion that rates are still restrictive mean that the next cut is also pretty much consensus already. This would bring the policy rate to the top end of the estimated neutral range of 1.75% to 2.5%. President Christine Lagarde flagged an upcoming staff report on the neutral rate to be released on 7 February, which helped her defer the discussion to that moment. Come March and reaching 2.5%, further deferral is no longer an option.

Markets have added conviction to the view that the ECB might have to go further, with a 2% deposit facility rate by year-end becoming closer to being fully priced in. Overall the EUR curve bull steepened in reaction to the meeting and press conference. To us faltering growth numbers and an ECB showing a willingness to cut means that the front end of the euro swap curve can still move lower. And with the bearish sentiment in US rates markets fading for now, shorter-dated euro rates can find themselves lower again in the near term. But we also note that data remains a key driver.

We maintain slight bullish bias on US rates, but PCE and payroll outcomes are key here

US rates have traded with a slight bullish bias over the past week, with 10y Treasury yields probing their way towards 4.5%. With a view to the PCE data today and possible larger benchmark revisions to payrolls next week we are inclined to maintain that bias, but are equally aware that room for long end rates to go much lower is limited by where markets are seeing the Fed bottoming out. The SOFR futures strip sees its trough at 3.9% and the 10y SOFR OIS currently sits not far above at roughly 4.1%.

Complicating the picture is the news flow around US tariffs, with President Donald Trump reiterating his plans to impose 25% tariffs on Canada and Mexico starting February and also imposing fentanyl related tariffs on China. Even if announced over the weekend, it does not necessarily mean tariffs will be collected from day one. There could still be room for negotiation and excluding certain products. But the uncertainty could keep Fed expectations at more elevated levels and also constrain also longer rates.

Today's events and market view

US PCE data will be the main release this Friday. The consensus is looking for a 0.2% in the relevant month-on-month core measure which should give the Fed the necessary room on the inflation side. But at the same time a 2.8% year-on-year figure signals that the issue is also not resolved yet. The employment cost index for the fourth quarter is also expected to come in slightly higher at 0.9% quarter-on-quarter from 0.8%. In addition, Trump threatened to impose tariffs on Canada and Mexico on 1 February and potentially also on China. Although concrete plans remain unclear, any developments will be closely watched.

The ECB will release its survey of consumer inflation expectations. The 1y figure has notched up from 2.4% in September to 2.6% in November and is seen to rise further to 2.7% for December – another fly in the ointment of the ECB's inflation narrative. We will also get more country inflation readings ahead of next week's flash CPI estimate for the eurozone – Germany and France will report. Markets see the bloc's headline inflation ticking higher, but maybe more importantly core inflation is seen easing toward an admittedly still elevated 2.6% YoY.

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