

Rates Spark: We're now in a holding pattern

The ECB keeping rates on hold reflects what will likely be a common theme at next week's Fed and BoE meetings, and its dovish tone will find affirmation in upcoming inflation and growth data. But longer-end rates remain under the spell of US Treasuries, where supply is also a key driver



ECB President, Christine Lagarde in Athens yesterday

The ECB delivers a dovish hold

The European Central Bank kept interest rates on hold as widely anticipated but struck a slightly more dovish tone than expected. Importantly, the ECB refrained from shifting the focus to the balance sheet now rates are deemed sufficiently high. According to President Christine Lagarde, both the PEPP and the minimum reserve requirement were not even discussed.

Lagarde highlighted again that data dependency also means rate hikes could not be excluded, but she said any discussion about cuts was “totally premature”. That said, the undertone regarding the economy has become more cautious. Also, with regard to a potential spike in energy prices, she highlighted the uncertainty of their medium-term impact on inflation.

Overall, market reaction in outright rates is more difficult to disentangle given the release of US

data just ahead of the press conference. Very front-end rates, which should be less influenced by US spillovers, reflected the somewhat more dovish take and a firming notion that the ECB has reached peak rates already. The already minimal hike speculation reflected in ECB-dated OIS forwards for December was further trimmed, and the strip is downward sloping from then onwards to fully discount a rate cut by June next year.

Sovereign spreads initially reacted with relief, with the key spread of 10Y Italian government bonds versus Bunds briefly narrowing back below 200bp. Obviously, it is unlikely to be the end of the story, and the ECB could pick up the discussion at some point. Indeed, Reuters later reported that policymakers agreed to postpone the debate until the winter. and a discussion on minimum reserves was reported to come as part of the operational framework review.

US 3Q GDP beats, but supply remains a key driver for the USTs

Just ahead of the ECB, the US 3Q GDP data showed the economy expanded by 4.9%, beating expectations. Markets, though, know that this is hardly sustainable and had more of an eye for the cooler-than-expected quarterly core PCE figure coming in at 2.4% versus 2.5%. This means a downside to the consensus that currently sees a hotter September figure. In other data, we note that initial jobless claims were only a tad higher, but continuing claims have extended the past month's steady move higher.

It was interesting to see a bull steepening of the US Treasury curve again. Since the Fed has started to indicate that long-end rates were doing part of the Fed's work, we have seen more instances of bull steepening. But a bull flattening soon followed: A solid 7Y auction had triggered an outperformance of long-end bonds. This reaction serves to highlight the sensitivity to US supply concerns, seen as a key driver of rising term premium. The next key event here is the upcoming quarterly refunding.

Today's events and market view

The ECB played out slightly more dovish than anticipated. In the coming days, ECB officials will add their personal flavours to the event as usual. But more importantly, next week's data including the flash CPI for October as well as Q3 GDP growth, could help underpin the dovish tone early in the week.

However, in longer tenors, US rates should remain in the driving seat. And here there will be a lot to digest starting mid-week with the FOMC meeting, quarterly refunding announcement, ISMs and jobs data.

As for today's data, the focus is on US personal income and spending data and the PCE deflator, but much can already be backed out of yesterday's GDP data.

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