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Rates Spark: Last call for 50bp in December

Today's eurozone flash CPI should end any chance of a 50bp ECB cut next month. A large undershoot would be needed to push market expectations back in that direction after officials did not latch on to the weaker PMIs. In France, it looks as if the worst can be avoided, but the difficult politics of reining in the deficit are not going away

Eurozone flash CPI should end any chance of a larger 50bp ECB cut next month

Spanish and German CPI slightly undershot consensus, which means a 50bp cut in December is not fully off the table. Having said that, the eurozone CPI today will have to come in significantly below expectations for markets to price in a higher probability of a 50bp cut. Right now, just 30bp are priced in, and with European Central Bank speakers not convinced a larger cut is necessary, we don't think this number will move higher on a consensus reading.

The more interesting story in our view is actually found in the pricing of long-term inflation. The 5Y5Y inflation forward has dipped below 2.0% this week, which is lower than the ECB's inflation target. The last time the 5Y5Y drifted below that handle was in 2014, on the eve of QE taking off. It took until 2021 for the 5Y5Y to edge above 2% again. This move highlights that concerns about the eurozone are not just of a cyclical nature, but also the long-term economic outlook is being repriced by markets.

Having said that, we think markets are underestimating long-term inflation risk, which in our view is tilted to the upside. Structural drivers of inflation, such as demographics, decarbonisation and deglobalisation will apply upward pressure in the coming years. And the willingness to provide fiscal support in case of severe growth headwinds should prevent a return to the low inflation environment that we had in the years before Covid.

France: Cautious optimism that the worst can be avoided

In France, the government has given in to the pressure coming from Marine Le Pen's party. While the latter is claiming victory already, it appears they see this as an opportunity to extract more concessions with the threat of bringing down the government. At least there is some movement and talk - markets have so far reacted with some relief, tightening the 10y spread of French government bonds over Bunds by 4bp to just over 80bp, although that is still above the prior June peak. The broader gauge for risk sentiment, the 10y Bund spread versus swaps hovered at -7bp, signalling ongoing caution.

In the end, the worst case might be avoided, but the episode does highlight the political struggles to rein in France's fiscal deficit. And it is likely to only get tougher if the macro backdrop deteriorates further. After markets close today, all eyes will be on S&P and whether it chooses to review its AA-/Stable rating of the French sovereign. The last review took place only in May which already led to the downgrade from AA, just ahead of the EU elections and subsequent French snap elections.

Today's events and market view

After the French flash CPI in the morning the focus will turn to the reading for the eurozone. The headline CPI is expected to rise to 2.3% from 2% YoY, although the reading on the month is seen at a negative -0.2%. Core CPI is expected to rise to an elevated 2.8% from 2.7% YoY. We will also get the ECB consumer survey on inflation expectations. Scheduled ECB speakers for the day are Vice President Luis De Guindos and Bundesbank's Joachim Nagel.

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