

Rates Spark: Many known unknowns to argue for more ECB easing

With lurking growth, disinflation and (geo)political risks, we continue to see the balance tilted towards more ECB easing. France is one of these risks and despite new efforts, there is a considerable chance we have new elections by year-end. Given the long list of risks, we don't see markets pricing out a last ECB cut anytime soon



ECB President Christine Lagarde

Unlikely to see the last ECB cut priced out anytime soon

Whilst volatility has fallen significantly, we do think the risk is tilted towards lower 2Y rates. First, growth remains weak and survey data such as the ZEW indices expected on Tuesday underline the fragile recovery path of the eurozone. Secondly, lower oil prices add to the disinflationary risks, together with our view that the euro should still strengthen going forward. And if these disinflationary factors are brought about by external factors, like worsening growth numbers for the US and China, then this would also weigh down the eurozone economic outlook.

Lastly, we have plenty of known unknowns – lurking (geo)political risks that have yet to unravel. France is one of them and Trump reminded us again that trade tensions are part of the new global environment. Meanwhile, the conflict with Russia has no end in sight, and Germany's fiscal plans

made a slow start. For now, the impact of these risks is difficult to quantify, but they do lower the bar for the ECB to ease further. If growth doesn't pick up more materially, the euro strengthens, and oil nudges lower, the case for one or even two rate cuts can be easily made. Not our baseline, but we do believe these factors are enough to prevent markets from pricing out another ECB cut anytime soon.

Expect more headlines out of France as the budget process begins

Markets will have to contend with continued headline risk emanating from France. Prime Minister Lecornu is expected to outline his programme to parliament and, by presenting his budget plans, kick off the budget negotiations process. At the same time, both the far right and far left have already proposed motions of no confidence, which could be voted on as early as Wednesday or Thursday. The Centre Socialists have for now agreed to a truce, but at the cost of concessions around the implementation of the pension reform. The budget process until year-end clearly brings plenty more opportunity to bring down the government, which is clearly reflected in betting market odds. They still put the probability of new elections being called by year-end at over 60%.

Arguably, with 10y yield spreads of French government bonds over Bunds at around 83bp the market is already accounting for that risk to a large degree. We see little reason for the spread to recover from its elevated range. Not just because of the lingering political risk, but also given the near-term risk of rating downgrades, as Moody's this month and S&P in November still have to cast their rating verdicts after Fitch lowered France into single A territory this September. Agencies will also closely watch political dynamics around the pension reform, which was once seen as an important factor in securing French rating stability.

Tuesday's events and market views

From the UK, we already received a relatively dovish jobs report this morning. Then from Europe we have the ZEW survey for Germany and the eurozone aggregate. German numbers are expected to nudge slightly higher, from 37 to 41. From the US, we expect the NFIB small business optimism index, which may get more attention given the absence of official data. Consensus sees the September figure practically flat at 100.6. In terms of speakers, we have Powell from the Fed talking about the economic outlook and monetary policy.

In terms of supply, we have an auction from the Netherlands for €2.5bn of 6Y DSLs and the UK has planned a syndication of 15Y Gilts for an estimated £8-10bn. Italy will auction 3Y, 7Y and 15Y BTPs worth €8.5bn. Lastly, we will see 2Y Schatz from Germany for €5.5bn.

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