

## Rates Spark: Markets positioned for back-to-back ECB cuts

The European Central Bank should cut but we still see a tail risk that the Governing Council decides to hold the deposit rate at 3.5%. Markets are already fully pricing in four consecutive 25bp cuts, which prevents the front end of the curve from going much lower based on current economic data. We have a bias towards a flatter EUR curve going into the meeting



ECB President Christine Lagarde

### ECB cut most likely, but sharp market positioning prevents the front end going lower

We think the ECB will cut by 25bp, and so do markets, but holding the deposit rate at 3.5% is still possible in our view. Not cutting would be a big surprise to rates given the implied probability of swaps is north of 90% and has been there for two weeks. After this meeting, markets price in consecutive cuts of 25bp for the next four to come, and thus a disappointment now would challenge the entire trajectory going forward.

Also if the ECB cuts as expected, we see a considerable chance that market expectations won't be met in terms of communication. The ECB will likely want to keep flexibility about a December cut

and will push back against the idea that this is the start of consecutive cuts, as is currently priced in. On the other hand, ECB President Christine Lagarde may place more emphasis on mounting growth concerns, which could be caught as a dovish tone by markets. Having said that, we deem it unlikely markets will move to pricing in a probability for 50bp cuts for the time being and thus the front-end of the curve should be supported from below.

A pushback against current pricing (or even a decision to hold rates) could see some flattening of the EUR swap curve. Not cutting would risk a broader risk-off move as worries about a policy error would rise considerably. In this case, the terminal policy rate of the ECB could actually fall back below the neutral range of 2-2.25% as recession risks get priced in more. With little scope for the front end to go lower, we go into the meeting with a bias towards a flatter curve.

## Thursday's events and market view

A cut from the ECB is seen as a done deal, not just looking at market pricing. All 37 economists surveyed by Bloomberg see a cut. If delivered, the cut itself could be a non-event for markets and the focus will mainly fall on communication with no new ECB forecasts to be presented this time.

US data should become more influential again. For retail sales, the strong auto sales should provide a good baseline, and our economists look for 0.4%MoM growth given decent consumer credit card borrowing numbers. Industrial production holds some downside after weak survey data. Markets tend to be more sensitive to the jobless claims which nudged higher last week. Hurricanes and knock-on effects of strikes have led to some volatility, but this time a stable level is anticipated.

Primary markets will see Spain in the market reopening 7Y to 24Y bonds for up to €5.5bn. France will also be in the market selling shorter-dated bonds out to the 5y maturity and linkers, up to €14.5bn in total.

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