Rates Spark: Markets stick to frontloaded ECB cuts

Markets are anticipating more aggressive European Central Bank rate cuts, with a 40% probability of a 50bp cut in December, supported by little resistance from IMF speeches. The spread between USTs and Bunds keeps widening and this may continue until we have more clarity on the US election outcome

IMF speakers give little pushback against frontloaded ECB cuts

Markets are seeing more frontloading of ECB cuts and the central bankers at the IMF annual meeting seem to be giving little pushback. We now have a 2Y EUR swap rate of 2.1%, some 20bp below the peak earlier this month. The known hawk Holzmann commented that some Governing Council members may push for a big cut in December, suggesting a 50bp cut may not be too far-fetched. Markets now price in a 40% probability of a 50bp cut, which seems high but without pushback could build further.

PMIs may strengthen markets' positioning for faster ECB cuts as the composite eurozone index is expected to remain below 50. The eurozone services component is still in expansionary territory, but with a German manufacturing index of 40.8, there are clear weaknesses in the economy. An upside surprise in the PMI numbers is of course still possible, but the question is whether this would dissuade rates much given the perceived ECB's keenness to return to neutral.

The spread between USTs and Bunds can keep widening

In the US, the Treasuries sell-off seems to continue and bearish sentiment is also reflected in the poor take-up of last night's 20Y Treasury auction. The 10Y UST is now well above 4.2%, the highest since July. This means that the gap between USD and EUR swaps keeps widening, whereby the 5Y SOFR-ESTR spread is around 160bp and approaching the peaks of April. Until we gain more clarity on the US election outcome, this divergence in rates may continue. From the US, the lack of disappointing data means the upward momentum in UST yields won't find any resistance, whilst a potential Trump victory caps the upward potential for Bund yields.

The Fed's Beige Book has once again painted a picture of a weaker economy than that portrayed in official data. It states: "On balance, economic activity was little changed in nearly all districts since early September, though two districts (out of 12) reported modest growth." The focus of course is on the jobs market, where "on balance, employment increased slightly during this reporting period". But demand for workers eased somewhat and hiring is focused on replacement rather than growth. Overall, the report contained nothing to dissuade the Fed from cutting rates in November but also did not signal any urgency to go beyond the 25bp that the market is currently still anticipating.

Thursday's events and market views

Data should take over as a driver with the next set of flash PMIs up for release and given how influential they were in the ECB's latest dovish shift. French and German PMIs are released first and the consensus is looking for a marginal improvement. This is also reflected in the eurozone PMI expectations, with the composite expected to inch up to 49.7 from 49.6. It will get quieter on the speaker front with the ECB's Lane and Kazaks scheduled to appear.

US data will also get more interesting with the initial jobless claims and the S&P PMIs up for release. Anything jobs-related always catches the eye, but weather effects might be behind the wider distribution in individual expectations, which is also skewed towards higher jobless claims.

In government bond primary markets we only have Finland with a small reverse inquiry operation and the UST selling new 5y TIPS.

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