# Rates Spark: Not as dovish as hoped

The European Central Bank cut by 25bp as widely expected but EUR rates moved higher coming out of the press conference with the belly underperforming. Lagarde sounded more balanced than a central bank geared to supporting growth if pressed. Up next is the Fed next week. We look at a technical adjustment in the works for the Fed's reverse repo rate


ECB President Lagarde was not dovish enough at the press conference, disappointing markets

## Lagarde not dovish enough for the market

The ECB cut policy rates by 25bp as widely expected but EUR rates moved higher coming out of the press conference with the belly underperforming. A next cut in January is still firmly priced, even with again a chance for a larger cut, but overall Lagarde did not meet the market's high dovish expectations. President Lagarde pointed out that the risks to inflation were two-sided, and that with four cuts the ECB had already covered a lot of ground in terms of easing. This sounded a tad more balanced than a central bank geared to supporting growth if pressed.

1y1y ESTR forward, which had the day before traded at around 1.65%, had moved towards 1.74% after the ECB meeting, though in the grander scheme of things those moves are still almost noise. It is a notable move away from formerly firm epectations that the ECB would take rates below neutral levels – or at least the current estimate thereof at around 2% to 2.25%. Further out the 10y

Bund is up by 8bp on the day going out at 2.20%, the highest since late November.

With the ECB coming across less dovish we also saw a correction wider in sovereign bonds spreads. Not led by France, but by Italy where the 10y spread over Bunds widened by 8bp. Quite notable, but it comes after a tightening run that previously defied all headwinds. The spread touched a low of 106bp versus Bunds and less than 30bp versus France – we would not exclude that some investors were looking to take profit at these levels.

## Technical adjustment in the works for the Fed’s reverse repo rate

Ahead of next week’s FOMC meeting, we note that he minutes from the last FOMC meeting made reference to a possible technical adjustment to the Fed’s reverse repo rate. It’s currently at 4.55%, and so 5bp above the Fed funds floor at 4.5% (with the ceiling at 4.75%). The suggestion is for the reverse repo rate to be cut by 5bp, bringing it flat to the funds rate floor. Technically what would happen is the Fed funds floor and ceiling rates would be cut by 25bp, and the reverse repo rate cut by 30bp, thus pitching the Fed funds floor and reverse repo rate flat at 4.25%. The other key rate, the interest on reserves, is currently at 4.65%, and so 15bp above the floor. This is projected to also be cut by 25bp, thus keeping spreads versus the floor and ceiling rates unchanged.

So what are the implications of all of this? There are a few moving parts here. First and foremost, the Fed’s main job here is to manage the effective Fed funds rate. This is currently at 4.58%. It generally sits between the reverse repo rate and the rate on reserves. The interest on reserves has been the most impactful factor driving the effective fund rate, in turn driven by Federal Home Loan Banks overnight cash activity. This spread has been steady at 7bp, and is likely to remain so. Although if anything, the effect could be to tempt the effective funds rate lower. But on balance, we’d expect the spread to the rate on reserves to hold. That would pitch the effective funds rate 25bp lower at 4.33%.

The main outcome here is a reduced compensation for cash going back to the Fed on the reverse repo facility, which makes that facility less attractive at the margin. In turn this continues to push on the falls in use of the facility ahead. That’s been the direction of travel in any case. The added benefit is the reverse repo balances head towards zero before eating into bank reserves. Ultimately as bank reserves then fall, the Fed’s quantitative tightening programme would be called to a halt. Not something to worry about though till second quarter 2025 at the earliest we think.

## Friday's events and market view

The day after the ECB meeting expect the usual flurry of individiadual central bankers' takes on the decision. Slated to speak are Austria's Holzmann, France's Villeroy, as well as Portugal's Centeno, thus already covering the full hawk-dove spectrum. In data we will see Eurozone industrial production as well as import prices out of the US.

The Dutch State Treasury Agency (DSTA) will present its 2025 outlook. Outherwise the primary market will be quiet apart from a small optional reverse inquiry sale from Belgium.

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