

Rates Spark: One central bank on hold, the other close to cutting again

We don't expect a cut from the ECB, but we will be listening for any communication tweaks about the reaction function, especially in regard to a stronger euro. The Bank of England is also very unlikely to cut rates today, but we take a more dovish stance than markets on future cuts



Markets are pricing in no change by the Bank of England for today, but we think we will see a rate cut in March

Recent events not enough to push the ECB out of its 'good place'

Going into the ECB meeting, the market community agrees that no action will be taken by the council to change the policy course. Virtually nothing is priced into the forward rates for the February meeting. While the growth backdrop remains largely resilient, recent jitters in FX and energy markets are clearly not enough to prompt any immediate reaction. But having highlighted the uncertainties around the ECB's 'good place', the market has seen an easing bias creep into the pricing through this year. The implied probability of a cut this year is seen to the tune of 25%.

With no new forecasts to be presented this time around, the main focus is on any potential tweaks to the communication and what this implies for the reaction function further down the line. Any

signs of more emphasis on, or more heated debate around FX, could be seen as lowering the bar to further easing. It would confirm the market's discount of an easing bias for the next few quarters.

We are still more dovish on the Bank of England than markets

Markets are not pricing in any chance of a Bank of England cut this week, but a March cut is not completely off the table. We actually still have a [March cut as our baseline](#), which seems out of consensus versus only a c.20% probability priced in by markets. The jobs market is weakening and inflation should still drop dramatically between now and April. We expect a 7-2 vote to keep rates on hold and will be listening if Governor Bailey turns more open towards a March cut. Even if the communication does not turn more dovish, the next two rounds of jobs and wage data should be convincing enough to cut in March, in our view.

For gilt yields to turn materially lower, we would need to see a more dovish turn in markets' BoE pricing. The risk premium that was baked into gilts leading to the budget last November has come down. That means that the 10Y gilt yield is now close to fairly priced in relation to the FX-hedged yields of Bunds and US Treasuries. Meanwhile, investors remain wary about fiscal pressures as reflected in the recent sell-off of Japanese government bonds. We therefore don't expect the back end of the gilt curve to ease much lower in the current environment.

If anything, the tensions in UK politics pose an upside risk to gilt yields. Therefore, for sterling rates to make a material move lower, markets would need to appreciate that the BoE has more room for easing. We think they will, but likely only once they get more comfortable with lower inflation readings later this year.

Thursday's events and market views

The focus will be on the central bank meetings, but in terms of data we also have December's data for German factory orders, French industrial production and eurozone retail sales. From the US we have the Challenger job cuts data, JOLTS job openings and weekly jobless claims, all measures that markets use to assess the severity of the cooling jobs market.

In terms of notable supply, we have Spain with 3Y, 7Y and 10Y SPGBs together with an 8Y SPGBei, totalling €6.75bn. France will auction 9Y, 10Y and 16Y OATs paired with a 23Y green OAT, amounting to a total issuance of €13.5bn.

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