

## Rates Spark: Stuff perking interest as we end the week

Oil price dynamics had muted feed-through to EUR rates. The Eurozone flash PMIs should remain in line with a weak but gradual recovery, confirming the longer-run picture anchoring EUR rates. Friday's US CPI will set the scene ahead of next week's Federal Reserve meeting, which could have reserve-management implications for Treasuries



### Consensus sees PMIs confirming the longer-run picture that still anchors EUR rates

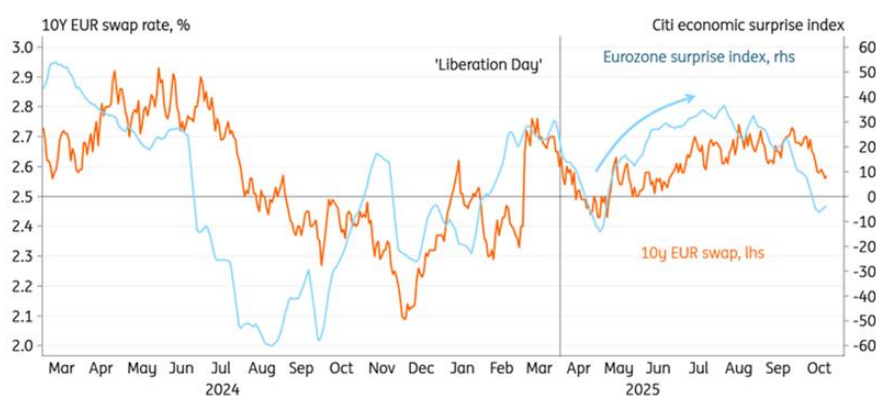
The latest hawkish turn in the US stance towards Russia and its impact on oil prices has seen muted feed-through into EUR rates. The 8% rally in Brent over the past few days pushed 5y5y inflation swaps higher from 2.05% to 2.08%. It did halt the latest slide, and this kept forward inflation expectations above the lows hit in the wake of liberation day. But looking at longer rates like the 10y swap, this was not enough to lift it back above 2.6%, a level it has lingered below since mid-October.

The front end has also budged very little, with the 2y up by a mere 1bp alongside the oil rally of

the past days. For a market already looking at a high bar for the European Central Bank to make further moves, higher energy prices do not change the bigger picture, with an inflation undershoot remaining part of the near-term outlook. Uncertainty around the US outlook and trade tensions might pose a greater risk of disrupting a feeble Eurozone recovery.

Looking a bit further back, Euro rates bounced back in the wake of Liberation Day on better-than-expected data, but the bar for upside surprises has risen since then. In May and June, the economic data was clearly better than markets had feared. The impact of tariff uncertainty did not set back the fragile yet gradual growth trajectory. Even though the data still paints that picture, the market needs a bigger improvement in the data now to still be surprised. So, even if PMIs reflect an improving growth outlook, rates may not be as willing to adjust higher this time.

## The bar for upside growth surprises has risen over recent month



Source: ING, Macrobond

## What will the Fed do about bank reserves next week?

Renewed focus on liquidity management is likely to be a feature at the Fed's 28-29 October meeting. Bank reserves are now just under USD\$3trn, which is about 10% of GDP, and should be comfortable. But the Fed won't want to take too many risks, preferring to ensure that excess reserves are ample enough to support the system. Identifying the exact level enters the realm of the dark arts, but the Fed knows very well that the last time it tested the lower end, they took reserves down to just below 7% of GDP. At around that level, there was considerable consternation in repo when a moderate corporate tax payment date, along with some bill settlements, left the market short, triggering severe funding market spikes. With reserves at 10% of GDP, we're nowhere near that. But a glide path that ensures we don't go below 9% is required. That implies a tolerance for some USD\$300bn of further reserve reductions.

As it is, some USD\$5bn of Treasuries are rolling off monthly. The cap on mortgage-backed-security roll-offs is USD\$35bn, but the actual monthly roll-off has tended to be much lower, around USD15bn. So the current roll-off is about \$20bn per month. At this pace, the identified US\$300bn of comfort would be exhausted in about a year. What to do? The Fed is likely to completely end the roll-off of Treasuries. With respect to MBS, the issue is that the Fed would prefer not to have these on its balance sheet; it currently holds about USD\$2 trillion. The simplest thing to do is to hold their nose and keep it on their balance sheet. But they could also consider maintaining the roll-off of MBS while buying either Treasuries or T-bills. Probably bills, to avoid it being construed as quantitative easing. There's not been much talk about this option, so if they did this, it could prove quite supportive.

## Friday's events and market view

The Eurozone flash PMIs will provide the ECB with a current reading on the state of the economic recovery ahead of next week's meeting. The consensus is looking for an unchanged manufacturing PMI at 49.8 and a slightly softer services reading of 51.2, overall, still in line with a weak but gradual recovery.

In the US, all eyes will be on the US September CPI, which will be published despite the shutdown, as it is needed to calculate the Social Security Administration's 2026 cost-of-living adjustment. Consensus expects headline prices to rise around 0.4% MoM and the core measure to rise around 0.3%. Tariffs may start to become a little more obvious but given the Fed's primary worry right now is a cooling in the jobs market, this won't block a 25bp rate cut later this month. We will also get US S&P PMIs and the University of Michigan's final consumer confidence reading for October.

After markets close, rating agencies' reviews of Belgium and France should receive some attention – S&P is scheduled to look at its AA/Negative rating for Belgium, and Moody's will likely be prompted to reassess its Aa3/Stable stance on France after Fitch and S&P have already lowered France to a single-A rating.

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