Rates Spark: ECB presser bear flattened the curve

The European Central Bank cut rates by 25bp as widely anticipated, but a slightly hawkish tilt bear flattened the EUR curve, which in our view remains priced aggressively. Prospects of a 50bp in the US cut next week are not off the table yet, but in any case, inflation data should leave the Fed with room to respond more aggressively at a later stage if needed

The ECB's press conference following yesterday's meeting in Frankfurt, Germany

ECB cut rates by 25bp as anticipated, but with a slightly hawkish tilt

A 5bp trading range for 10-year bunds on ECB day and some of that volatility was probably more down to US data highlights than the ECB's cut, as it had been well flagged and ECB President Christine Lagarde did not give away too much.

Data dependence was reiterated and in terms of new staff projections, there was a slight downgrade to the growth projections, while headline inflation projections remained unchanged versus June. But Lagarde noted that progress on underlying inflation was unsatisfactory, which was backed by core inflation forecasts being nudged up slightly for this year and 2025.

Overall, the presser contained less dovishness than the market had hoped for and there was more movement in front-end rates as markets pared back the odds of a next cut in October to below 25%; Lagarde had noted the short time until the 17 October meeting. The market shaved 5bp from December forwards, and the July 2025 meeting was also pushed up by 7bp to above 2% again. That is still more aggressive than our ECB forecast of 2.25%. On the day, 2-year yields were up by more than 7bp while 10-year rates rose around 4bp to end at 2.15%.

A 50bp Fed cut next week not completely off the table

As markets head towards the Federal Reserve's first rate cut, the probability of a larger cut rose slightly on Thursday in the wake of the PPI figures and a report from a renowned WSJ Fed watcher stating that the size of the impending cut was still a close call. The OIS implied odds for a 50bp move increased back to more than 20%. Away from the very short end, the pressure on rates was to the upside, however, slightly steepening the curve where the 2s10s slope had been back to flirting with the zero line again.

While the monthly PPI headline figures came in slightly higher than expected, components feeding into the Fed’s favoured inflation measure – the PCE deflator – backed the prospect of a 0.2% month-on-month reading. This inflation backdrop should provide officials with the flexibility to respond more aggressively should the jobs backdrop weaken. Not necessarily next week, but further down the road. Thursday’s initial jobless claims data came in in line with expectations and did little to move the market.

Today’s events an market view

EUR markets will be focusing on post-meeting communications. The first “insider” stories that broke Thursday evening noted that the door to an October cut was not closed, but that chances were low.

The main drivers should come via US data. On the slate are import and export prices as well as the preliminary University of Michigan consumer confidence index. The latter could be more important, especially if the data fails to meet the consensus expectation of a slight improvement.

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