Rates Spark: ECB unlikely to trigger any directionality in rates

The ECB will most likely cut 25bp, which is almost fully priced in by markets. With plenty of uncertainty ahead from the US-EU trade tensions, we doubt the ECB will steer markets out of the current range-bound trading. A sharp move lower of UST yields on Wednesday did little to move euro rates, further highlighting the disentanglement between the two markets

Markets widely expect the European Central Bank to cut rates by 25bp today

Both markets and the ECB need more data to decide on direction

Heading into Thursday's European Central Bank meeting, the market is almost fully priced for a 25bp cut. This means the market will be mainly looking for hints about future rate trajectories during the press conference. A downwardly revised inflation projection and a balance of risks around the growth outlook, perhaps more clearly pointing to the downside, would generally paint a dovish backdrop, but given the uncertain environment around trade specifically, one should not expect any concrete hints from President Lagarde.

The market still anticipates at least one more cut by the end of the year, bringing the deposit facility rate to 1.75%. There is a moderate chance of further cuts, but pricing is largely influenced by sentiment around US-EU trade relations these days and its feed through to activity this side of the Atlantic – the US data on Wednesday did not move the needle here at all.

Between the tariff news and Germany's fiscal U-turn in March, markets have established a range for the terminal deposit facility rate of 1.5% to 2%. Currently, at the lower end of this range, a slightly dovish tone from the ECB now is unlikely to change the overall picture, keeping pricing in the lower half of the range. A significant drop in rates would likely require a series of weaker data points. However, the downside in rates is limited by the prospect of increased EU defence spending and fiscal stimulus from Germany.

US rates wary of worsening data but euro rates relatively unfazed

A day like Wednesday highlights the disentanglement between US and euro rates. Where the 10Y UST dove some 7bp lower on poor jobs numbers and ISM data, the 10Y euro swap rate remained unfazed close to 2.5%. The short end of the US curve is in a difficult position because the prices paid component of the ISM survey rose significantly in May, potentially already reflecting the impact of tariffs. Risk sentiment seemed to keep up, perhaps because the Friday US payroll numbers are more the focus.

In an environment where euro rates seem detached from US Treasury dynamics, the landing zone of the ECB plays an even more important role in setting the 10Y EUR swap rate. The front end of the swap curve also, however, shows little movement, simply because the uncertain environment doesn't really dictate whether the ECB will have to cut below 1.75%. A faltering US economy could, in our view, weigh quite heavily on the global economy and risk sentiment. If we therefore see more bad US numbers, from e.g. Friday's payrolls, then we would expect a more material move lower in euro rates than witnessed on Wednesday.

Thursday's events and market views

The ECB meeting is the main event for EUR rates, but with markets fully priced for a cut, the reaction to such an outcome should be muted, in particular if the ECB offers little further guidance.

US data in the run-up to Friday's payrolls report could prove more market-moving, at least for US rates. The weekly jobless claims had risen somewhat last week. If the anticipated bounce back does not materialise, it could add to the gloom instilled by the ISM on Wednesday. From the Fed, we will hear from speakers Kugler, Harker and Schmid. In politics, we will be watching the White House visit of German Chancellor Merz.

France and Spain will be active with bond auctions. Spain sells 3y to 7y bonds and 15y linkers. France sells long-end bonds from 10y to 30y maturities.

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