Economic Research Unit



ECB now less likely to raise rates above 3%

Despite the fall in Brent oil prices to $98pb this morning and AI-related sell-off in equity markets, investors still see a December 17th ECB rate hike as close to a foregone conclusion, priced in with an 80% probability. However, it is striking the ECB's October Survey of Monetary Analysts (SMA) indicated the median expectation was for the ECB deposit rate to peak at 2.75%. This is consistent with the view expressed by several prominent investment banks that events in France, pressure on European government bond yields and broader tightening of financial market conditions will obviate the need for further ECB rate hikes in 2027. Just last week the ECB set out estimates indicating that implied market expectations from options and swaps that the deposit rate will move above 3%, are distorted upwards by the compensation investors demand for risk and the uncertain environment.

ECB rate hike in December had been perceived as a foregone conclusion: Christine Lagarde's language, following the ECB's October 29th decision to keep rates on hold, came as close as possible to signalling a hike to 2.75% is likely at the next policy meeting - whilst preserving the '*meeting-by-meeting*' approach. Specifically, she said '*unless there was a major development, the direction of travel is quite clear*' and indicating that if incoming data confirm the inflation outlook set out in the ECB's September forecasts the governing council would raise rates on December 17th.

Markets still expect December hike despite oil and equity market sell-off: The impact of Democratic party gains in the US mid-term elections has been twofold. First, the S&P500 (-4.4%) and Nasdaq (-5.5%) suffered heavy losses yesterday, as investors worried the Democratic party may act to curb data center construction. Second, Brent oil prices are trading at $98 per barrel this morning - reflecting a view that Donald Trump will be constrained in escalating the conflict in the Middle East.

However, both Brent oil and European gas (€87mh/hr) prices are still well above the levels incorporated into the ECB's September projections. Hence, as of this morning options still imply an 80% probability the ECB will raise the deposit rate to 2.75% on December 17th. The key question is whether the ECB will move further, raising rates to 3% or above in 2027?

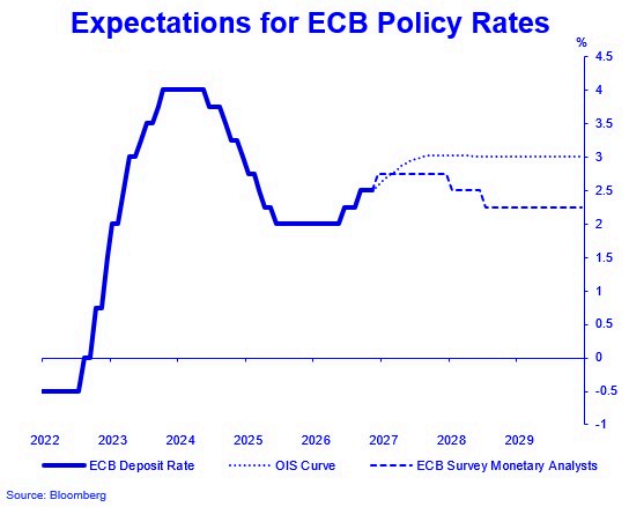
Survey of Monetary Analysts shows median expectation for ECB rates to peak at 2.75%: On October 30th the ECB's Survey of Monetary Analysts (SMA) showed the median expectation amongst respondents was for the deposit rate to rise to 2.75% in December, but remain flat in 2027, before a cut to 2.5% in early 2028 and eventually to 2.25% (see chart below). Even at the more hawkish 75th percentile, expectations were for the ECB deposit rate to peak at 3%. This is a starkly different view to the market curve - which at times has indicated up to an additional 100bps of tightening to 3.5% was likely.

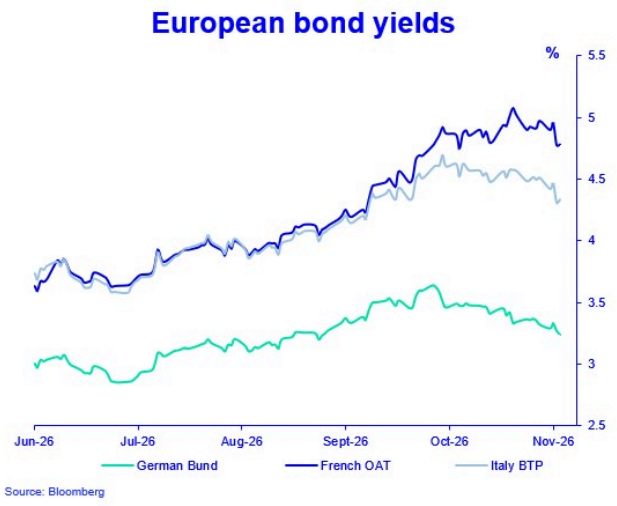
Of course, one reason for this discrepancy is that investors are demanding greater compensation for risk. Specifically, the threat of sharp rises in oil prices and HICP inflation. The ECB recently set out analysis showing the forward OIS curve on October 26th rose to 3.25% in 2027, remaining at that level throughout 2028. However, once the ECB's estimates of 'term premia' are removed, the underlying market expectation for the most likely path for the deposit rate was a peak at 3%, before gradually falling back to 2.75% by end-2028. This implies close to 50bps of compensation for risk at the 2-year horizon.

Pressure on European bond yields makes further ECB rate hikes less likely: Of late, several prominent investment banks have argued the tightening of European financial market conditions means the ECB is far less likely to raise rates to 3%. Specifically, markets have pushed French OAT 10-year yields towards 5% (see chart below) as concern on the size of the public deficit heading above 5% of GDP amid difficult budgetary negotiations and civil unrest have grown - with investors looking ahead to next year's Presidential election. Put simply, this exogenous tightening of financial market conditions will itself cool both euro area GDP and inflation - obviating the need for further ECB rate hikes.

ECB's analysis supports view tighter financial market conditions will bear down on HICP inflation: ECB Chief Economist Philip Lane's October 30th San Francisco speech set out that the ECB's Financial Conditions Index (FCI) had tightened by 45-50bps since the September policy meeting. In September, Lane had set out estimates that an 80bp tightening of the FCI through 2026 would be expected to reduce both euro area GDP and HICP inflation by 0.75%-1.25%. These estimates certainly support the view set out by some investment banks that the recent tightening of European financial market conditions since September will make further ECB rate hikes above 3% far less likely.

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