Article | 11 September 2026

RATES

Rates Spark: The heat ratchets higher

The US back-end remains untethered. Over to the Fed to see if it can tame it. Probably not; see more here. US CPI is up next, and then it s decision time. Meanwhile, the ECB is showing the Fed the way. Energy prices are also reigniting pressure on rates

US CPI for August would have to be stunning to avert the inevitable

Energy prices remain in the driving seat, not the ECB

The day the European Central Bank hiked rates was not so much about the policy decision or what ECB President Christine Lagarde said in the press conference. The hike was a “no-brainer,” in Lagarde’s own words, and was already largely priced in. Lagarde did not offer any concrete guidance around the ECB's next moves, highlighting that “the outlook remains highly uncertain, with risks to the upside for inflation and to the downside for economic growth.”

Energy prices were the actual driver of the market dynamic – though to be fair, the ECB and US data did not stand in the way of it. As Brent prices pushed further above US$100/bbl, the EUR front-end had moved in lockstep and started to fully discount three more ECB hikes by mid next year. That implies a depo then landing at 3.25% at least. Pushing pricing beyond that would require scenarios where the ECB either hikes at meetings without new projections, or more than 25bp at meetings where it has new projections.

The by now almost customary ECB sources story later on Thursday brought October into play, suggesting at the same time that December might still be more appropriate. Of course, the longer view that the market now still broadly contemplates is one where the ECB keeps rates on hold at 3.25% from mid-year, and that landing level might well be questioned next if energy markets do not calm. Our economists point out that the ECB's new set of projections forecasts inflation above target for too long, and that, based on the assumption of one or two more hikes, leaves a hawkish aftertaste.

Looking even further out the curve, the 10y Bund yield topped the 3.5% mark. The last time it did so was in 2011 on one day. Spreads versus swaps have tightened since then, so if one looks at the 10y swap rate, it has now topped the 3.5% mark for the first time since 2023. But also note that in 2023 the swap rate was above 3.5% only on 8 trading days spread out over roughly a month – and with an ECB depo rate at 4%.

We would argue that pricing does start to look stretched, but with the US long-end remaining untethered and geopolitical tensions pointing to higher energy prices, it is hard to stand in the way of that dynamic.

Friday’s events and market view

All eyes will be on the US CPI release as it should help shape the upcoming Federal Reserve decision. Headline CPI is expected to come in at an unchanged 3.4% year-on-year, and the core rate at 2.4%, slightly lower versus the previous month. The main focus will be the core CPI rate, where consensus is eyeing a 0.2% month-on-month rate. We think anything higher should tip the balance further towards a hike, with energy price dynamics only adding to underlying pressures again. We will also get the University of Michigan consumer sentiment index. It's expected to come in softer, accompanied by short-run inflation expectations nudging higher.

During the European morning we will get UK GDP and industrial production data, but thereafter no other releases of note. The ECB’s Lagarde and Chief Economist Philip Lane will speak, but we also expect other commentary in the wake of the ECB meeting.

The countries of note slated for possible rating reviews after markets close are Spain (by Fitch A/Stable and S&P A+/Stable) and Italy (Fitch BBB+/Stable).

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