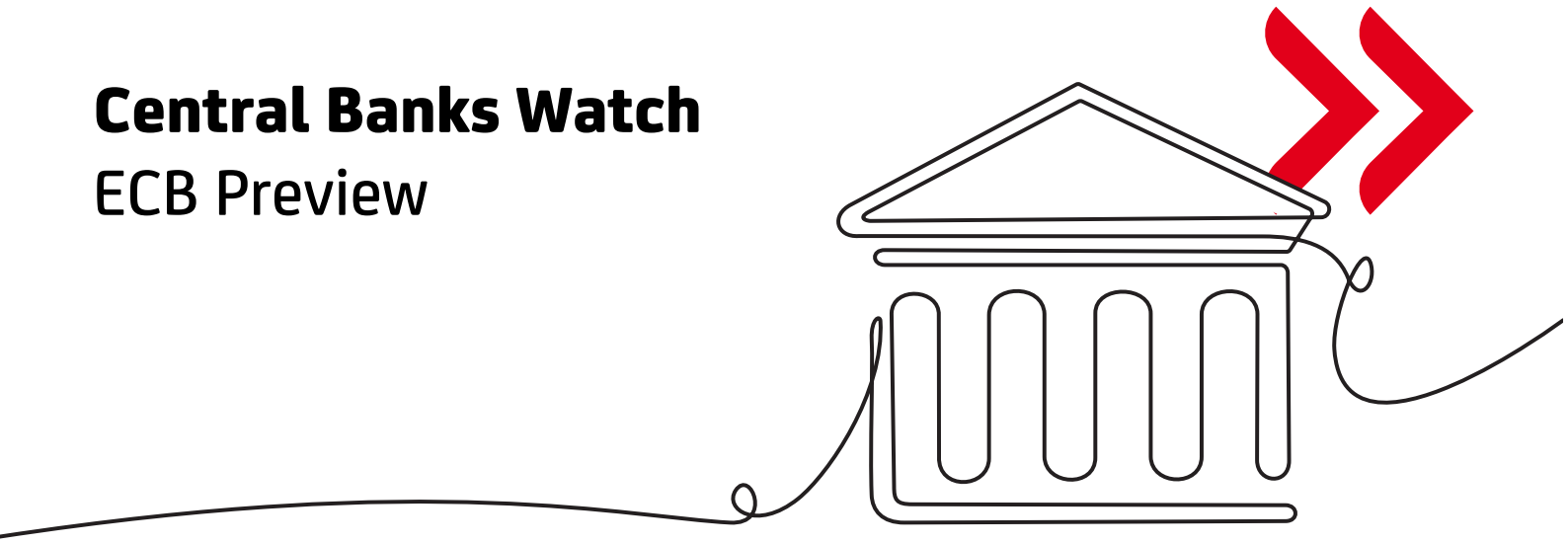
Central Banks Watch
ECB Preview



Walking a fine line between inflation and sovereign risk

27 October 2026

On hold this week, low bar for a December hike

On Thursday, the ECB will almost certainly leave interest rates unchanged. With energy prices still on the rise and inflation risks tilted to the upside, a rate hike in December appears very likely. The impact of sovereign tensions on the outlook for monetary policy is likely to be a prominent topic during the press conference.

ECB rhetoric on recent spread tensions is key

With no new staff projections and markets fully pricing in unchanged rates, the scope for significant moves in government bond yields is limited. A relatively hawkish message could put further pressure on sovereign spreads while supporting Bunds through safe-haven flows. Conversely, a softer tone could encourage a further unwinding of rate-hike expectations. In FX, whether and how the ECB intends to manage renewed debt tensions within the eurozone would probably be the most critical factor for the euro's reaction to this meeting.

The ECB will almost certainly stand pat at its meeting on Thursday, remaining on track for a further increase in interest rates at its December meeting, as inflation risks continue to point to the upside. The decision is likely to be unanimous. Rising long-term rates in several jurisdictions have tightened financial conditions, buying the ECB time to better assess incoming data. The December round of macroeconomic projections will likely provide the Governing Council (GC) with a solid rationale for raising the deposit rate into slightly restrictive territory, from 2.50% to 2.75%.

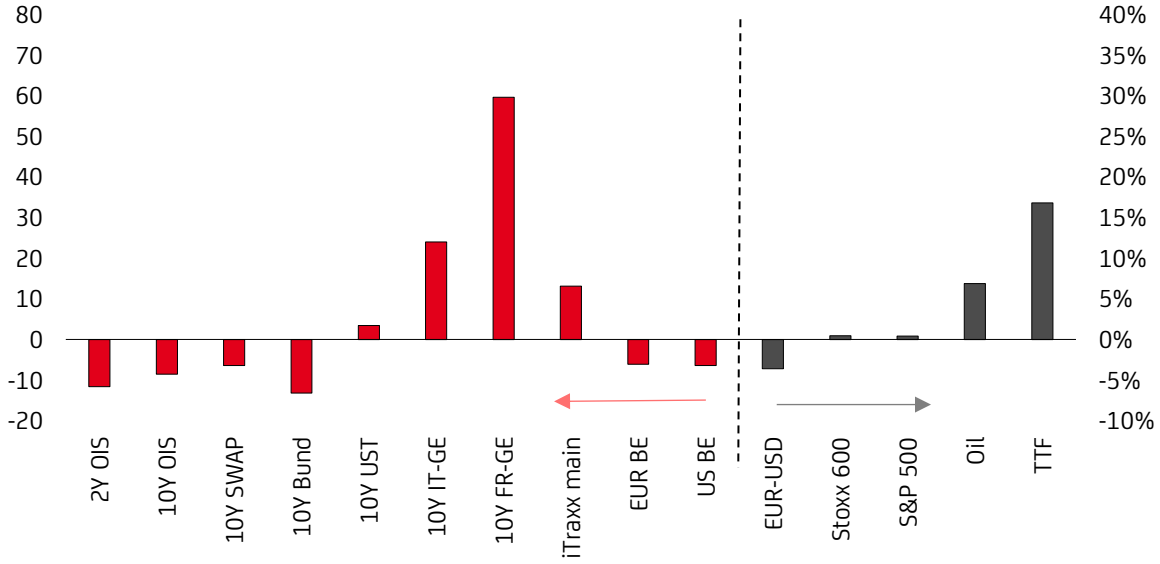
The reference macro picture is one of intensifying energy pressure on headline inflation as both oil and natural gas prices are drifting further away from the ECB's September baseline. Against this backdrop, data still point to broadly stable core inflation, ongoing moderate economic growth and no evidence of second-round effects through wages. Sovereign tensions have increased, mainly reflecting investor concerns about the fiscal and political outlook in France, but have not escalated, remaining far from levels that would push the ECB to seriously consider intervention.

At the press conference, ECB President Christine Lagarde is likely to face several questions regarding the implications of sovereign stress on the outlook for monetary policy. In our view, a strong focus on financial conditions would serve the ECB well here. As highlighted in our *Coffee Break*, a broad-based tightening of financial conditions would reduce the need for additional rate hikes. At the same time, Ms. Lagarde will have to show confidence in the central bank's toolbox to cope with risks to the transmission mechanism of monetary policy if sovereign market dynamics become disorderly and not fundamentally warranted. In the current context, the Transmission Protection Instrument (TPI) would likely be the GC's reference tool.

In our view, a slowdown in quantitative tightening (QT) would not prove effective at calming sovereign stress. Reversing or suspending QT at a time of heightened inflation risk would appear inconsistent with previous guidance, signalling the ECB's reluctance to deploy the TPI, which could ultimately undermine the credibility and effectiveness of the tool.

MAIN MARKET DEVELOPMENTS SINCE THE LAST ECB MEETING

VALUATION CHANGES (BP FOR FIXED INCOME, % FOR EQUITIES, FX AND COMMODITIES)



Source: Bloomberg, The Investment Institute by UniCredit

Market reaction

RATES

Since mid-September, markets have scaled back expectations of an additional ECB hike before year-end, with the probability now at around 80%. Over a one-year horizon, investors are still pricing in slightly more than two additional rate hikes, which would take the deposit rate to just above 3%.

Among the key market moves since the ECB's September meeting, the widening in sovereign spreads, particularly French OATs, stands out. The stress remains largely confined to sovereign debt, as evidenced by the relatively limited move in iTraxx spreads. With the OAT-Bund spread at multi-year highs and some spillover to BTPs and SPGBs, this is likely to be a major focus during the Q&A session. As spread widening is primarily driven by domestic political developments, the ECB faces a delicate balancing act: reassuring markets while maintaining that fiscal challenges ultimately require a national response. A key question is whether Ms. Lagarde will emphasise downside risks stemming from market volatility. We think such a shift would be premature, but any signal in that direction could significantly support fixed-income markets.

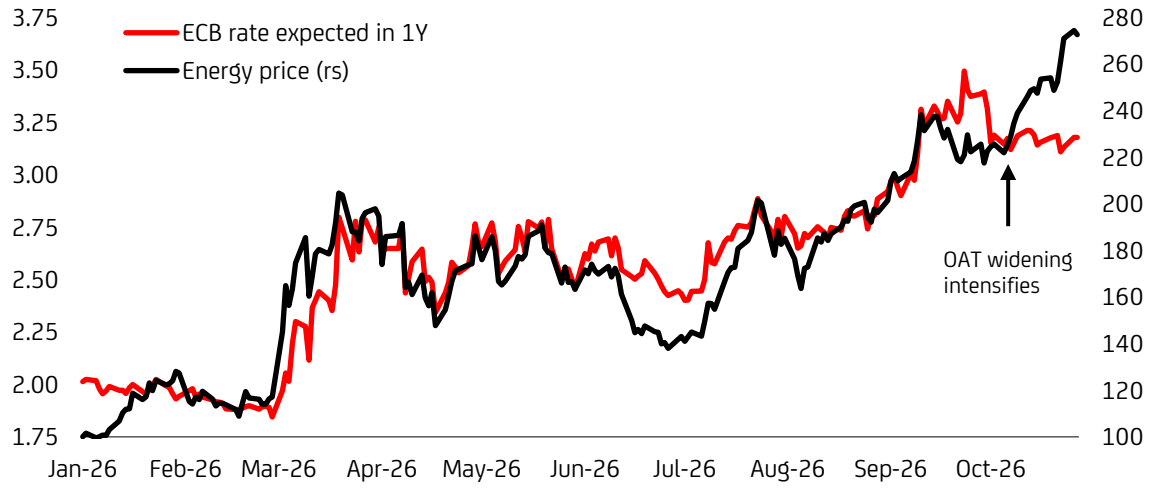
Oil and gas prices are up strongly, yet breakeven inflation is virtually unchanged. The ECB scores a point here, with its pre-emptive action having contributed to keeping inflation expectations anchored. We expect the central bank to flag more tightening, thus providing stability to inflation expectations. Indeed, another key point in the press conference will be how Lagarde will square the recent increase in energy prices, which should support more policy tightening, with the fallout from financial market volatility.

Despite the recent weakness in AI and technology stocks, major European equity indices are broadly unchanged since the September meeting and are unlikely to be a key concern for the ECB.

With no new staff projections and markets fully pricing in unchanged rates at this week's meeting, the scope for significant moves in government bond yields is limited. Lagarde is also likely to reiterate the ECB's meeting-by-meeting approach. As a result, investors will focus on any clues regarding the medium-term policy outlook, particularly against the backdrop of widening EGB spreads and AI-related equity market volatility. In this context, a relatively hawkish message could put further pressure on sovereign spreads while supporting Bunds through safe-haven flows. Conversely, a softer tone could encourage a further unwinding of rate-hike expectations. EGB spreads should benefit but Bund yields are unlikely to rise much in this case.

ECB EXPECTATIONS: ENERGY PRICES ARE LESS OF A DRIVER

EXPECTED ECB RATE OVER ONE YEAR AND ENERGY PRICES



Source: Bloomberg, The Investment Institute by UniCredit
Note: Energy price indicates the price of an equally weighted basket of Brent and TTF, based to 100 on 1Jan26

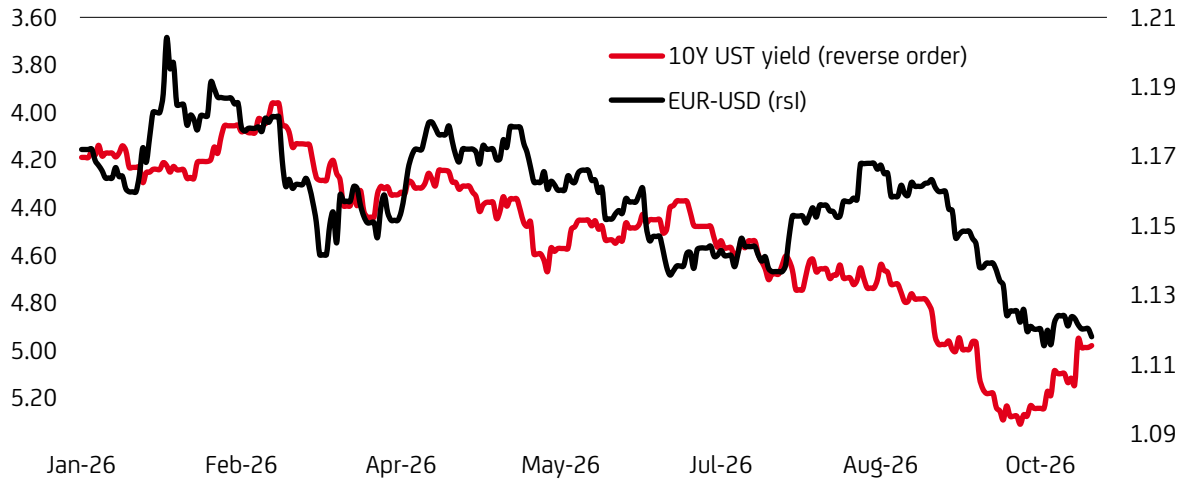
FX

A steady ECB meeting outcome, probably preparing markets for a rate hike in December, is unlikely to provide EUR-USD with substantial support, although the eurozone's forward curve is no longer fully pricing in such a move on the back of ongoing market turmoil, which is primarily affecting French bonds.

That said, the recent EUR-USD decline from its highs above 1.17 to the new YTD low of 1.1114 reached on 14 October has been mostly driven by soaring UST yields, even before any yield-spread considerations (see chart below). Hence, any solution to the crisis must primarily pass through the US again. If US yields ease further, the USD will be forced to loosen its grip, potentially allowing for some recovery in EUR-USD. However, the margin for this is capped by two factors: **1.** as Bund yields fall alongside UST yields, the corresponding spreads are unlikely to narrow much in favour of the common currency; **2**. political tensions across the eurozone still represent a risk factor, further weighing on the euro. To some extent, whether and how the ECB intends to manage renewed debt tensions within the eurozone would probably be even more critical for the euro's reaction.

US YIELDS ALONE REMAIN A KEY DRIVER FOR EUR-USD

EUR-USD AND 10Y UST YIELD



Source: LSEG, The Investment Institute by UniCredit

Authors
Marco Valli, Head of Macroeconomic Analysis, Chief Economist (UniCredit, Milan), marco.valli@unicredit.eu
Dr. Luca Cazzulani, Head of Strategy, FI Strategist (UniCredit, Milan), luca.cazzulani@unicredit.eu
Roberto Mialich, FX Strategist – Global (UniCredit, Milan) roberto.mialich@unicredit.eu

Editor
Edoardo Campanella, Director and Editor-in-Chief of The Investment Institute (UniCredit Milan), edoardo.campanella@unicredit.eu

UniCredit S.p.A
Client Solutions, Group Investment Strategy, Piazza Gae Aulenti, 4, I-20154 Milan
www.the-investment-institute@unicredit.eu

Legal Notices

Glossary

Terms used in the report are available on our website: Our glossary.

Marketing Communication

This publication/video constitutes a marketing communication of UniCredit S.p.A., UniCredit Bank Austria AG, Schoellerbank AG and UniCredit Bank GmbH (hereinafter jointly referred to as the "UniCredit Group") is addressed to the general public and is provided free of charge for information only. It does not constitute investment recommendation or consultancy activity by the UniCredit Group or, even less, an offer to the public of any kind nor an invitation to buy or sell securities. The information contained herein does not constitute an investment research or financial analysis since, in addition to the lack of content, it has not been prepared in accordance with legal requirements designed to promote the independence of investment research, and it is not subject to any prohibition on dealing ahead of the dissemination of investment research.

UniCredit Group, including all its group companies may have a specific interest in relation to the issuers, financial instruments or transactions detailed herein. Relevant disclosures of interests and positions held by UniCredit Group are available at: Conflicts of interest. Any estimates and/or assessments contained in this publication represent the independent opinion of the UniCredit Group and, like all the information contained therein, are given in good faith on the basis of the data available at the date of publication, taken from reliable sources, but having a purely indicative value and subject to change at any time after publication, on the completeness, correctness and truthfulness of which the UniCredit Group makes no guarantees and assumes no responsibility. Interested parties must therefore carry out their own investment assessments in a completely autonomous and independent manner, relying exclusively on their own considerations of the market conditions and the information available overall, also in line with their risk profile and economic situation. Investment involves risk. Before any transaction in financial instruments please refer to the relevant offering documents. It should also be noted that:

1. Information relating to the past performance of a financial instrument, index or investment service is not indicative of future results.
2. If the investment is denominated in a currency other than the investor's currency, the value of the investment can fluctuate strongly according to changes in exchange rates and have an undesirable effect on the profitability of the investment.
3. Investments that offer high returns can undergo significant price fluctuations following any downgrading of creditworthiness. In the event of bankruptcy of the issuer, the investor may lose the entire capital.
4. High volatility investments can be subject to sudden and significant decreases in value, being able to generate significant losses at the time of sale up to the entire capital invested.
5. In the presence of extraordinary events, it may be difficult for the investor to sell or liquidate certain investments or obtain reliable information on their value.
6. If the information refers to a specific tax treatment, it should be noted that the tax treatment depends on the individual situation of the customer and may be subject to change in the future.
7. If the information refers to future results, it should be noted that they do not constitute a reliable indicator of these results.
8. Diversification does not guarantee a profit or protect against a loss.

The UniCredit Group cannot in any way be held responsible for facts and/or damages that may arise to anyone from the use of this document, including, but not limited to, damages due to losses, lost earnings or unrealised savings. The contents of the publication – including data, news, information, images, graphics, drawings, brands, and domain names – are owned by the UniCredit Group unless otherwise indicated, covered by copyright and by the industrial property law. No license or right of use is granted and therefore it is not allowed to reproduce its contents, in whole or in part, on any medium, copy them, publish them and use them for commercial purposes without prior written authorisation from UniCredit Group unless if purposes of personal use only. E 25/1