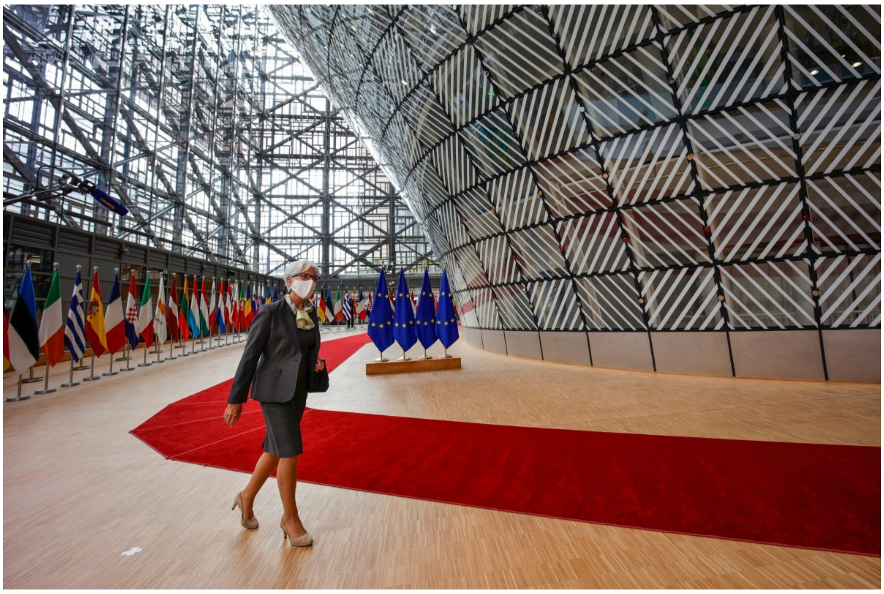
ECB decision time: For rates, QE helps but it’s hikes that really matter

How rate markets react to this ECB meeting depends in part on the tone of Lagarde’s statement, but the more lasting impact will be based on a cold hard fact: what is the ECB’s inflation forecast? Eventually, markets will draw the logical conclusion for a central bank that has reached its target: exceptional support measures need to be removed



Christine Lagarde at the European Council building in Brussels earlier this year

Cold turkey or not, bond scarcity is here to stay

Among all the exceptional measures we've seen, the decision on the future of asset purchases isn't the most important thing, at least for EUR swap rates and core yields even though they're often most talked about. Bond scarcity, a key plank of current rate valuations will remain a fact of life. The stock of sovereign and supranational bonds available for private investors to buy is set to increase by only €160bn next year after ECB purchases are taken into account.

Inflation fear had the 2Y fall out of bed in October; this could happen again

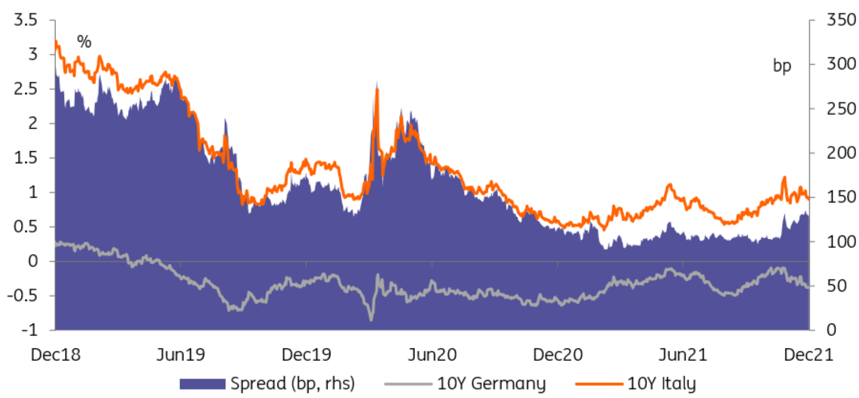
Source: Refinitiv, ING

This could change of course. Should the ECB decide to let markets go cold turkey at the end of PEPP in March, with only the €20bn/month APP net purchases for the rest of the year, that figure would grow to €330bn. Not a sea change, but a forewarning that private investors will need to step up in the future, provided they are compensated with higher rates.

Taper is really about hikes, in the market's mind

Instead, it is the signal about the timing and the extent, of the coming rate hikes that will matter the most. It has the potential to send 10Y core rates, for instance, Germany and swaps, higher by more than 50bp next year. The Covid-19 uncertainty, and an economic slowdown in late 2021/early 2022 means this is a debate for the latter half of next year. Here too, risks are skewed towards a more hawkish reaction, however. If Lagarde overemphasises inflation worries, rates will jump the gun and price-in imminent hikes again, as they did in late October.

Italian spreads are starting to price waning monetary support



Source: Refinitiv, ING

Our benign view for this meeting doesn't apply to higher beta fixed income, notably peripheral sovereign bonds. With valuations largely riding on ECB support, the degree of inflation worries will have a direct impact on spreads. An improvement in fiscal fundamentals is a threat as much as an opportunity. They are a factor helping muffle bond volatility but we hope that this won't lull the ECB into a false sense of security. The bond market is on the mend, but it still requires crutches to walk.

Italian spreads, a spike to 150bp

With political background noise increasing next year, and in an environment characterised by less monetary support, our high confidence call is for sovereign spreads to widen at the start of 2022. In the case of the 10Y Italy-Germany spread, we think this will translate into a spike above 150bp in the first quarter. As with any attempt to forecast a spike in volatility, there isn't much certainty about its timing. Much will depend on how the ECB manages the policy change, starting at this meeting.