

## ECB preview: Avoiding taper talk

Higher inflation, an accelerated vaccination roll-out and a strong economic rebound on the back of post-lockdown reopenings will put not only the ECB's asset purchase front-loading to the test next week. Avoiding the T-word contributed to a pause in the climb in EUR rates - we think this will resume after the meeting.



When the ECB meets again next week the economic outlook will have brightened further, inflation will continue to surge, and it will be hard to once again avoid any taper talk. The Thursday meeting could be packed with insightful information but probably not with tangible action.

Here is where the excitement should be:

### New staff projections

First of all, the ECB will present a fresh round of staff projections. Remember that back in March, the staff projections predicted GDP growth to come in at 4% this year and at 4.1% in 2022. Inflation was expected to come in at 1.5% this year and 1.2% next year. While confidence indicators point to strong activity, no hard data is yet available for the second quarter. As actual 1Q GDP was weaker than ECB staff had expected in March, we expect the growth projections to

remain broadly unchanged for 2021 and 2022. The inflation projections, however, could be revised upwards. Not only has actual inflation come in higher than the ECB had penciled in so far, but the combination of supply chain disruptions, elevated commodity prices and the reopening inflation will in our view keep inflation closer to 3% than to 2% in the second half of the year.

## Assessing financing conditions

Another interesting element will be the first official quarterly assessment of financing conditions in the eurozone. Remember that last year, favourable financing conditions had all of a sudden become a new quasi target for the ECB. Other than 'holistic', 'multi-faceted' and 'upstream' or 'downstream' no clear definitions were given. Maybe only that financing conditions in December were regarded by some as the benchmark. As at least bond yields have increased by around 40bp since then, the ECB's official assessment will be interesting. Official comments that rising yields were a natural development at turning points in a recovery already point to a possible communication line, preventing the ECB from being caught in its own logic from a few months ago.

## (Avoiding the) taper talk

The final discussion next week will be on tapering, or at least on how to avoid this discussion. Why? Even if economic developments would in our view clearly justify at least having a first tapering discussion, the sheer mention of such a discussion could push up bond yields further and consequently undermine the economic recovery before it has actually started. The fact that several more dovish statements have been made by ECB officials recently underlines this view. Last week, ECB Executive Board member Isabel Schnabel, who currently for us gives the most informative speeches and interviews for those searching for the ECB's reaction function, set the scene by warning against "a premature withdrawal of either fiscal or monetary support". However, the ECB will not be able to avoid the tapering discussion for long.

## How ECB tapering could eventually look

Tapering, in our view, will be a very special operation twist, not extending the PEPP beyond March 2022 but increasing the 'old' APP to the extent that the ECB will still purchase between 40bn to 50bn euro per month after March 2022. This operation twist results from the fact that the PEPP was mainly aimed at bringing the inflation path back to its pre-crisis level, while APP can be used to bring the inflation path back to target.

## Changes to the ECB communication next week

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*All in all, next week's ECB meeting could fall into the category "exciting but uneventful". We have seen worse...*

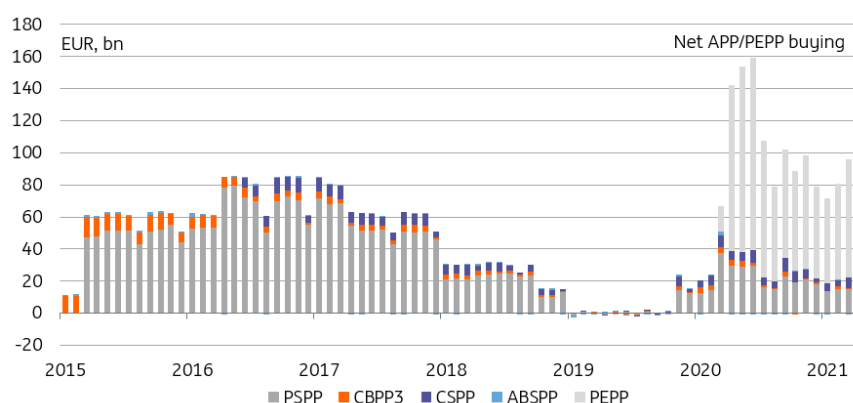
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As the ECB will try everything it can to avoid any explicit taper talk at next week's meeting, all eyes will be on the wording of the current front-loading of its asset purchases. This front-loading was implemented in March when bond yields had started to increase on the back of higher US yields but not on the back of improved eurozone fundamentals. The key sentence in March was "the Governing Council expects purchases under the PEPP over the current quarter to continue to be

conducted at a significantly higher pace than during the first months of the year.” We would expect the ECB to drop the “significantly higher pace” and replace it with something like “the Governing Council expects purchases under the PEPP to ensure current favourable financing conditions”. Any additional changes to the communication would be a surprise and would signal either a growing willingness for, or opposition to, taper talk after the summer.

## PEPP purchases, just a bump on the road to higher EUR rates

Bond and wider interest rate markets will receive mixed messages at this meeting that they will find hard to process. By and large, it is true that maintaining PEPP purchases at their current rate for another quarter (liquidity and seasonality of purchases allowing) should be the overriding influence but, this has to be weighed against the fact that Lagarde and in particular Schnabel have done a good job steering markets towards this outcome last week.



Source: ECB, ING

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*The countdown to another leg higher in rates has started last week*

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Moreover, an upbeat tone from Lagarde next week and heavy flow of positive economic releases over the coming months should dampen the impact of purchases. In fact, we think the reaction to the March PEPP boost surprise is a good template for how EUR rates will trade in the coming months. At the time, the ECB managed to engineer a pause in the bond market sell-off that lasted a few weeks. The rise in EUR rates resumed in April.

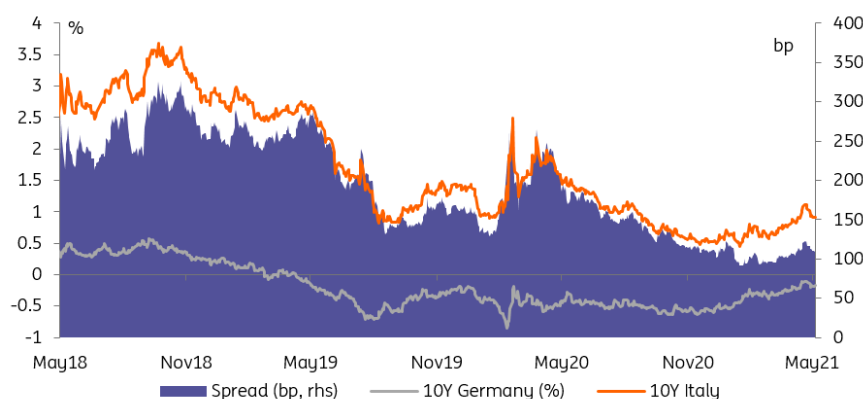
This time around, we’d argue that the countdown to another leg higher in rates has started last week, with the expectations-setting exercise mentioned above. This leaves little room for EUR rates, for instance Bund yields, to drop further, and should set the stage for the climb in rates to resume once the curtain has been drawn on the June 10th press conference.

## A greenlight for carry trades in higher yielding bond markets

We wouldn’t dismiss the relevance of faster PEPP purchases in Q3 altogether however. It is true that their impact on Bund yields and swap rates should prove temporary at best but they will send

a signal to the broader fixed income markets: the ECB will work to suppress volatility well into the European recovery, and thus provide an extra incentive for investors to chase returns in higher yielding investments. The effect has already been felt in significantly tighter Italian spreads since their spike in May, but [we think they are on course to cross 100bp even as Bund yield rises resume](#).

## Faster PEPP purchases won't stop higher yields, but they will stabilise sovereign spreads



Source: Refinitiv, ING

Our expectation of higher rates in the coming months also requires qualification. It is true that the rate markets are facing a degree of normalisation this year as economies reopen, but not a regime change in terms of long-term growth and inflation. This implies that most of the rise in yields should be front-loaded to this year, with much tamer increases in 2022. If the ECB decides to double the pace of APP purchases to €40bn/month next year, we estimate this will be enough to Hoover up the roughly €320bn of sovereign net issuance we're forecasting, and upward of €100bn of EU net debt sales, with some change to spare (for agencies and regional government for instance).

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Limited scope for much higher rates next year is an additional argument in favour of tame spread developments in higher beta fixed income markets. In addition, our colleagues in credit strategy [continue to see strong fundamentals to their markets](#), and the broader EUR sovereign complex still trades with a distinct appetite for carry trades.

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