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ECB preview: Silence is golden

To use the ECB's language - the risks to next week's meeting are tilted to the downside, so very little to gain, only to lose. And even if we take into account the further rise we forecast for this year, real interest rates will remain near record lows



ECB President Christine Lagarde in Brussels

Source: Shutterstock

After all the excitement ahead of the March meeting and speculation about how the European Central Bank would react to higher inflation rates and bond yields, it took a while for the ECB to communicate its reaction function. Almost six weeks later and after several speeches, interviews, blog entries and minutes later, the ECB has finally brought clarity.

In short, the ECB will look through any temporary increases in headline inflation and will not accept any increases in bond yields unless they are the result of improved growth prospects. The front-loading of asset purchases was meant to support this view.

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With clarity on the reaction function and very little news on economic and inflation development since the last meeting, next week's meeting should be an unexciting one. The

ECB should try to bridge the time to the June meeting without any new communication accident. In June, the eurozone should have seen some reopenings, there will be new staff projections and the ECB will reassess the pace of its asset purchases.

If the positive and optimistic vaccination and economic scenario play out over the summer, there will be calls to bring the pandemic emergency purchase programme to the planned end in March 2022. In exchange, we could see the ECB stepping up the traditional asset purchase programme. Moderating this rotation in asset purchases, while at the same time reducing the monthly pace will not be easy as fears of a taper tantrum could return easily.

Consequently, the ECB will have to avoid getting involved in any such discussion in public. There is very little to gain from such a debate, only to lose; in the form of turmoil and the so-called unwarranted tightening of financing conditions. Therefore, instead of a long press conference with holistic, multifaceted upstreams and downstream, the ECB could simply play an evergreen song from the Tremeloes next Thursday.

Implications for rates: It's all for real

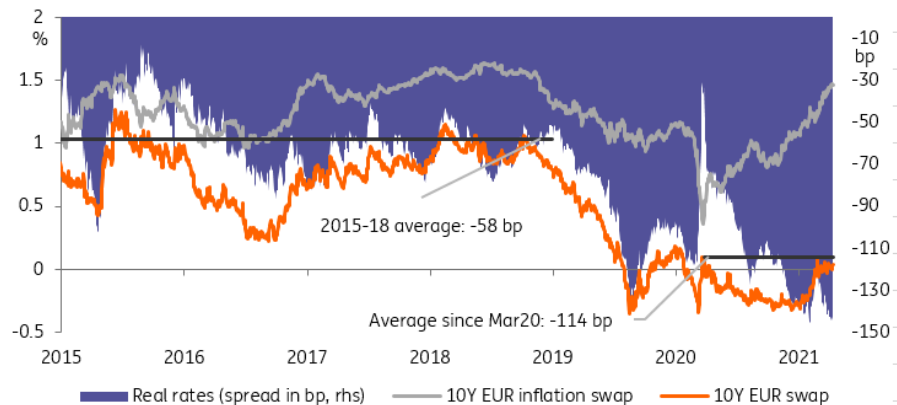
The debate about the ECB's reaction function has spotlighted real rates as a key metric (among a range of other indicators) to assess how supportive monetary policy is.

Also, their relevance extends not only to economics and ECB policy but also to risk appetite in financial markets. In short, the lower real rates are, the more of an incentive investors have to chase returns on other markets.

The debate about the ECB's reaction function has put the spotlight on real rates

Put in historical context, the -140 basis points in negative rates currently prevailing in the eurozone (using as an example the difference between 10-year EUR inflation swap and 10-year EUR nominal swaps) are close to a record low. For comparison, they averaged -58bp in the first four years of quantitative easing (2015-18) and -114bp since the launch of PEPP, the ECB's new asset purchase programme in 2020.

EUR real rates are near record lows despite the imminent recovery



Source: Refinitiv, ING

This current state of play results from rising inflation expectations, with 10-year inflation swaps just shy of 1.5%, while nominal swap rates have remained relatively contained around 0%. Barring a major accident on the road to recovery, we find it difficult to envision inflation swaps falling materially this year, especially taking the US recovery into account. This suggests that at most, the adjustment higher in nominal rates we're expecting for the rest of the year, by roughly 30bp to 0.35% in 10Y swaps, will bring real rates to -110bp.

Our forecast for higher EUR rates this year, is relatively benign

By all account, this would still be extremely accommodative levels for the economy. This would also provide a tailwind to asset valuations across financial markets. This also goes to show that our forecast for higher EUR rates this year, is relatively benign, and not something that would keep the ECB up at night.

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