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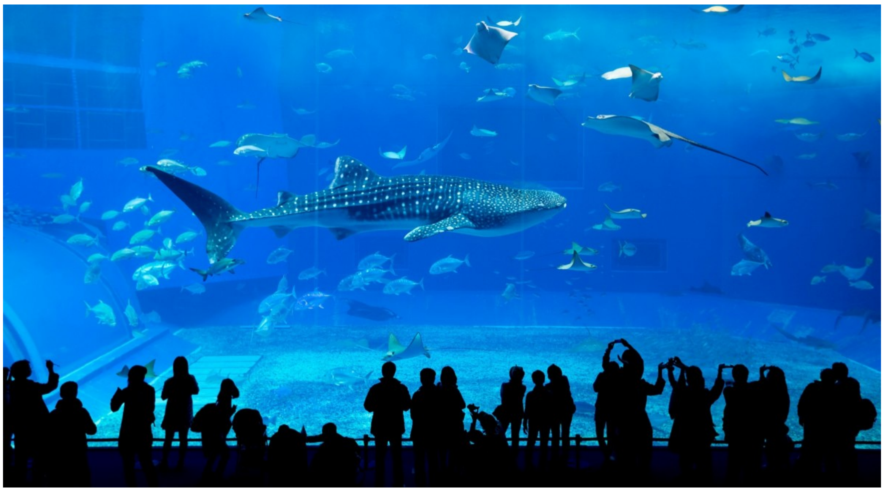
EUR rates: Fraught with risks

Recession will weigh on EUR rates in 2023 but Bund yields dipping below 2% is not a normal state of play. Balance sheet reduction at the European Central Bank will bring a new round of tightening even after hikes stop



The ECB is cautiously dipping its toe into the quantitative tightening shark tank

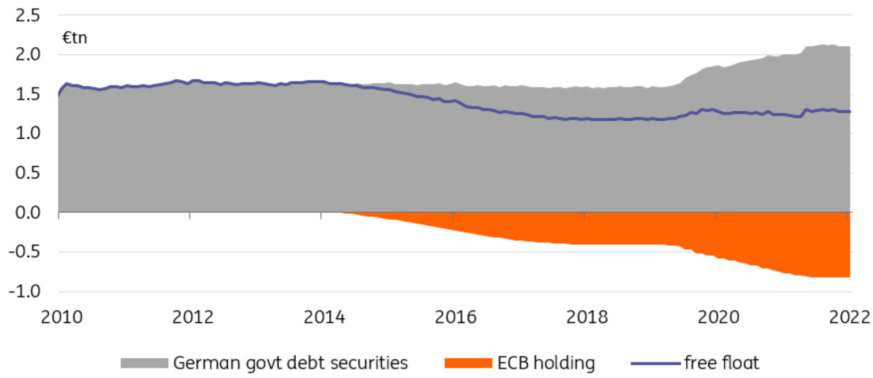
The inflation peak is not certain, and rates are already low

2022 has brought the end of negative interest rate policy (NIRP) and of expanding ECB balance sheet. In 2023, the challenge for markets will be how to deal with contradictory inflation and growth signals. Our economists sit at the more pessimistic end of the growth spectrum in their 2023 forecasts, and there are signs that the ECB is moving in the same direction, albeit slowly. The first order of business in 2023 should be to see tangible signs that inflation is actually on a declining path. Markets have been disappointed in the past.

> *2% in 10y Bund yields is already low when compared to our (below consensus) call for a 2.25% terminal deposit rate*

We think this should eventually push EUR rates down further, but one has to be realistic. 2% in 10yr Bund yields is already low when compared to our (below consensus) call for a 2.25% terminal deposit rate. This is all the more true given that financial conditions will tighten further due to a shrinking ECB balance sheet even after the ECB stops its hiking cycle. A dip below 2% should be a temporary one for 10yr Bunds and one we can only justify with significant assistance from declining dollar rates in 2023.

The ECB has reduced the amount of German debt in circulation to record lows



Source: ECB, Refinitiv, ING

Chipping away at the reasons for structurally low rates

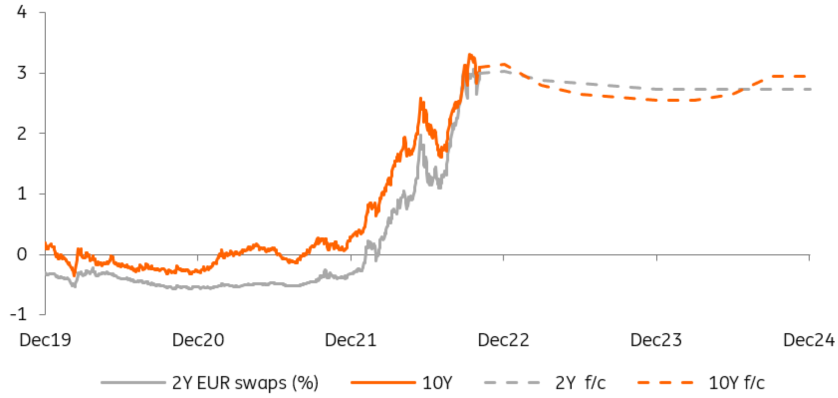
The low EUR rates story has been a structural one since the global financial crisis of 2008. The low growth and perma-crisis environment resulted in ever-lower interest rates, enforced by the ECB's NIRP and ever-growing balance sheet. Another feature of the post-GFC world was a single-minded commitment to fiscal austerity, which contributed greatly to the scarcity of German government bonds. Some, but not all, of these drivers are now going into reverse.

Take austerity, the energy crisis and growing pressure to shield consumers from its effects have tipped the scales in favour of greater issuance. The ECB is also cautiously dipping its toe into the quantitative tightening shark tank. Both processes will be gradual indeed, and fraught with risks, but they are chipping away at the main technical driver for structurally low rates in the eurozone.

> *We could see 10yr EUR swap rates (vs Euribor) dip towards 2.5%*

10yr swap rates, which at times this year have been more than 100bp above Bund yields, are less sensitive to these factors but are not entirely insulated from them. Worse still, a new round of upward pressure on rates will come from shrinking excess liquidity and rising Euribor (and eventually Estr) fixings relative to the ECB deposit rate. At a push, we could see 10yr EUR swap rates (vs Euribor) dip towards 2.5% in the course of 2023 but we expect a jump back towards 3% by the end of 2024.

The EUR curve should invert mildly in 2023



Source: Refinitiv, ING

Curve inversion is still ahead of us

Persistent inflation, and so uncertainty about the path of policy rates, should prevent front-end rates from dipping much below their 2022 levels in 2023. This should be mostly true in the first half of 2023. A corollary to our below-consensus call for a 2.25% peak in the ECB deposit rate is that the end of this hiking cycle shouldn't be followed by much easing, unlike what our US colleagues expect. This means that the case for much lower front-end rates is flimsy in our view, and we're expecting 2yr swaps to remain within their late 2022 range in 2023.

> *After a shallow inversion of EUR swap 2s10s towards -15bp, we expect the re-steepening process to begin by 2024*

Where the read across from US to European rates is relevant is at the back end. A meaningful drop in Treasury yields will bring 10yr Bund yields through 2% and 10yr EUR swap rates potentially as low as 2.5%. This dynamic will come at a time of worsening recession in Europe but, as the economy recovers, so will the term premia on the curve. After a shallow inversion of EUR swap 2s10s towards -15bp, we expect the re-steepening process to begin by 2024.

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