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Rates Spark: a few weeks of Goldilocks

The EUR reflation trade has scant fundamental drivers, but looks to have at least a few more weeks to go thanks to USD markets. Rising inflation swap rates should add steepening pressure on the nominal rate curve, and help sovereign spreads tighten. We extend our tightening target on 10Y Italy-Germany.

Overnight: easy does it

Calm market conditions prevailed in overnight trading but with little changes in bond future prices. Stocks futures on the other hand continued recovering from yesterday morning's losses, leaving the improving risk sentiment trend intact in our view.

Although cautiously, the focus in Europe is turning to reopening plans. German federal and regional governments are discussing early March as a reopening date for some shops and hotels.

Reflation in the Eurozone, a few more weeks to go

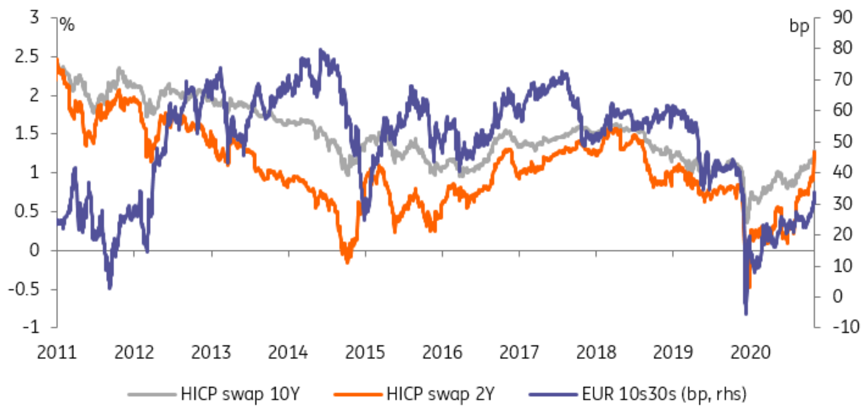
If US and Eurozone markets were completely isolated from each other, we'd wager that no reflation trade would be happening this side of the Atlantic. The conclusion of a side by side comparison of the factors driving the reflation trade in the US and Eurozone is unequivocal in our view. Fiscal stimulus, Fed average inflation targeting, rapid vaccine rollout, are all drivers 'made in America'. And yet, EUR interest rates and inflation swaps are content to rise alongside their USD peers, sometimes even outpacing them.

EUR 10s30s can steepen to 60bp, from 35b currently

Deeply negative real rates, the result of rising inflation swap rates and of more muted nominal interest rates, is a supportive backdrop for risk appetite. This state of play could last a few more weeks (or months at best) before one of two things happen. Either reflation expectations are proved correct and the risk of central banks tightening increase. Or they are proved wrong and inflation swap rates fall. Either way, real rates will rebound, by the end of Q2 is our best guess.

In the meantime, we expect 10Y Eurozone inflation swaps to reach the same peak as in 2018: 1.5%. This alone has important implications. If the relationship between inflation swaps and the slope of the EUR (nominal) swap curve still holds, this would imply EUR 10s30s can steepen to 60bp, from 35b currently.

Inflation swaps can rise further, and the nominal curve should steepen along 10s30s



Source: Refinitiv, ING

As most other risk assets, Italian bonds will benefit too

This also means the positive backdrop to risk assets will be maintained. Italy-Germany spreads have continued tightening in anticipation of Mario Draghi's nomination as prime minister. As support from various parties to the former ECB president pour in, it is easy to overlook the contribution of negative real rates to ever tighter spreads. As long as inflation swap rise faster than Italian yields, markets will understand this as improving the country's debt sustainability. It also reveals a degree of optimism (justified or not) about the recovery.

In short, momentum is on the side of tighter sovereign spreads. The 10Y Italy-Germany is now flirting with our 2021 target of 90bp (115bp at the time) and we feel the tightening move has time to extend to 75bp before real rates start rising again, and damage risk appetite. On the political front, a long period of stability, and the prospect of a credible plan to spend the EU recovery fund are enough for the feel good factor to continue into the scond quarter.

75bp

our new target for 10Y Italy-Germany

our previous target of 90bp is almost reached

Today's events and market view

US CPI is the main release today. Our economics team expects inflation to climb abruptly towards the middle of this year. Not all drivers are durable, but it is enough for the Fed tapering debate to intensify next quarter. The release will act as a timely reminder of these dynamics, to which one needs to add the inflationary potential of additional fiscal stimulus being discussed this week in congress. As a reuslt we expect the progressive rates uptrend to resume today.

Pablo Hernandez de Cos, Fabio Panetta, and Christine Lagarde make up today's ECB speakers list. Fed chair Jerome Powell is also scheduled to speak.

The US Treasury will auction $41bn 10Y T-notes and Germany €4bn 5Y Bobl.

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