Rates Spark: Aggressive market pricing and ECB caution can coexist

The European Central Bank takes centre stage today. Given how far market pricing has evolved, it will be difficult for President Lagarde to sound hawkish. Still, we expect any rally in rates to be short-lived as inflation worries remain

European Central Bank building and the Frankfurt skyline

Aggressive market pricing and ECB caution can continue to coexist for now

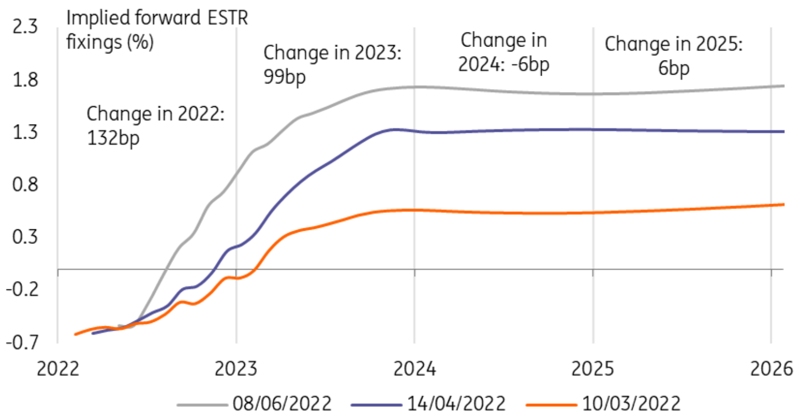
As the ECB meeting takes the spotlight today, the main question will be whether President Lagarde can live up to the hawkish expectations of the market. Money market pricing implies the expectation that the ECB will raise its key rate cumulatively by more than 130bp this year alone. Given that after today there are just four rate setting meetings until the end of the year, that would mean at least one 50bp hike. As it currently stands markets are homing in on September as the most likely date for a larger move by the ECB.

Aggressive market pricing stands in contrast to still cautious ECB *undertones*

Aggressive market pricing stands in contrast to still cautious ECB undertones, prevalent also in President Lagarde's blog post two weeks ago when she set out a roadmap with 25bp hikes in July and September – as a "benchmark case" as later specified by Chief Economist Lane. Gradualism, optionality and flexibility still have their right to exist amid an environment marked by high uncertainty, not only given the ongoing war in the Ukraine, but also surrounding the prospective neutral level.

Equally markets have their right to diverge from the benchmark case, especially following the upward surprises to inflation data. Looking ahead the peak in inflation may not have been passed just yet. And should any hints of inflation expectations becoming unanchored emerge, then gradualism is likely to be the first thing the ECB will abandon – any unanchoring would have to be nipped in the bud to avoid even more painful adjustments further down the road.

The swap curve implies a 50bp hike in July or in September



Source: Refinitiv, ING

What to look out for today

1. The ECB will have an **updated set of forecasts** at its hands. It should show upwards revisions to the 2022 and 2023 inflation forecasts and lower growth for the same periods. Overall though they should show that all previously stated conditions to begin raising rates are now met. The pledge to stick to the sequenced normalisation process is probably the only thing keeping them from hiking already today.
2. All **key rates expected to be left unchanged** today. The 2bp higher average for the overnight rate priced for the upcoming reserve period may also account for uncertainty with regards to the looming targeted longer-term refinancing operations repayment date. More important for the pricing of the money market curve is how President Lagarde phrases the risk surrounding her roadmap that outlined 25bp hikes in July and September. The possibility of 50bp hikes is unlikely to be taken off the table.
3. The ECB is set to **announce the end of net asset purchases**. Whether the exact end date is with the end of June or early in July should have little implication in theory, though the earlier date could add a hawkish twist.

4. The fate of bond spreads will be more dependent on whether there is a stronger and detailed commitment deal with any unwarranted widening of Eurozone government bond spreads. While an FT report suggested the promise to create a **new spread management tool** if needed could make its way into the press statement, it is widely expected that the ECB will stick to its approach of constructive ambiguity, sparing any details of how such tool could actually look like. As of now the widening in spreads has been rather mechanical alongside the rise in rates. In the best case, this will be the mode going forward. But we fear that markets will eventually test the ECB's resolve.

Today's events and market view

All eyes are on today's ECB meeting. President Lagarde sticking to her plan of 25bp hikes in July and September would look dovish set against the aggressive pricing of policy tightening that markets have started to incorporate. We would thus not exclude markets rallying with the ECB decisions today, but we would expect this to be short-lived.

In data the only notable release are the US initial jobless claims. More relevant for the direction of long end rates should be supply as the US Treasury sell US$19bn in 30Y bonds later today.

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