Rates Spark: Balance sheet chatter

Today's first inflation releases for June from the eurozone will likely confirm what central bankers have been stressing all the while: Their job is not done. But deep yield curve inversions also signal a diminishing reach of their current strategies, which may explain why their balance sheets are moving into focus again

Central banks' current hawkishness is losing some of its reach...

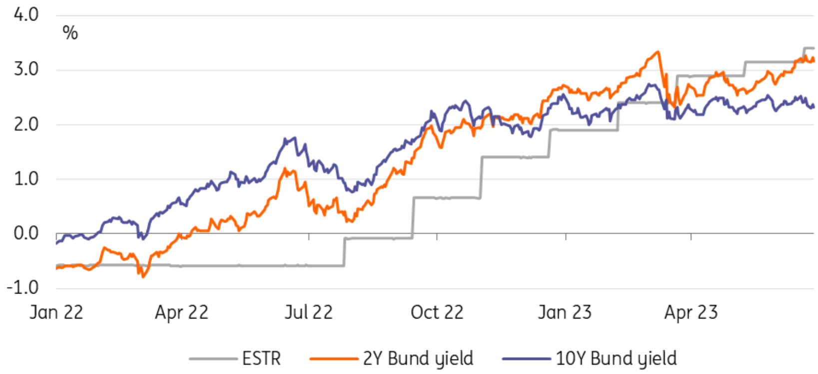
In coming sessions all eyes are on the inflation data, as today we have the German and Spanish country releases in the eurozone, tomorrow the bloc's flash estimate and also US PCE inflation. And data is showing that while headline pressure is easing, inflation remains far above central banks' target level.

> *Central banks' ability to push terminal rates higher and also influence longer rates appears to run into resistance*

This is why we have heard the usual hawkish comments from the four governors in their joint panel at Sintra yesterday. More tightening is on the cards, but this was largely only confirmation of what we already knew from prior communication. If anything, Powell's emphasis that he would not rule out consecutive rate increases in July and September was slightly hawkish against the backdrop of markets only fully pricing one more hike. But as we highlighted before, central banks' ability to push terminal rates higher and also influence longer rates appears to run into resistance as it faces market scepticism about how much economies will be able to stomach.

Perhaps it is in the face of deepening yield curve inversions and dropping longer end real rates in particular, that some of the central bank chatter has recently focused on the balance sheet strategies again. At the Sintra panel, the heads signalled being content with current decisions and pace of shrinkage, but in some of the more hawkish minds might still be contemplating how the reach and effectiveness of policies could be increased.

EUR long end yields have been relatively resilient to policy tightening for a while



Source: Refinitiv, ING

... bringing balance sheet strategies back into focus

Bloomberg reported early yesterday that some European Central Bank (ECB) council members were mulling a faster pace of balance sheet reduction via active asset sales from the Asset Purchase Programme (APP) portfolio or phasing out the reinvestments of the Pandemic Emergency Purchase Programme (PEPP) portfolio. Of the ECB's €4.86tn stock of QE assets, the APP roll-off – once reinvestments come to a full stop next month – could equate to around €370bn per year, just extrapolating the current maturity profile. Active sales could be a next step once targeted longer-term refinancing operations are fully repaid by the end of next year. That the repayment of the €500bn of these loans has happened without major hiccups this week is probably encouraging the balance sheet hawks.

> *Changes to the PEPP guidance and/or reinvestments could unnecessarily risk financial stability*

But there are also more cautious voices on the topic. Just as Lagarde pointed out in yesterday's panel, interest rates remain the ECB's primary monetary policy tool. In another background report by Econostream released in the afternoon, ECB officials signalled that the current passive run-off was sufficient, and especially speeding it up via the changes to the PEPP guidance and/or reinvestments would unnecessarily risk financial stability. After all, the possibility to flexibly reinvest PEPP holdings is one of the main tools that the ECB still has to quickly react to spread widening pressures in bond markets.

At some point the ECB has to decide on the balance sheet size it wants to target, which goes hand-in-hand with an ongoing review of the ECB's operational framework. Yesterday, Lagarde flagged that this work could hopefully be completed in the next "six to nine months". This indicates some upside risk to previous communication which saw the review being concluded by the end of the year.

Today's events and market view

Inflation remains the central banks' one needle in the compass that dictates their policy nowadays. This puts the focus squarely on today's inflation readings out of Germany and Spain. German headline and core rates are seen higher on the back of base effects and statistical tweaks. Spain's headline rate is seen falling below the 2% level but, more importantly, the core rate is seen to come down only marginally.

Alongside Italy's data from yesterday this should already give a good idea of where tomorrow's eurozone reading is headed – and it should signal no let up in the pressure on central banks to continue to act forcefully.

In this set-up yield curves will remain inverted for some time. Markets will see the softness in wider data, such as in yesterday's eurozone credit growth which shows that policy transmission is working. Still, if there is anything that could turn the market it is surprises in the inflation data, which markets might be quicker to extrapolate even if central banks themselves might want to see confirmation from more than just one reading.

In other data we will get the initial jobless claims out of the US, pending home sales, as well as a third reading for first quarter GDP growth.

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