

## Rates Spark: Blissful ignorance

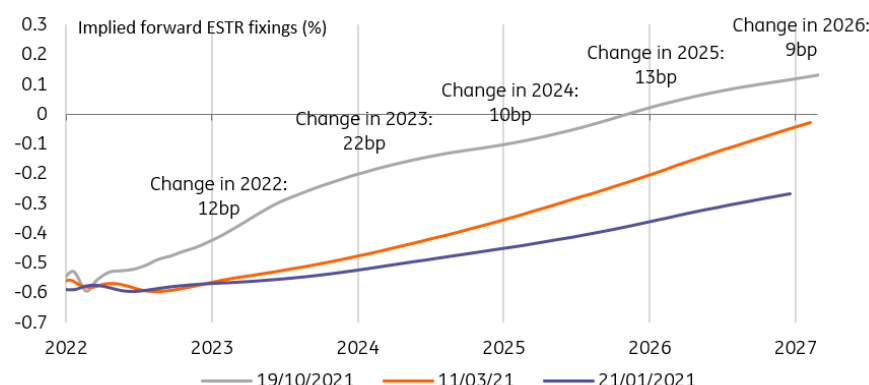
If central banks need to tighten policy faster than had been previously anticipated, as markets now seem convinced, it will take a different form at the ECB. We see no hike before late 2023. Instead, markets should be concerned about the impact of QE tapering, in particular on long yields and on spreads



### Too early, but possibly too little

There are numerous ramifications of central bank tightening. Today, we focus on EUR rates and the implications of the ECB's exit strategy. We surmise that the scale of the rise in EUR front-end interest rates will be addressed by the officials scheduled to make public appearances today. If it isn't, we suspect that it will be seen by markets as a tacit acknowledgement that the re-pricing accurately reflects the ECB's reaction function. This is particularly true, as today is the last day before the pre-meeting quiet period.

## ECB hike expectations have risen alongside that of other central banks



Source: Refinitiv, ING

As a starting point, current money market pricing is consistent with 10bp of hikes in 2022, and a further 20bp and 10bp in 2023 and 2024 respectively. In a sense, that's fair enough. We take no issue with the scale of tightening priced over the next three years, if the basic assumption is that developed markets are entering a phase of sustainably higher inflation. This is the same assumption that seems to have pushed GBP and USD markets to bring forward central bank hikes, excessively so in the case of the GBP curve.

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*The ECB has two asset purchase programmes to taper before it can hike*

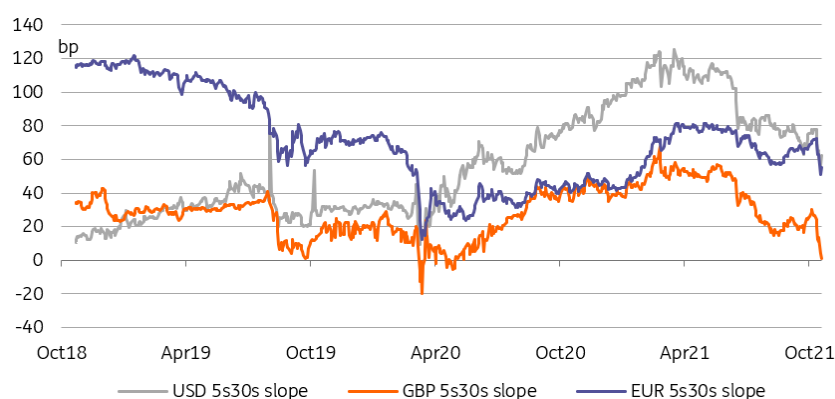
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We take no issue with the degree of tightening that is priced into the market, and indeed, the actual ECB deposit rate at the end of 2024 might end up higher than the one currently implied by the curve. But we doubt that hikes can start before late 2023. This is because the ECB has two asset purchase programmes to taper before it can hike rates. What's more, public comments and ECB 'sources' in the press, suggest that a new programme could be introduced to replace PEPP when it ends in March 2022. In our view, purchases will continue for the whole of 2022, and will continue well into 2023.

### First things first: QE tapering

Given the ECB's commitment only to raise interest rates once purchases have ended, we think this means no hikes until the latter half of 2023. This also means that, if inflation is near escaping central bank control, EUR markets should be more concerned about an abrupt end of asset purchases. In practice, it seems to us that the rise in EUR front-end interest rates has more to do with similar moves in the US and UK, but if inflation fears prove correct, upcoming central bank tightening spells trouble for other sectors.

## The EUR curve should flatten less than its US and UK peers



Source: Refinitiv, ING

The first implication is that, as purchases are largely seen as suppressing long-end interest rates, a bear-steepening of the yield curve should occur as the ECB edges towards the exit. This is far from a foregone conclusion, as demand for long bonds is correlated across countries, so the domestic steepening impulse runs counter to the flattening impulse from other jurisdictions, like the US and UK. It is perhaps that realisation that has helped the EUR curve re-steepen more severely than its peers yesterday.

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*If inflation fears boil over, spreads will have to adjust higher rather rapidly*

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The other implication is that fixed income spreads, for instance between Italian and German bonds, will come under widening pressure as central bank purchases diminish. Here too, that effect has been muffled by other factors. In this case, favourable policies implemented by domestic governments, and intra-EU fiscal transfers through the NGeu fund. Truth be told, once a reduction in central bank purchases becomes the majority view, we think it will far outweigh improving fundamentals. The only question in our view is how abruptly purchases will end. So far, ECB communication has been encouraging, but the risk is, if inflation fears boil over, that spread will have to adjust higher rather rapidly.

## US remains geared towards rates continuing to edge higher

There is little out there to materially force market rates lower right now. The data remains one-sided. The risk-off that dominated through much of September has morphed into renewed risk-on. China CDS has eased lower again, and high yield generally is on a re-tightening trend. Earnings season does present a risk, as it feels like we are going into it on quite an optimistic footing. But until that optimism is actually negated, it does feel like market rates can continue to drift higher.

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*Pressure on the belly of the curve should continue to dominate*

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Pressure on the belly of the curve should continue to dominate, as it is too early for an actual hike. That can still mean a flatter 10/30yr segment; in fact that segment should be on a structural flattening journey, probably all the way to zero. All the dynamics are around the 2/5yr, which for now is under steepening pressure. That makes sense, but this time next year, watch that segment flatten quite dramatically as the 2yr rate rockets. But before that can happen, longer rates need to make some room, and that means edging higher.

We're above 1.6% now for the 10yr. The 1.75% area would be the next zone to aim for, where we were in March when it looked like it had 2% written all over it.

## Today's events and market views

Green supply is back at the top of the agenda with Germany selling €3bn of 10Y green Bund via auction, and as Italy has mandated banks for a syndicated tap of its existing 2045 green BTP for a €5bn size.

Compared to its US and UK peers, the ECB has managed to stay out of the headlines. This is despite the pre-meeting quiet period starting tomorrow. As such, today represents the last opportunity for officials to prime markets for next week's policy meeting. Villeroy, Elderson, Holzmann, and Visco make up today's slate. Central bank tightening pricing has received little pushback so far (the exception being from Philip Lane, a dove) so we think markets will interpret this silence as a sign that interest rates need to continue their adjustment higher.

Data today is mostly what we would term 'tier 2' due to its lower market-moving power. Eurozone CPI will be a final release, and the other release is on the current account.

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