Rates Spark: Brace for more upward pressure

Rates remain under upward pressure. As long as central banks see inflation as their greater challenge, then the underlying market dynamic is unlikely to change.

European Central Bank, Frankfurt, Germany

Source: Shutterstock

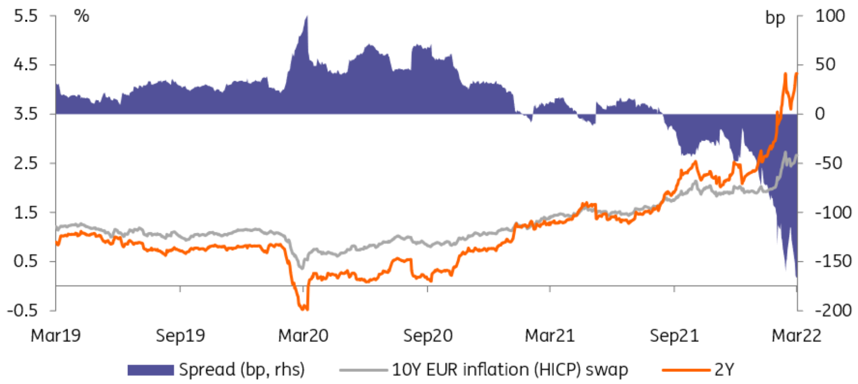
No let-up for rates central banks' inflation fight takes precedence

The economic sentiment indicators surprised by not deteriorating as much as feared. At least for now they look still robust despite the war raging in Ukraine. And, more importantly, despite the increase in energy prices. However, there were indications in the surveys that pass-through effects of higher costs are happening quicker than anticipated. Inflation expectations could begin to be entrenched, something central banks are keen to preempt.

Markets should not bank on the ECB replacing the TLTROs

There is no let-up in rising price pressures in the week ahead. The next Eurozone flash inflation reading is expected to rise to 6.3%. This would serve to confirm the ECB in its determination to normalize monetary policy. Only yesterday the ECB announced a gradual rollback of the collateral easing measures originally introduced with the onset of the pandemic. The prospected timeline through March 2024 suggest that markets should not bank on the ECB replacing the TLTROs – at the very least not to the very generous conditions we have seen before. European government bonds can find solace in the ECB's decision to waive the credit rating requirement for Greek bonds for the PEPP reinvestment period, though. But that should come as a reminder: net PEPP will end next week and the APP will only temporarily be ramped up to avoid a cliff effect.

PMIs reinforce already high near-term inflation worries



Source: Refinitiv, ING

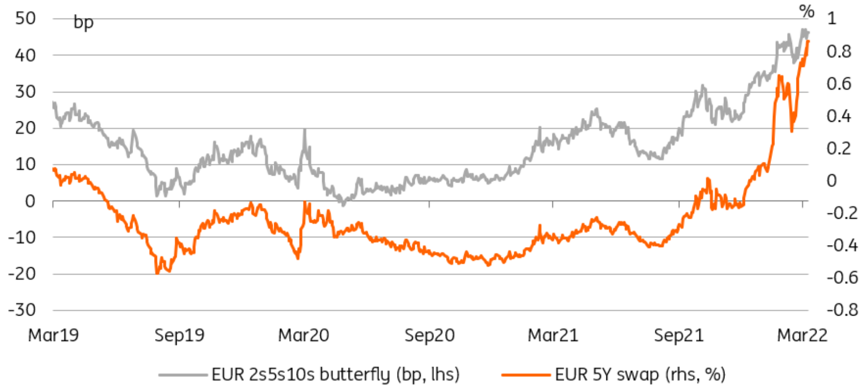
The pricing of hiking paths becomes even more aggressive

With this backdrop, it comes as no surprise that EUR money markets are back to almost fully pricing two 25bp hikes before the end of the year. Yesterday saw the more policy-sensitive belly of the curve underperforming - the 5y rate cheapened more than 3bp on the 2s5s10s butterfly spread. In absolute terms the 5y swap rate is now close to 0.9%, its highest since 2014. The long end is not pressured up as much, though. The flattening of the curve is where markets are showing their lingering concerns over the economy's ability to stomach the quickly tightening financial conditions. Technical factors going into month-end could exacerbate flattening pressure in the near-term.

> *The prospect of an even steeper Fed rate hike path is rising*

Across the pond, the prospect of an even steeper Fed rate hike path is rising. Fed members have come out speaking of the necessity of larger hikes and to bring rates eventually above the neutral rate. Next week's US jobs data should only reinforce that notion. A tight labor market and upward pressure on wage growth against a solid investment backdrop will give the Fed more confidence to hike interest rates by 50bp in May according to our economist.

The 5Y EUR is still in the lead, showing medium term tightening expectations



Source: Refinitiv, ING

Today's events and market view

Geopolitics and headline risk remians, also as the EU summit continues today. In Eurozone dta the focus is on the German ifo business index wich is seen declining against the backdrop of the Ukraine war. Following the PMIs we dont think that it will change the dynamics of markets pricing even quicker policy normalisation and subsequent tightening from the ECB, althoug he curve flattening dynamic could be reinforced by upcoming month-end rebalanceing.

The US will see the release of pending home sales data and a still busy slate of scheduled Fed speakers with Williams, Barkin and Waller.

In supply Italy will today issue up to €3.5bn in short term and inflation linked bonds.

Authors

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Disclaimer