

Rates Spark: Chronic gloom

A dovish Fed and an ECB under pressure to impress, subsiding supply and risk sentiment turning more cautious on the spreading virus variants - it all should limit upside to rates. Yesterday's hawkish twist by the BoE was the outlier and showed little spillover into other markets - but served to highlight the ongoing tensions.



Bank Of England,
London

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As the week draws to a close, concerns surrounding the spread of virus variants and with it fears of delayed economic reopening dampen risk sentiment again. 10Y yields in the Eurozone have closed in on last week's lows. With the dovish tone being maintained by both Fed and ECB it adds to the ongoing bias for lower rates - the BoE's change of tack has not spilled over. Despite already depressed levels, the upside to rates appears limited, especially as there does not seem to be an excessive build up of expectations ahead of the ECB meeting, despite its newly gained importance. The main supply events are now also out of the way. In EUR, only Germany has scheduled auctions for next week.

Focus shifts to the ECB meeting ahead

The key event to look forward to is next week's ECB meeting. Changes following the strategy review are awaited and have been flagged, such as a aligning the forward guidance with the new

inflation goal. On the face of it, the newly formulated strategy shifts the ECB towards a more dovish stance. Whether that already translates into a more concrete policy response already next week is another question.

The ECB's strategy review means an updated guidance, but possibly no concrete action just yet

Our hunch is not yet, as also the minutes of the last meeting have highlighted remaining rifts within the council. And the hawks have already been pushing for the end of the extraordinary crisis response measures. It may end up being a missed opportunity to restore some of the ECB's lost credibility on the inflation front. On the other hand, we think it is more likely than before that the ECB will try to cushion the end of net PEPP once we get closer to the currently envisaged expiry date. Perhaps we will get first hints.

Markets have refrained from getting too excited after the strategy review, that is most evident in the still subdued pricing of inflation expectations. No sign of a reflation trade to be seen in the curve, instead just an even shallower trajectory for rates. The flash PMIs a day after the ECB will be a reminder, though, that this trajectory should still be pointing upwards as economies emerge from the pandemic.

BoE moves closer to removing stimulus

While in the case of the ECB the discussion surrounding tapering at least some of the stimulus will better be saved for September, it has become very concrete for the Bank of England after Saunders' speech yesterday.

While still flagging remaining risks surrounding the outlook, he sees the conditions met to withdraw some of the monetary stimulus soon, such as ending the asset purchase programme "in the next month or two". The Gilt curve bear flattened as short to intermediate rates rose by up to 6bp. However, there was very little spillover into other markets from this hawkish distraction.

Today's events and market view

Spotlight today is on the US retail sales data where consensus sees a small drop on the month. Our economists think autos could be a drag on consumer spending this month given carmakers are failing to keep up with demand and a lack of inventory of finished goods.

Overall, the backdrop for retail sales remains robust, though, which should also be reflected in a high (preliminary) University of Michigan consumer sentiment reading today. Particular focus here also on the inflation expectations components – so far the transitory inflation picture is shared by consumers.

There is not much in the cards today to change the current dynamic in rates markets with the focus having shifted back to the pandemic and the spread of the Delta variant as well. The eurozone will see the final release of June inflation data today. More important is what lies ahead. Subsiding supply and an ECB under pressure to impress should limit the resteepling potential. But Eurozone periphery bonds could be the main beneficiaries in this

environment.

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