Rates Spark: Collateral scarcity issues

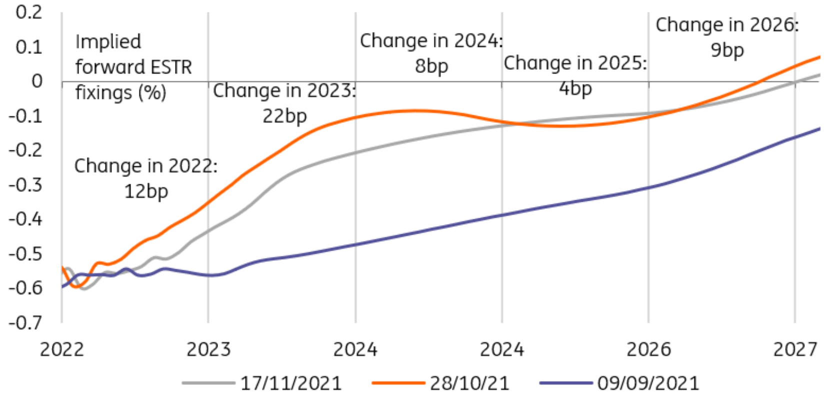
The UK and Canadian CPI prints will ensure that inflation fears stay in the headlines, testing central banks' calls for patience as front-end rates pressure higher. The main story on the EUR front end remains collateral scarcity and widening ASWs, with markets showing some doubt that the ECB's latest measure will alleviate distortions in the near term

Patience is increasingly tested

The broader theme is little changed. Better data such as yesterday's US retail sales and industrial production, against a backdrop of rising inflation is continuing to challenge central banks' narratives that still call for more patience.

In the US, upward pressure on front-end rates is still counterbalanced by hopes for a more dovish successor to Fed Chair Powell – more news on that "in about four days" President Biden told reporters yesterday – and potentially accelerated tapering ahead of rate hikes. By the end of yesterday the US Treasury curve was actually a tad steeper. Front-end Sterling rates though posted a larger rise following that morning's employment data while markets likely also already eyed today's CPI.

The EUR swap curve is still pricing a 2022 hike after the ECB's numerous pushbacks



Source: Refinitiv, ING

ECB's Wunsch highlighted the narrow path that central banks are navigating with regards to inflation. In the case of the Eurozone, he remarked that it would not take much for the ECB's inflation forecast for 2023 to be at 2% or higher – i.e. at or above the ECB's inflation target. While he is a known hawk, he stopped short of calling for a change of policies and called for patience, but also warned against dismissing the tail risks.

Still, in the Eurozone market measures for inflation are creeping steadily higher, the 5y5y inflation swap is back at 2%. The front end is still pricing higher ECB rates already for 2022. The main story in front-end EUR rates these days however remains another – that of increasing collateral scarcity driving a growing wedge between swap rates and bond yields.

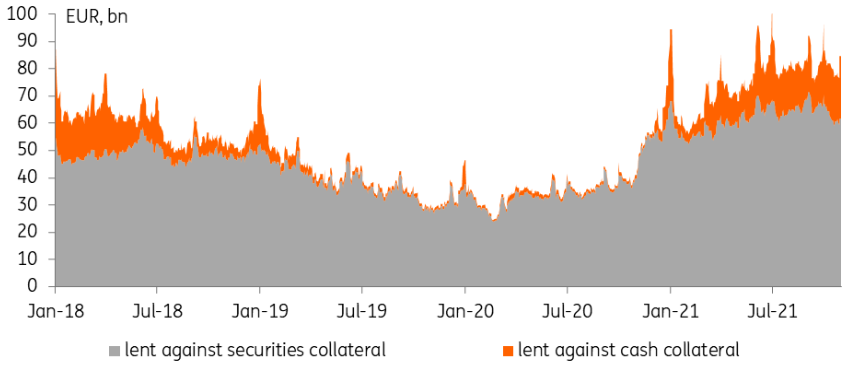
ECB: dealing with QE side effects

For now the ECB is still in the business of removing collateral from the system via its asset purchase programmes – net ECB purchases via the PEPP over the past week have risen to €18.3bn after two weeks of relatively muted purchases. While in part by design, scarcity of high quality collateral has become a growing issue going into the year-end as evidenced by the notable distortions in front-end rates in recent weeks.

> *The ECB is still in the business of removing collateral from the system via its asset purchase programmes*

The ECB does lend out the collateral it holds against cash, and has only this week doubled the amount made available to €150bn at the start of this week. Whether this will help to alleviate the high prices for German Bund and even French govie collateral has to be seen – markets at least appear less convinced as the spread between swaps and bonds has rewidened again, reversing the tightening on the back of the ECB's adjustment. German 2Y yields dropped by 4bp while swaps hardly budged yesterday.

ECB PSPP and public sector PEPP securities lending, aggregate daily balances



Source: ECB, ING

To put the ECB's increase in the securities lending limit against into context: the amount added is only somewhat more that the ECB takes away via net purchases in a month. Also, the added amounts are allocated to the participating national central banks in relation to their PSPP holdings. For the Bundesbank that translates into an added €20bn using the ECB's capital key as a proxy. Yesterday the ECB published data for the use of its securities lending facility until the end of October. Note that lending against cash reached €22bn by the end of October, but had seen a peak of close to €41bn at the half year turn – all well below even the original volume limits.

Today's event and market views

The UK CPI release this morning points the direction of travel for inflation, and should further tip the scales for a BoE hike in December. Later today Canada will release its CPI for October,and with headline seen rising to 4.7% year-on-year, the pressure for a more aggressive policy response is growing. As such GBP and CAD rates may well move into the driving seat today, putting upward pressure on front-end rates more globally.

While the Eurozone releases its final October CPI print today, the main focus should be on ECB's Schnabel, due to speak on the monetary policy outlook. It is a chance to alleviate inflation concerns, but it is doubtful that she will be able to present anything fundamentally new at this point.

The US sees a busy slate of Fed speakers which will be scrutinized for any change of tone following the blow-out US CPI reading last week. Fed's Bullard already provided a taste of more hawkish tones yesterday.

In supply Germany taps the 30y benchmark for €1bn, and Italy will conduct a syndicated tap of its 30Y USD bond which should be swapped back to EURs. The US Treasury will sell 20Y bonds today.

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