Rates Spark: Curbing the lower rates enthusiasm

The ECB's operational framework review will likely propose a demand-driven model with a structural bond portfolio. Wednesday will feature on this. In the background, the January pop in inflation has extended to February. Not great for rate cut bulls, although we're impressed with the implied resilience to the June rate cut discount

Three elements will be key in the ECB operational framework review

The ECB will share the much-awaited outcomes of their monetary policy framework review on Wednesday and in our view there are three elements that will be especially important to watch: (1) the balance between liquidity operations and bond portfolio, (2) the composition of the bond portfolio and (3) the trajectory of the transition period.

First of all we think the ECB will target a demand-driven floor model, which implies that the demand for bank reserves are satisfied through liquidity operations (e.g. MROs and LTROs) and supported by a (smaller) structural bond portfolio. The balance between these two will impact the overall liquidity conditions and the way monetary policy influences the longer end of the yield curve. Although we don't expect the ECB to share a quantitative target for the level of excess reserves, we do hope to learn more about their approach to determining a potential target.

Albeit smaller, the structural bond portfolio will continue to affect market dynamics going forward and is thus its intended composition is the second aspect we will watch. For instance, Chief Economist Lane shared the view earlier that the maturity could be shortened and that the portfolio could also include supranational and corporate bonds. In general, our view is that the ECB will want to minimise market distortions and thus the portfolio will be kept simple initially with a continued overweight of EGBs.

Regarding the transition, we don't foresee the new framework to be implemented overnight given the large balance sheet inherited from QE. Earlier Bloomberg reported that the transition period could take at least two years, which seems reasonable based on our projections of excess liquidity. Apart from shrinking the balance sheet, the ECB will need time to narrow its key interest rate corridor in order to revive refinancing operations and with a bit of luck the interbank market. As such the announcement will be important but given the extended timeline may not move markets in the short term.

Treasury yields with more upside as US core CPI remains too high

The big question post the hot 0.4% month-on-month CPI outcome for February (and same for January) is whether there is an appetite for the 10yr yield to make it's way back up to the 4.35% area. There is an excuse to do so given the February 275k payrolls outcome and now this CPI report. Our view is its far easier to see an edge higher than a capitulation fall in yield from here. Continuing to move clear of 4% and towards 4.35% makes a degree of sense.

The poor 10yr auction outcome made the same point. It tailed by a basis point (priced at 1bp above the when-issued level). Market direction into the auction should have helped to avert a tail. But clearly it didn't, and indicates less aggressive pricing and less than impressive demand at current yield levels. The indirect bid was also a tad lower than the previous auction. Not awful, but at the margin placed more pressure on dealers to take the auction down.

Wednesday sees the 30yr auction, which has had a bigger habit to tail. There is a clear intense focus on the inflation pop risk and supply pressure. The other element of pressure is ongoing jobs strength. PPI, retail sales and trade prices in the coming days are typically second tier in importance, but have the capacity to push things around, and likely placing net upwards pressure on yields based off what we expect through to Friday.

Wednesday's events and market view

Main focus is the ECB's communication on the operational framework review which Lagarde had flagged for today. We have little idea of what form this announcement will take and in the end it may well turn out very technical with little immediate market impact. Data should take a back seat on Wednesday with mortgage applications in the US and industrial production for the eurozone the only data releases of note.

Primary markets we will be busier, key event to watch being the US Treasury's US$22bn 30Y note reopening. In the eurozone, Germany reopens its 10Y benchmark (€4.5bn) and Portugal reopens 8Y and 18Y bonds (up to €1.25bn). Italy will tap bonds across 3 to 15 year maturities including a green bond (up to €8.5bn).

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