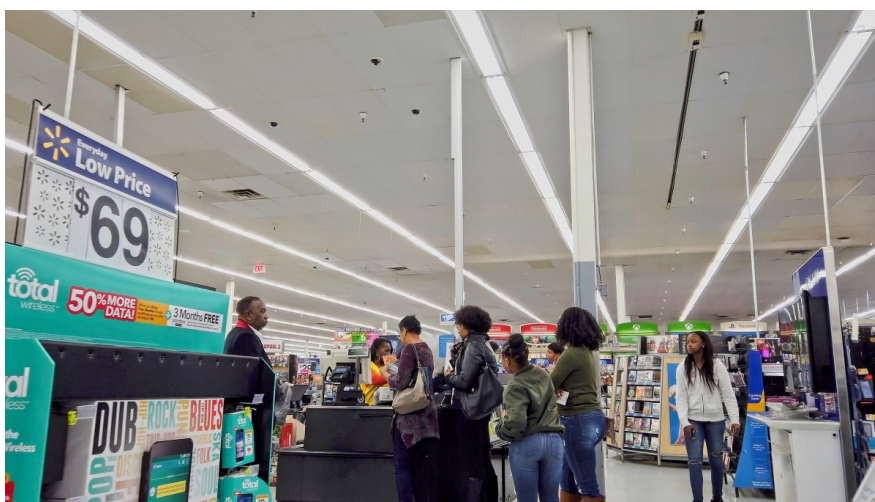


Rates Spark: How does 4% core feel

US CPI ahead - while headline may have peaked, a higher core rate could feed into the Fed's tapering debate. Technically, a faster taper makes sense too, as liquidity remains in excess. In EUR rates, the ECB has provided an excuse to look through these factors to the 22 July meeting after Christine Lagarde raised the stakes over the weekend



The Fed should consider a faster taper

We think the debate on tapering is not just about the taper itself, but also on how fast the Fed is willing to move from US\$120bn per month to zero. Until the Fed has wound down all the way to zero, the back end of the Treasury curve will continue to trade with surplus excess demand that can be difficult to dis-entangle from the discount signal that comes from the yield curve.

Ideally the Fed would like to see long end rates much higher than they currently are before starting a rate hiking process. How much higher? Ideally 100bp, enough to bring the real yield back up towards zero. A 2-handle on the 10yr would at least help to avoid eventual Fed hikes prematurely inverting the curve (after just two of three hikes).

While that is not a risk right now (as the Fed is not yet in hike mode), the 10yr eyeing up 1% is not particularly helpful. Some proper taper talk can help flip market psychology in the other direction. In any case, with still some US\$800bn getting thrown back at the Fed reverse repo window, the market could do with a technical adjustment.

US inflation data should feed into the taper debate

The start into the week was relatively uneventful, though with rates briefly testing the downside, at least initially, even with risk sentiment supported. Ultimately, yields were little changed to higher, the US front end slightly underperforming. Yesterday's auctions are blurring the picture, but in the broad strokes the UST curve is still painting a degree of pessimism that does not square with further economic recovery.

UST curve is still painting a degree of pessimism that does not square with further economic recovery

Certainly, there are concerns surrounding the rapid spread of the Delta Covid-variant, but given higher vaccination rates, at least in the US and across Europe, the template could replicate the UK experience. Some might call it a gamble, but in the UK a lifting of remaining restrictions is still envisaged from next week onwards despite elevated infection rates. Germany's public health institute is also considering taking into account the number of hospitalisations to evaluate the pandemic rather than infection rates alone – infection rates are still low but this would reduce the prospects of new curbs should the variant spread further.

This week further steepening impulses also lurk. US rates markets still have to digest a 30Y auction later today, and with a CPI release that could further feed into the Fed's tapering debate. – and possibly more hints from Powell on that matter in his semi-annual policy testimony to congress tomorrow. Also, the political front, which has been rather quiet given the 4 July recess, could turn livelier again on infrastructure plans as congress return to work. Whether that will be enough to turn rates higher before the end of the summer is another question. The market seems desperate for guidance that only time can deliver. But at some point the Fed will have to engineer a higher back-end to have credible room for manoeuvre on the policy rates front.

ECB shifts focus to the July meeting - and the battles ahead

EUR rates markets face plenty of supply, including another sizeable EU deal that would usually see steepening pressure on yield curves. But the ECB has given markets a good excuse to look through these factors. Over the weekend President Lagarde said the new formulation of the inflation target would lead to a revisit of the forward guidance next week. She also indicated that the Pandemic emergency purchase programme (PEPP) could “transition into a new format” after the net purchase phase ends, currently still envisaged for end Q1 next year. We have flagged the possibility of higher conventional QE purchases to buffer the end of PEPP, but her words could indicate that some of the PEPPs flexibility is also carried over.

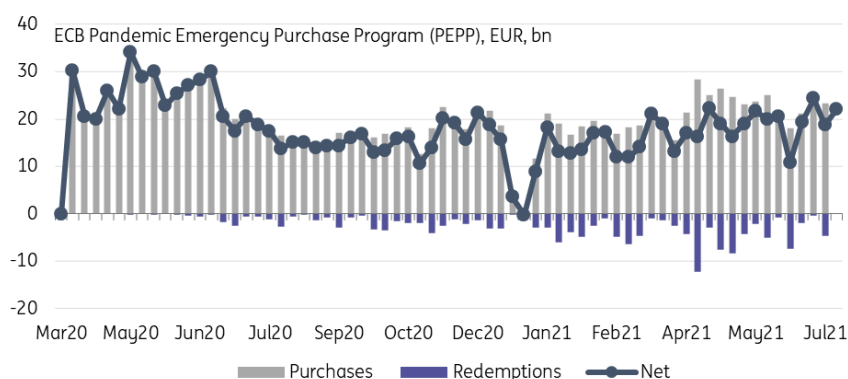
Internal ECB battles are still to be expected

As the ECB has been pushing on a string when it comes to generating inflation for a while now, we think the implication will be a lower for longer in rates without any increased prospect of greater

reflation as in the US at stages - and that should be more a confirmation of what many have been thinking already. But such talk also deflects from the immediate need to talk tapering the extraordinary emergency measures as economies recover further from the pandemic. Lagarde [pointed out that internal battles](#) are still to be expected.

For now, an updated guidance may help dampen volatility and slow the rise in market interest rate levels but will not prevent it. As before, the main beneficiaries of the ECB's ever-more dovish rhetoric should be peripheral debt like Italy. The country's bonds had seen their spreads spike last week but have recovered much of the lost ground over the past few sessions even as sizable auctions are lined up for today. The 10Y Italian spread over Bunds is now back to around 103bp.

ECB weekly net PEPP buying keeps up its elevated pace



Source: ECB, ING

Currently the ECB is still buying assets via the PEPP at an increased pace, last week €22bn. We may see lower numbers amid higher redemption flow, especially if the lack of market liquidity constrains the ECB's ability to make up for it. But the ECB has given no signal that it intends to think about slowing purchases ahead of the September meeting.

Today's events and market view

When it comes to data, eyes are squarely on the US CPI release today where an increase of core inflation to 4% YoY - its highest since 1991 - is on the cards. Also to watch is the NFIB Small Business Optimism index that could provide more indication of higher prices being passed on to consumers. It all serves to intensify the tapering debate as the data comes after the Fed grew more concerned about inflation at the last FOMC meeting in June. With the US Treasury also reopening a 30Y bond today, we could see the curve flattening, taking another breather.

European primary markets will be particularly busy today. In general the supply this week is tilted more towards shorter tenors, but the elevated volumes could still imply a brake on the curve flattening trend also in EUR. Germany sells €5bn in 2Y and, also in core, the Netherlands sells up to €2.5bn in 20Y in bonds. Italy sells a new 3Y bond alongside taps out to 15Y, overall up to €9bn.

The highlight is in SSAs where the EU yesterday mandated a two tranche deal, a €5.25bn 10Y bond to finance the EFSM and a €10bn 20Y to fund the NGEU.

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