Rates Spark: Don’t be distracted from the defining moments ahead

Poor market liquidity likely amplifies rates' sensitivy to wider risk sentiment ahead of the defining events later this week. With central banks looking firm in their intent to fight inflation, lower long end rates and flatter curves may prove the better conduit for Italian political turmoil coming to a head and European gas supply challenges

The European Central Bank's TPI backstop could be key in shifting the relationship between Italian bonds and the euro this time around

Rates markets remain sensitive to the ups and downs of wider risk sentiment, the swings also being magnified by currently poor market liquidity conditions. Pre-meeting black-out periods also mean a pause from hawkish rhetoric and reminders of the central bank tightening that is still to come.

Still, we would not want to read too much into such market moves and they should not distract from the main events this week – in politics, geopolitics and monetary politics, which all have potential to define dynamics through summer and beyond.

Italian political turmoil come to a head as the ECB is seen outlining its back-stop for spreads

Tomorrow will see the political turmoil in Italy come to a head. Prime Minister Draghi will address parliament, after which he could decide to immediately resign or call a vote of confidence if he sees a possibility that the government could continue. One of the more eye-catching market moves yesterday was in EUR rates with the tightening in BTP/Bund spreads. Sure, that followed the broader risk-on tone early yesterday, but was also supported by newswires pointing to last ditch efforts of at least some M5S members to save the Italian unity government. Paired with the possibility that the European Central Bank could still outline an anti-fragmentation tool that ticks all the boxes, that may all have been enough to prevent positioning for wider spreads.

> *The roots of the widening lying in domestic politics could tie the ECB's hands*

The ECB may well decide on a sizeable backstop this Thursday. But depending on the conditionalities the ECB eventually decides to attach to its new tools, the roots of the widening lying in Italian domestic politics could tie the ECB's hands. The central bank will be aware that it has to strike a balance between reining in bond spreads but also not being seen meddling with fiscal politics and the supervision set of other European institutions. We fear that the bar to the ECB stepping in, could be higher than markets currently hope. If snap elections are the outcome in Italy, we might well see the 10Y BTP/Bund spread testing levels of 250bp and beyond.

Markets still seeing the ECB tightening against all odds?

Regarding the ECB's decision on interest rates this Thursday, markets continue to price a non-negligible chance of a 50bp hike with the respective forward OIS rate around 29bp above current levels. A 25bp hike remains the base case, which then would shift the focus on what the ECB signals as the possible next step in September and beyond. The possibility of a larger move in September had already been flagged at the meeting in June. But the ECB's main take from that meeting will probably be not to paint itself into a corner again by committing too early, even if we could imagine the ECB hawks continuing to push for a more aggressive stance.

> *The ECB's main take from the June meeting will probably be not to paint itself into a corner again*

A smaller hike this week itself may not be enough to already warrant a repricing of the front end, which we think still reflects a tightening cycle that the ECB will hardly be able to complete as it gets overtaken by economic reality – 184bp of tightening by mid-2023 are currently priced. Some form of reckoning may come with news this week surrounding Russian gas flows to Europe. Nord Stream 1 pipeline maintenance, which has currently completely stopped the flow, should be completed on Thursday. If and in what quantities flows then resume will be crucial for the economic outlook. But as markets balance inflation and recession risks, the more likely conduit might be via lower longer dated rates and a flatter curve.

Today's events and market view

The main challenge for rates these days remains the balancing of inflation and recession risks. Longer end rates seem as the more likely conduit to price Italian politics and Europe's energy supply challenges. Ahead of the crucial events later this week and with poor liquidity rates remain sensitive to wider risk-sentiment in the meantime. In data this week's US housing market indicators, today with housing starts, will be scrutinized for their reaction to the rising rates environment.

In EUR rates the larger primary market supply can prove an additional more technical headwind for rates. Following yesterday's Belgian auctions, Germany will re-open a 5Y bond for €4bn today and a 10Y green bond tomorrow. France and Spain are active on Thursday.

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