Rates Spark: Duck-diving the fourth wave

The ECB sticks to its guns even as stricter containment measures loom large as the fourth pandemic wave sweeps over Europe. If the ECB keeps full optionality in light of inflationary risks, it willl have to contend with money markets being priced for tail risks.

Source: Shutterstock

EUR rates caught between pandemic surge and hawkish ECB

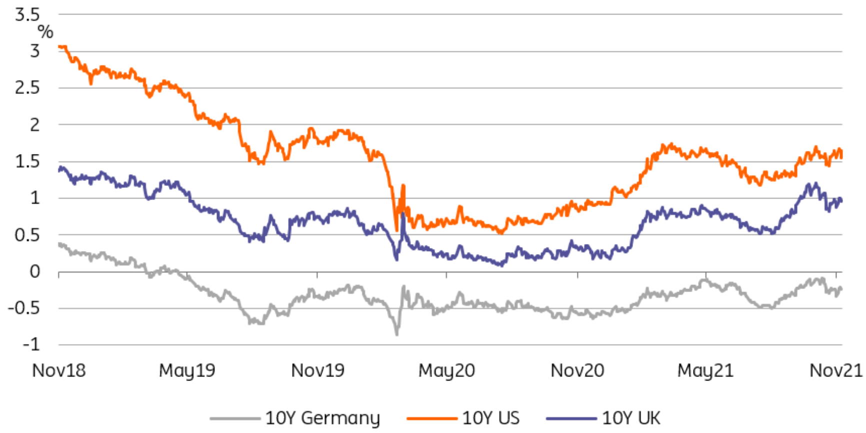
Left to their own devices with holidays in the US, the European rates markets will continue to assess the potential impact of governments' stricter containment measures as Covid caseloads continue to climb and with hospitalization rates at critical levels.

That this has not resulted in even lower core yields is at least in part also owed to the ECB sticking to its guns - PEPP will end as planned after March next year. ECB's Villeroy reiterated this just yesterday, although suggesting again that the flexibility could be kept in a "virtual toolbox". Sovereign spreads over Bunds are creeping wider, and US Treasuries and Bund received a significant bid for safety overnight on concerns of the emergence of a new, more transmissible, Covid-19 variant in South Africa.

The ECB had only just started acknowledging the increasing *upside risks to its inflation outlook*

Sure, uncertainty over the economic backdrop has increased with the fourth Covid wave in full swing, but the ECB had only just started acknowledging the increasing upside risks to its inflation outlook. Yesterday's ECB meeting minutes were testament to that, although it refers to a policy-setting meeting the predates the prominent speeches of ECB officials over recent days. Nonetheless, money markets stubbornly pricing in 10bp higher overnight rates by the end of next year is likely a direct reflection of the ECB's desire to maintain "sufficient optionality in the calibration of its monetary policy measures".

Fears over a new Covid-19 variant have sent yields lower overnight



Source: Refinitiv, ING

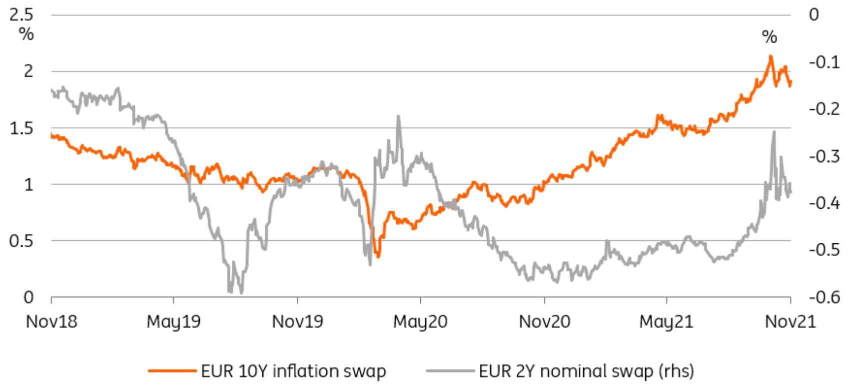
What lies beyond forward guidance

If even the ECB is hedging its bets, then this may already answer the question ECB officials discussed, as to "whether the jump in short-end EUR rates is as a result of markets questioning the new ECB forward guidance or its inflation forecast." It is probably both. Market measures of expected inflation - such as the 5y5y inflation swap jumping over 2% around the time of the meeting - indeed indicate the fears that the overshoot of inflation could force the ECB's hand, but naturally the forward guidance in turn is based on the forecasts.

Looking ahead that situation could persist for quite a while if the ECB were to consistently underestimate inflation, forecasting that it will drop below its 2% target again.

On the other end a quick glance to the UK shows us that the BoE is also one step ahead when it comes to forward guidance. Governor Bailey stated that the Bank has moved on to a guidance which is "reminding people of the policy framework" - which is the "price stability business". A 10bp hike at least is fully discounted by markets for December, with close to another 100bp of hikes over the course of 2022.

Higher front-end EUR rates reflect genuine inflation worries



Source: Refinitiv, ING

Today's events and market trend

The long Thanksgiving weekend will keep market activity depressed. The main focus is on the pandemic situation across Europe. In Germany chancellor Merkel called for stricter measures yesterday as infection rates continue to spike higher, though without going into details. Countries such as Belgium and the Netherlands are anticipated to announce stricter measures today.

Quite a few ECB members are again scheduled to speak, though the venue suggests topics outside of current monetary policy: Lagarde, Schnabel, Panetta and Lane all speak at the ECB's Legal Conference.

Authors

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("**ING**") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit http://www.ing.com.