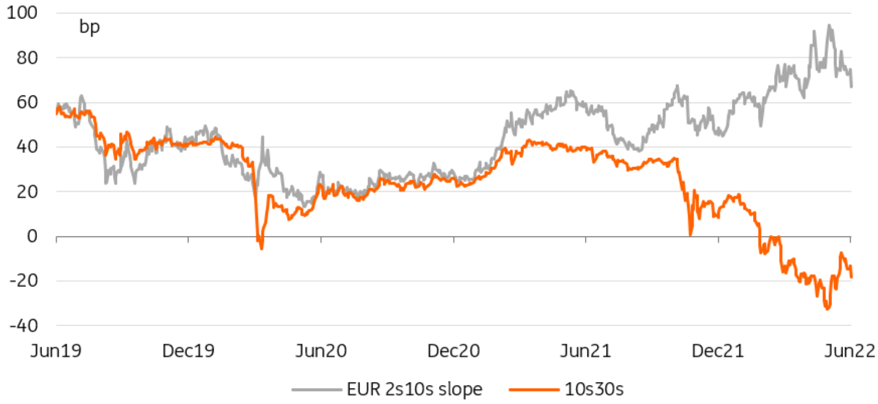
Rates Spark: ECB gets ahead of the curve

Despite already aggressive pricing the ECB's hawkishness pushed rates higher still. Periphery spreads widened with no further details on any tool to deal with fragmentation. Today's US CPI is set to remain high enough to keep the Fed in tightening mode.

The market thinks the ECB is getting on top of the inflation problem

The ECB has managed a hawkish twist that pushed EUR rates higher, with the front-end 2Y swap rate up by more than 10bp, and the 10Y rate was still up by 7bp. It should be seen as an encouraging sign that the curve bear flattened as it suggests that the market starts to think that the ECB is finally getting on top of the inflation problem.

Further EUR 2s10s flattening is a sign of more credible ECB action on inflation



Source: Refinitiv, ING

The ECB signals hiking cycle ahead, but gives no details on tackling fragmentation

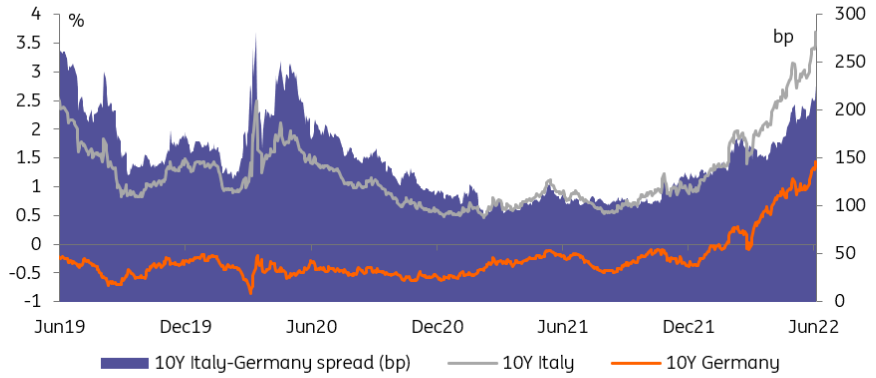
As expected the ECB announced that **net asset purchases will end on 1 July**. The wording on Asset Purchase Programme (APP) reinvestments saw a subtle change. The targeted liquidity conditions moved from “favourable” to “ample” and the aim to maintain an “ample degree of monetary accommodation” has scaled back to an “appropriate monetary policy stance”. While Pandemic Emergency Purchase Programme (PEPP) reinvestments will still be kept “until at least the end of 2024”, APP reinvestments could see a sooner end on the face of it.

Ending net purchases makes room to **embark on a proper rate hike cycle at the next meeting**. The ECB intends to hike by 25bp in July and deliver a further hike in September that could turn out to be a larger 50bp move if the medium-term inflation outlook does not improve. The rates corridor would not be changed at first, but it will be debated in September whether to return to a more symmetrical corridor.

Beyond September the ECB signaled a **“gradual but sustained path of further increases”**. The wording suggests a more set trajectory and notably it is not tied to the neutral rate which Lagarde had still included as a target in her blog post. Indeed, our economists have argued that it is not only a fuzzy but also moving target – very likely lower. After a 25bp hike in September our economists forecast another 25bp hike in December and one more in 1Q23. For now the market is likely to run with the ECB’s hawkishness and even price in the possibility on further 50bp hikes. The level of the overnight rates is seen more than 140bp higher by year end with only four meetings to go.

The ECB refrained from becoming more specific on how it intends to deal with the threat of fragmentation. Lagarde **reiterated the commitment to prevent fragmentation** as the first line of defense remains the existing reinvestments of the PEPP portfolio, but also said there were no particular thresholds that would trigger intervention. As of now the widening of the 10Y Italy/Bund spread, which extended with yesterday’s decision, remains orderly in the sense that it is in line with the general increase in rates levels. We still see the risk of the spread testing 250bp.

A more hawkish ECB with no tool to soften the widening impact on sovereign spreads



Source: Refinitiv, ING

Today's events and market view

Today's US CPI release means the focus will turn to next week's FOMC meeting. The annual rate of inflation should remain above 8%. Core inflation may slow marginally but should remain close to 6%. This will keep the Fed in tightening mode for the upcoming two meetings, but the debate on a possible pause in September may linger.

Still, yesterday's move higher also in US rates alongside the ECB meeting shows that markets may remain susceptible to the Fed refraining from signaling any notion of a pause just yet. US rates may not have seen their peak even as EUR rates should remain in the lead amid the latest leg higher.

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