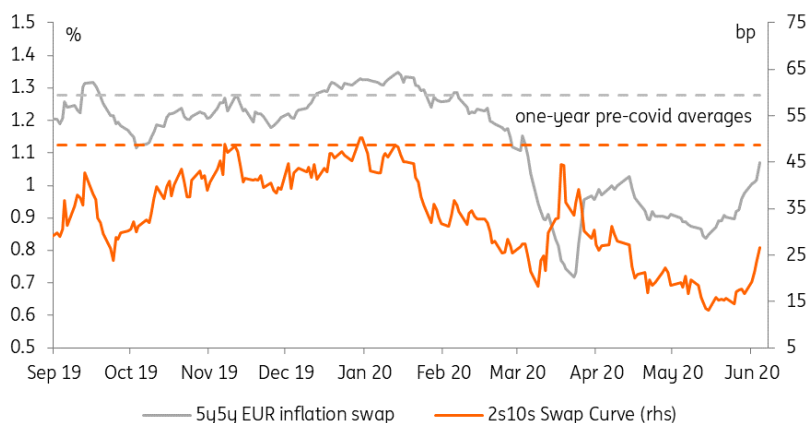


## Rates Spark: ECB implications and wider steepening

Rates markets are telling us that the ECB has regained some credibility. Lagarde has demonstrated that it can act on most markets to deliver easing and financial convergence. In the US, a re-steepening of the curve is ongoing. Not a complete breakout though, as the belly is still rich. Steepening is the escape valve from risk-on. The ECB is adding to this.



Source: ING

### ECB take away: largely as expected

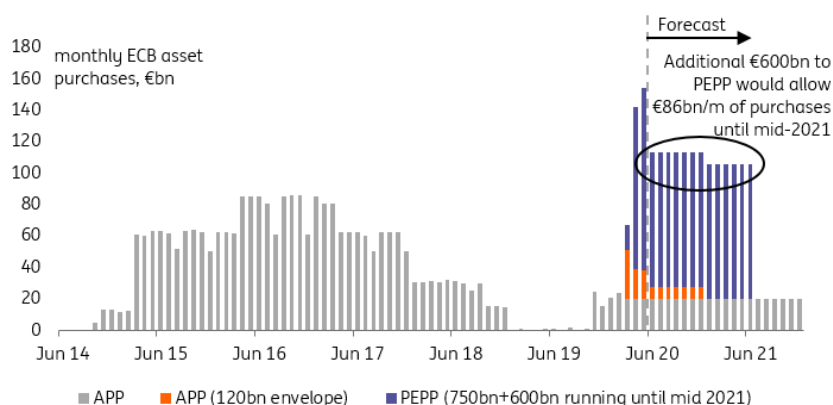
The ECB meeting yesterday offered some interesting insights into the ECB's thinking and delivered slightly more easing than we were expecting. As far as interest rates markets are concerned however, they do not change materially the outlook we presented ahead of the meeting [for money markets](#), and for [longer-dated interest rates and spreads](#).

The upshot is that another €600bn of PEPP purchases to be executed before 'at least' mid-2021 will help slow the pace of interest rate rises as the economic outlook improves, but also imply a slower average pace down from €109bn/month in April and May to €86bn/month by mid-2021.

With a more gentle path of interest rates should also come lower volatility which we think is key for drawing investors back into carry trades. This is why we think sovereign spreads should continue on a tightening trend, if slower than in May. This is just as well as the EU recovery fund

should only have a benefit in the medium term. There are also doubts.

## What €600bn of additional PEPP means for monthly purchases



Source: ECB, ING

The keyword of this meeting in our view was ‘flexibility’. Lagarde explained rather eloquently that the key to PEPP’s success was its ability to be deployed where and when it was needed the most, to deliver both easier monetary conditions as a whole, but also to prevent financial fragmentation. This is what allows the ECB to claim success in restoring commercial paper (CP) market functioning, in tightening sovereign spreads, and in reviving primary markets for corporates.

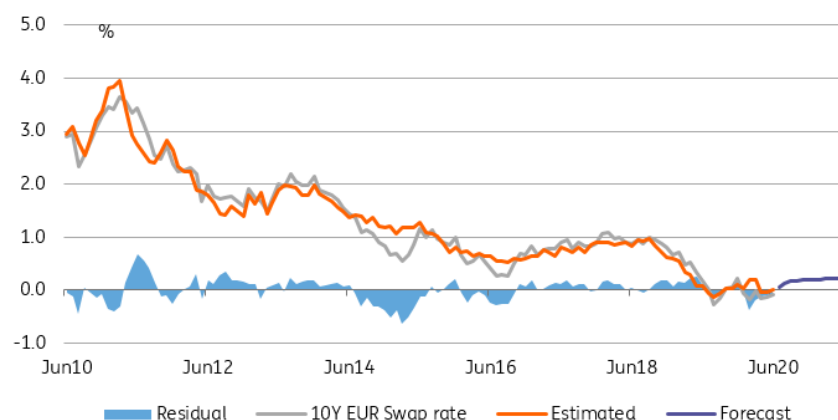
*"The keyword of this meeting was 'flexibility'"*

## In numbers: impact on swap rates and sovereign spreads

Plugging the new ECB policy decision into our rates models, we see 10Y swap rates rising to 0.15% by year-end which is roughly 15-20bp lower than without the PEPP boost. All of this is premised on a slow recovery but risks remains skewed to the downside due to both the odds of another wave in the covid epidemic, but also of a correction lower in risk markets.

*"We see 10Y swap rates rising to 0.15% by year-end"*

## More QE means rates will rise slowly



Source: Bloomberg, ING

Lagarde made explicit reference to the higher average yield on European government bonds (EGB), including Germany's, as an indication of tightening financial conditions. This makes sense as we have likely not seen the last upward revision to government borrowing plans this year. For instance, Spain is due to update on its borrowing programme in [an investor call today](#). The ECB making full use of the flexibility of PEPP to lean against rises in rates, even in a context of improving risk sentiment, reinforces our view that if rates rise, they will do so gently.

This feeds into our spread tightening view. We think too fast a rise in interest rates would actually be a threat to carry trades, and for spreads ultimately. We see 10Y Italy-Germany spread tightening to 150bp by year-end as the most risk adverse investors gradually shift their exposure. This view is reinforced by the extended PEPP reinvestment period. As De Cos noted, this allows the ECB to deviate from the capital key for a longer period of time. We think it is right for markets to extrapolate the skew in favour of peripheral bonds in purchases so far in 2020.

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*"We see 10Y Italy-Germany spread tightening to 150bp by year-end"*

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## Euribor: pulling all the levers at once

The ability of the ECB to deploy PEPP in the various corners of the market is above all relevant for Euribor fixings as it affects most of its components. Firstly, balance sheet growth lowers the cost of liquidity. Its impact on sovereign spreads also reduces the risk of 'high contributions' from peripheral banks. In addition, ensuring corporates access to the bond market eases pressure on banks' balance sheet. Last but not least, its intervention in CP markets removes an upside risk to Euribor fixings.

## And meanwhile the steepening is validated on the US curve

For a long time we have been calling for the 2yr to target zero and for the 30yr to break back above 1.5%. Right now the 2yr still feels anchored. There is a possibility that yield curve control

would start there. The 30yr is less afflicted, for now. There has not only been a break above 1.5% towards 1.65% now, but the 10/30yr has been on a steady steepening process since end-April.

We can see the 10/30yr heading for 100bp, the 10yr heading for 1% (so the 30yr at 2%), and for the 2yr to not deviate much from the 20bp area (maybe edging out to 25bp). That's a 75-80bp 2/10yr curve.

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*"We can see the 10/30yr heading for 100bp and the 10yr heading for 1%"*

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The interesting aspect here is the relative flatness of the 2/5yr segment. It sits with a richness being attached to the 5yr on the 2/5/10yr fly, which is typically a bullish construction. We'd suggest that stays and that investors will not be fooled into shorting the belly.

If the 5yr stays rich, it implies this is not really a bear market for bonds, and by extension suggests that a 1-handle on the 10yr and/or a 2 handle on the 30yr could be good entry points to go the other way (go long). Here, yield curve control, or the threat thereof has a role, but need not be the determining factor.

## Today's events: May US jobs report

The official US job report for May will take center stage today. As opposed to April, last month has seen the re-opening getting on the way which should be reflected in the data. The consensus is eyeing 7.5 million jobs lost last month after 20.5 million in April.

Our economists have a provided a detailed rundown of what to expect [here](#). They think the market might be leaning on the pessimistic side also in light of the ADP figures from Wednesday. With all the caveats that the ADP "model" carries, it cannot be entirely dismissed. The unemployment rate is still likely to rise, but perhaps not as high as the 19.5% figure expected by markets. Something closer to 17-18% looks more probable.

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