

Rates Spark: Emotional rollercoaster

ECB expectations management is rife but markets seem to have made up their mind. We think communicating a dovish decision will be made more difficult by strong CPI readings, and optimism in PMIs, both released today. EUR curve dynamics suggest, perhaps prematurely, a focus on ECB hikes. We think it is all about QE.

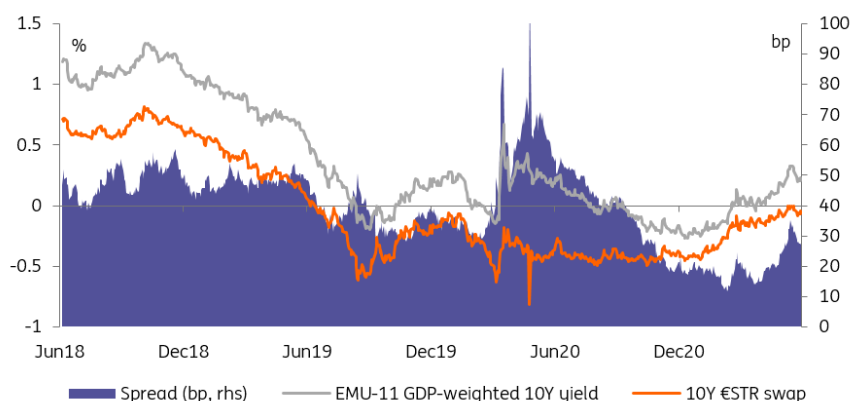


Source: istock

Two way risk in ECB comments, but markets have made up their mind

Klaas Knot and Martins Kazaaks, by making comments consistent with a reduction in PEPP purchases in June, have reintroduced some two-way risk around the June 10th ECB meeting. It may still be that a majority of their fellow governing council members still favours continuing purchases at the current rate of €80bn/month for at least one more quarter, but this complicates prices action in rates until the self-imposed quiet period that starts this Thursday, especially in light of strong inflation data and upbeat surveys.

As in March, the ECB has paused the bond sell-off, but the trend is clear



Source: Refinitiv, ING

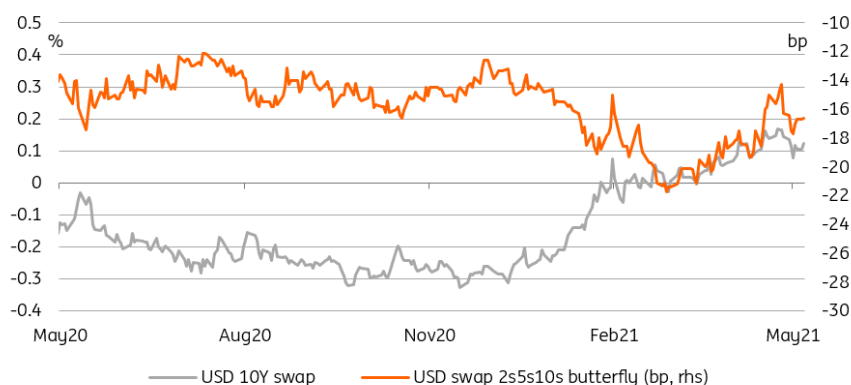
A dovish decision by the ECB is largely priced in

Clearly, the rates sell-off in reaction to the comments mentioned above was expected but also proportional to the perceived clout of those who uttered them. On balance it seems that rates markets are putting more faith in the ability of the likes of Christine Lagarde and Isabel Schnabel to sway their colleagues in a little over one week's time. This means that our intuition last week, that a dovish decision by the ECB is largely priced in, still stands.

A premature foray into the realm of US curve dynamics

Looking at the pick-up in volatility in the belly of the EUR curve, it may be tempting to conclude that the debate about ECB tapering is not really about tapering itself, it is about the timing of the first hike. This is at least what the directionality of the EUR 2s5s10s butterfly suggests if 5Y cheapens relative to the 2Y and 10Y wings when rate rises. That feeling may be reinforced by the fact that this is the directionality the US curve has exhibited since the start of the year, in reaction to the strong recovery and need to stamp out inflation.

EUR rates are (perhaps prematurely) concerned about hikes, we think it's all about QE



Source: Refinitiv, ING

To be clear, we think this analysis doesn't apply to EUR rates markets, at least not yet. One should not overlook that fact that in the US, tapering is pretty much a done deal, the only uncertainty being when it will start. The much bigger debate is when and how fast will the Fed hike. Contrast that to the ECB where another extension of the €80bn/m PEPP pace would inevitably raise the question of an increase of the €1.85bn target, and where officials are openly discussing increasing the rate of the other purchase program, the APP, to offset an eventual slowdown in PEPP.

The marginal tool at the ECB is still asset purchases

In short, the marginal tool at the ECB is still asset purchases. The implication is that longer-dated rates (in particular 10Y, but in some instances 30Y) should remain the most volatile, and directional, part of the curve. Combine that to our upbeat view on the recovery [and expectations of higher EUR rates](#) and the conclusion is that more curve steepening is in the cards. Tactically, this should be magnified by the proximity of long-dated French auctions later this week, and as NGeu issuance (the EU's recovery fund) could start as early as June with a €10bn deal, as a French minister noted recently.

Today's events and market view

Optimism in today's ISM manufacturing should contrast with the relatively muted 500k job growth we're expecting in Friday's payroll. The message is less balanced for financial markets than it seems. If bottlenecks, for instance on the job market, might hold employment growth for a few more months, this is as many months of additional upward pressure on wages. The same applies to goods and services.

European PMIs and CPI today are mostly second releases or have had their surprise spoiled by member states' releases. The fact that many markets were closed yesterday when Germany's CPI surprised to the upside means potential for a continued sell-off in European rates today. Similarly, last week's Eurozone PMIs suggested a decent pick-up in activity

outside and France and Germany.

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