Rates Spark: Financial conditions targeting

The ECB reduced PEPP purchases without causing a hawkish reaction. Its secret? Fanning hopes of more easing in December. We think an acceleration of APP is now the market's base case, thus putting carry traders in the driving seat. Core rates should tread water from here, until the debt ceiling is resolved and the growth soft patch is over.

Source: Shutterstock

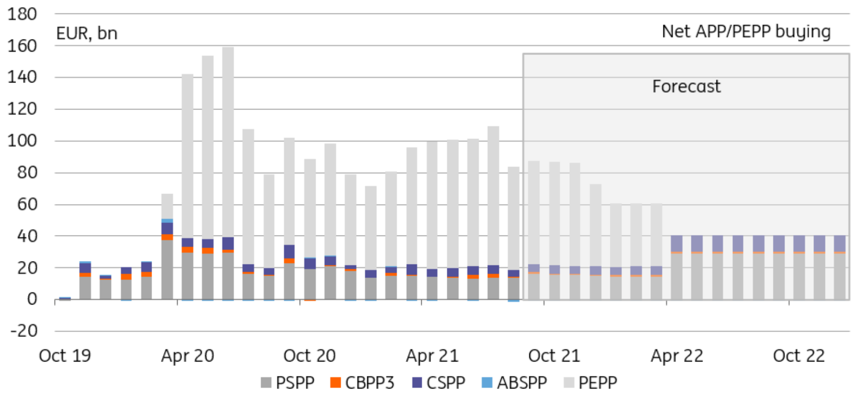
See you in December

Of the two truisms overused in our line of work, 'we'll know more in the future' was the one most evidently in favour at yesterday's ECB press conference (the other one is 'uncertainty is high', when were we ever certain about the future?). It seems like president Christine Lagarde's standard answer to questions about the ECB's many policy tools was: 'we'll see in December'. If the aim was to prevent a hawkish reaction to a reduction in PEPP purchases, this was the right strategy. EUR yields ended the day lower.

The ECB could accelerate purchases if financial conditions were to tighten again

To be fair, PEPP purchases continuing at a 'moderately lower pace' is hardly a sea change. We may yet find out what monthly rate the ECB has in mind but we would guess that purchases in the last months of the year won't differ much from the €65bn/m realised in August. Anonymous ECB sourrces quoted by Reuters after the meeting suggested this much. Financial markets also took to heart that easier financial conditions since June were a criterion used to decide on a reduction of purchases. The implication, it seems, is that the ECB could accelerate purchases if financial conditions were to tighten again in the absence of meaninful progress towards its inflation goals. We call this 'financial conditions targeting', and we find it strikingly reminiscent of the Fed put.

The path for QE the market now assumes has a smooth transition from PEPP to APP



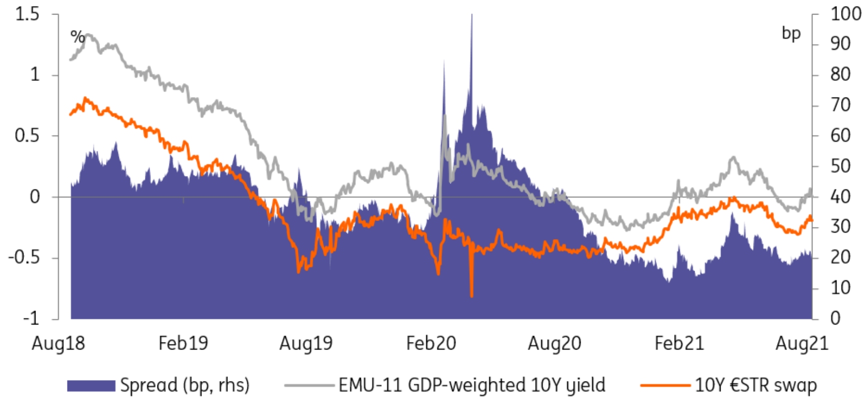
Source: Refinitiv, ING

The problem of course, is that we have only a partial understanding of what constitutes accomodative financial conditions. In addition to the usual market variables (dubbed "upstream" by the ECB) including bond yields and credit spreads, ease of access to and cost of credit for firms and households (downstream) feature prominently. This puts increased focus on the ECB's lending surveys, with the next and only release before the December ECB meeting scheduled for October 26th (incidentally, two days before the October ECB meeting although this one is widely considered not to be 'live').

Carry traders win the day

Market reaction was telling. We expected this kind of rally but thought it could only be achieved by keeping PEPP purchases at around €80bn/m. This speaks to the hawkish tilt in market expectations, but also to the ECB's success in communicating its new reaction function. In this context, we think the view that an increase in APP purchases will be announced in December to cushion the end of the PEPP, what our economics team calls 'a grand recalibration between the PEPP and APP', will gain in popularity.

Financial conditions are easy but we could yet see more sovereign spread tightening



Source: Refinitiv, ING

Only a further acceleration of inflation can upset this state of play

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This is all positive for EUR bond markets. Supply pressure remains of course but the removal of a hawkish risk means they are more likely to tread water, Treasury-style. There is still scope for upward momentum for rates of course, but we think it will have to wait until the US debt ceiling is lifted, and for the current Covid-related soft patch in data to end. The main winners are carry traders in our view, as they can look to a quieter Autumn. Only a further acceleration of inflation can upset this state of play in our view.

Today's events and market view

The main release today is the US PPI for September. The, arguably more important, CPI will only be released next week but the PPI data is expected to slow down on a MoM basis as is also suggested by the decline in ISM price components. This would only be a baby step in that direction but an easing of inflationary pressure, as long as it is due to better supply capacity rather than to lower demand, could be seen positively by markets.

Post-ECB chatter will feature prominently today, in additional to the possible anonymous 'ECB sources' stories emanating from the press, no less than Francois Villeroy, Christine Lagarde, Frank Elderson, and Olli Rehn are scheduled to speak.

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