

Rates Spark: The ECB doves should prevail

Markets are primed for a small reduction in PEPP purchases, but not for the fallout of any hawkish messaging. Tone will be key, and so will 2022 inflation forecasts in a context of accelerating prices. A regime of higher rates volatility and wider spreads is at stake in the case of tapering - we think the ECB should refrain.



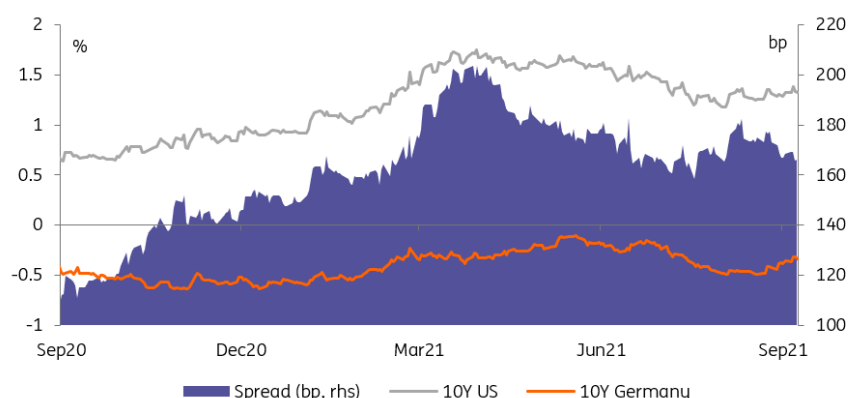
Hawkish ECB expectations may not be met

Today should be the day the baton is passed to EUR rates again to lead markets, with the ECB meeting being closely followed. When it comes down to market reaction it is again more about how the ECB manages expectations, especially regarding the future of its asset buying programmes, especially the APP, rather than the concrete announcement of the volume target for the upcoming quarter.

Any decision to reduce the pace of PEPP purchases would bear the risk of being extrapolated

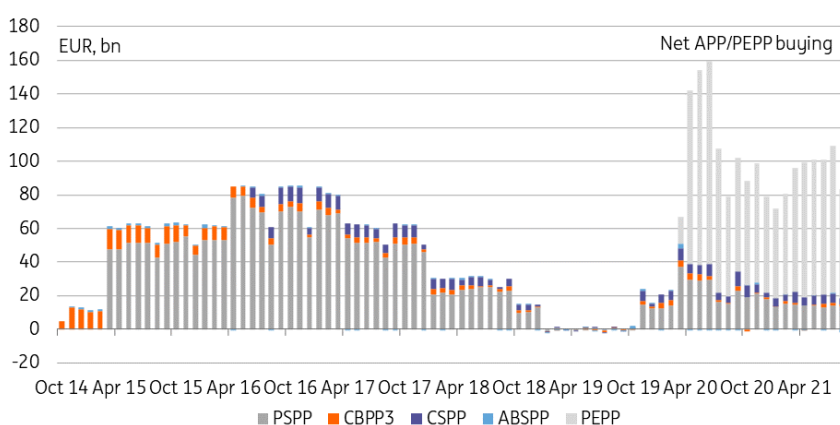
Here we argue that indeed any decision to reduce the pace of PEPP purchases would bear the risk of being extrapolated. Perhaps in terms of volumes not so much as to what it would imply for the overall amount the ECB eventually purchases under the PEPP. This currently still has the March 2022 end date attached to it. But rather what it may say about the ECB handling the regular asset purchase programme once PEPP ends.

Bund underperforming Treasuries this week shows a hawkish tilt in ECB expectations



Without going into too much detail, what is at stake is the size (whether it increases next year), duration (whether inflation forward guidance applies to it), and parameters (are they relaxed to match PEPPs?) of the APP programme. None of these issues is likely to be addressed before December we reckon which makes a reduction in PEPP perilous, particularly if markets infer a hawkish future decision on APP from it.

ECB buying slowed considerably in August

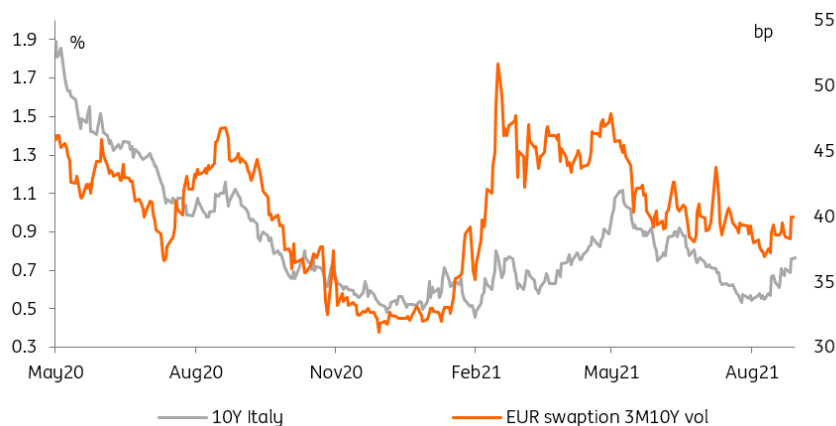


...but hawkish risks dominate for EUR rates

The rise in yields, alongside a narrowing gap versus UST yields, suggests that market expectations have increasingly incorporated hawkish risks into their outlook. Following the reemergence of

more hawkish voices in the ECB governing council that looks sensible, and also on the front of implemented purchases, the PEPP has indeed slowed more in August than one could have inferred from frontloading that was conducted in July. But our economists believe the hawkish voices to be in the minority still. What should outweigh is the newfound dovishness introduced with the new monetary policy strategy. When it comes down to the actual buying, it is also more about keeping the financial conditions in line with the ECB's stated targets rather than meeting the volume target, something the ECB's Lane had suggested last month.

Much is riding on a successful ECB communication today



Source: Refinitiv, ING

In terms of market reaction, our base case is for a small dovish reaction that will see bond yields retrace part of their late summer sell off. Higher beta fixed income, for instance Italy, are set to benefit the most. The long-term impact should be limited however, as the widespread assumption will remain that PEPP is set to end in March 2022.

We have an unhealthy cocktail of hawkish risks staring the ECB, and markets, in the face

The risk scenario is more interesting. Even with a PEPP reduction priced in, we expect the bond sell-off would continue. This could add to the roughly 15bp cheapening in 10Y Bund since August and call into question long positioning as economic data deteriorates globally. Add to this the threat of a higher inflation forecast, with the 1 year-ahead view gaining in prominence after the change in forward guidance, and a jump in inflation unlikely to subside this year, and we have an unhealthy cocktail of hawkish risks staring the ECB, and markets, in the face.

Today's events and market view

Hawkish expectations have built going into the ECB meeting. We could see some profit taking as the chips are taken off the table ahead of the event. But then it is down to what the ECB decides: our baseline view is that the hawkish expectations will not be met with no slowdown in purchases announced yet. Obviously the adverse scenario would lead to higher rates and more uncertainty about the outlook, the volatility introduced could prove

detrimental to periphery spreads such as Italy vs Bund in particular.

In European supply Ireland sells up to €1.25bn in 10Y and 20Y bonds.

In other date the focus is on the US weekly initial jobless claims. Yesterday's job openings data had suggested that the appetite to hire remains strong but faces a lack of workers. Later in the day the US Treasury will then auction US\$24bn in 30Y bonds after a successful couple of 3Y and 10Y sales earlier this week.

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