

Rates Spark: Hello EUR curve inversion

The US CPI reading kicked off the latest curve flattening leg, but the coordinated hawkishness of European Central Bank officials is helping to extend it. The 2-10Y EUR OIS curve has inverted, and the German curve should eventually follow. The ECB has successfully shielded sovereign spreads, but still has to grapple with its own bill for hiking rates



When the ECB All-Stars align, curves invert

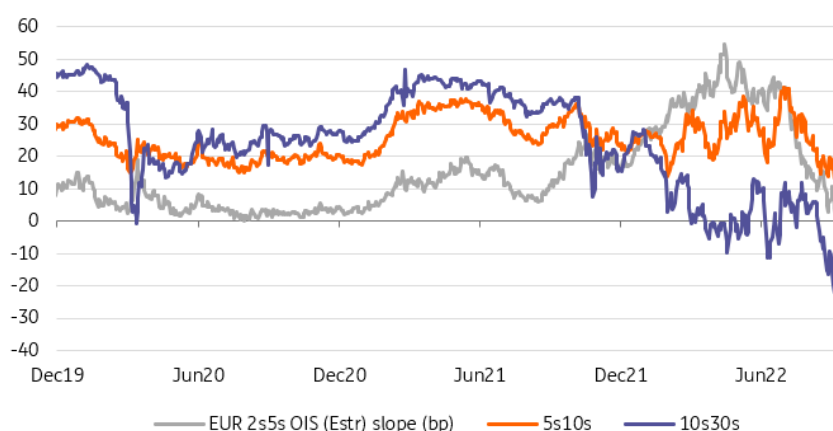
Curve flattening remains one of the main themes. And its EUR markets actively pushing in the same direction as investors continue to ramp up their rate hike expectations.

It is not that often that one sees the ECB Council is singing in tune from the same hawkish hymn sheet. While ECB Chief Economist Lane had confirmed the central bank's new reaction function, Vice President De Guindos yesterday signalled that there was also still a long way to go for key rates – current monetary policy was still accommodative, supporting demand and ultimately price pressures he warned. It underscores a desire to get rates to neutral as soon as possible, with current 'guess-timates' putting that target closer to 2%.

2Y-10Y OIS was first to invert, the Bund curve should get there eventually

Money markets are accordingly setting their sights on at least another 125bp of tightening by year end. A caveat as always, the neutral rate is a fast moving target and amid geopolitical uncertainty and energy crunches it can still prove fleeting. Such doubts though are subject area for the long end of the yield curve. So what we are witnessing now is the [inversion of curves which we cautioned would likely follow on the heels of a 75bp ECB hike](#). First to invert was the 2Y-10Y OIS curve, the swap curve standing at a meager 2.5bp looks likely to follow soon. The German curve still has more than 20bp to cover, but should get there eventually.

The EUR swap curve is inverting fast



Source: Refinitiv, ING

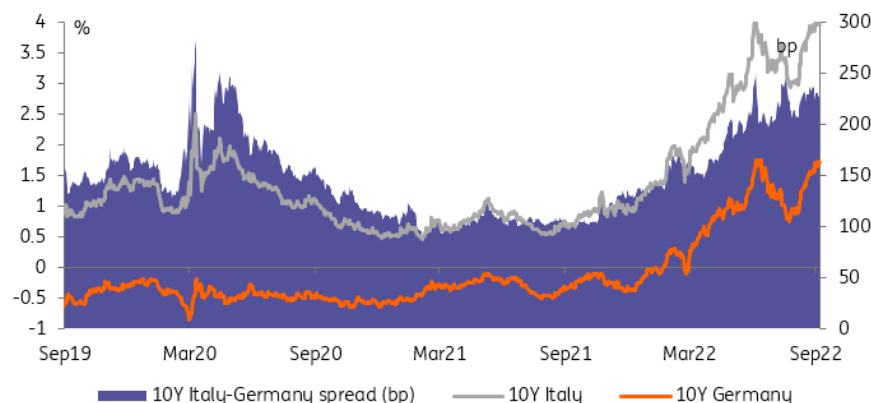
Eurozone government bond spreads prove resilient

The Italian general elections next weekend are closing in and Italy's sovereign bond spreads over Germany have proved quite resilient. Not just to the political uncertainty that comes with the likely changeover of the government to a centre-right coalition, but also in the face of the ECB's increased tightening pace. At around 225bp the 10Y spread is below levels observed late in August and early September ahead of the 75bp ECB hike.

ECB reinvestments or markets coming to terms with a right-wing government?

We will have to wait until early October for the ECB's next set of detailed pandemic emergency purchase programme data to evaluate to what degree the ECB's flexible PEPP reinvestments have played a role this time around, or whether it is markets coming to terms with a right-wing government, which actually might bring along something Italian politics have been lacking for a while: stability.

We think the ECB cares more about the speed than the magnitude of spread widening



Source: Refinitiv, ING

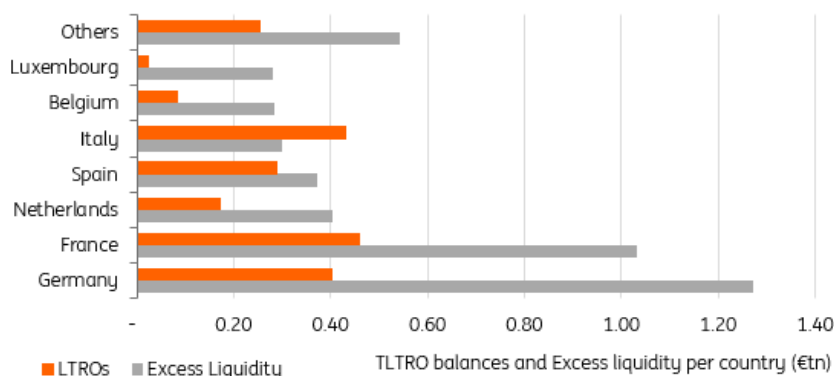
ECB hikes are not without costs – literally

Now that the deposit facility rate is at 0.75% this is also the rate that the ECB has pay to banks on the excess liquidity it had injected into the system – via bond purchases and via targeted longer term liquidity operations.

ECB could soon announce a tiered remuneration of excess liquidity

As was hinted at by President Lagarde at the last press conference, the [ECB could soon announce measures to address this cost issue, possibly by introducing a tiered remuneration of excess liquidity](#) and subjecting parts of it to a zero interest rate remuneration. The ECB would again effectively micro manage banks' profitability, but more importantly the choice of design can determine the impact on money market rates. We think the ECB will make sure that the deposit facility rate remains the marginal policy interest rate determining market pricing. This requires that a large enough portion remains subject to the depo rate. Lowering that portion will of course lower the ECB's cost, but may prove more disruptive for money markets with increasing rebalancing of the currently still unevenly distributed excess liquidity across jurisdictions.

€4.6tn of excess liquidity and €2tn of TLTRO loans to banks are becoming a problem for the ECB



Source: ECB, ING

FOMC next week and beyond remains key for market rates

Next week sees a crucial FOMC meeting, from which we expect a 75bp hike. What happens after that is key.

For market rates, their prognosis is tied up with the terminal fed funds rate i.e. where the funds rate peaks. When it does peak, the likes of the 10yr Treasury yield will feel unshackled and can go ahead and discount future cuts, with yields capable of trading well through the funds rate. But we are not at that point just yet; we're still in the fed funds up-move phase. For as long as that's the case, long tenor market rates will tend to be pulled higher. Should the Fed hike by 75bp in September and by another 75bp in November, that would pitch the funds rate ceiling at 4%. Against that backdrop, and given the likelihood that the funds rate pushes above 4%, the 10yr Treasury yield is likely to target the 3.75% area (versus 3.45% currently).

the bid for longer tenor bonds is no longer being supported by Fed buying

One clear consequence is a likely further inversion of the yield curve. The Federal Reserve will not want to see this become too pronounced, as it would open a gap between the longer term implied subsequent rate cut discount versus the nearer term objective to get the funds rate up. Balance sheet roll-off, which is now running at USD95bn per month, will slowly address this issue, as the bid for longer tenor bonds is no longer being supported by Fed buying. This also helps to tighten conditions. The Fed has not had a whole lot to say about this in recent months, preferring to let the process play out quietly in the background. But in any case it is pushing in the same direction as rate hikes, and should help to coax longer tenor rates higher.

Today's events and market view

In the US money markets have made it a choice between 75bp or 100bp at next week's Fed meeting following the CPI reading earlier this week. Current inflation certainly remain key,

but so will any indications of receding price expectations. To that end today's University of Michigan consumer sentiment including its surveyed 1Y and 5-10Y inflation expectations will be scrutinized. After yesterday's [mixed retail sales data](#) our economist continues to favor a 75bp hike.

In Europe ECB president Lagarde and France's Villeroy have public appearances, Finland's Rehn speaks at a monetary policy conference. Eurostat will release the final inflation figure for August.

Authors

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.