Rates Spark: Higher and flatter

The ECB has chosen a path of agressively frontloading its policy tightening, which sets EUR curves up for further flattening and eventually inversion should the economic outlook not keep up with the ECB's relative optimism. For now, broader upward pressure on rates should persist, with larger hikes from the BoE and Fed to follow soon.

Source: Shutterstock

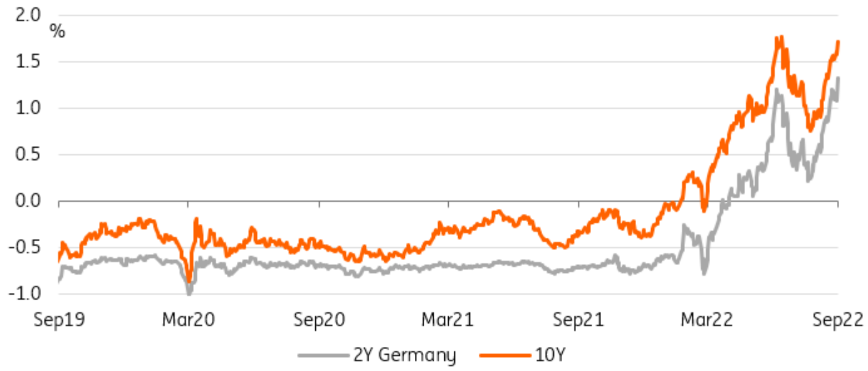
ECB: 75bp and more to come

The hawks won the front-loading argument and the ECB's council unanimously decided to raise all key rates by 75bp. More hikes are likely as inflation risks are seen as still skewed to the upside. The ECB's own inflation forecasts have increased, warranting a more aggressive approach. The growth forecasts, while lowered, do not project a recession next year and thus provide the leeway for more forceful action.

Quantitative tightening will reportedly also be part of the discussion at the next non-policy setting meeting

The broad support for the ECB's hawkish turn was later confirmed by press reports that even the Council's doves are not opposed to repeating yesterday's action in October. Chief Economist Lane's presentation to the council reportedly struck a decidedly more hawkish tone than his latest public speech, which was then widely viewed as an attempt to counterbalance the prior hawkish barrage. What is more, quantitative tightening will reportedly also be part of the discussion at the next non-policy setting meeting in early October. That cuts into one of the rare dovish undertones of yesterday's meeting – that reinvestment guidance was left unchanged and quantitative tightening hadn't been discussed yet. Lagarde had said rates were the preferred instrument.

2Y German yields should soon catch up to 10Y, inverting the curve as a result



Source: Refinitiv, ING

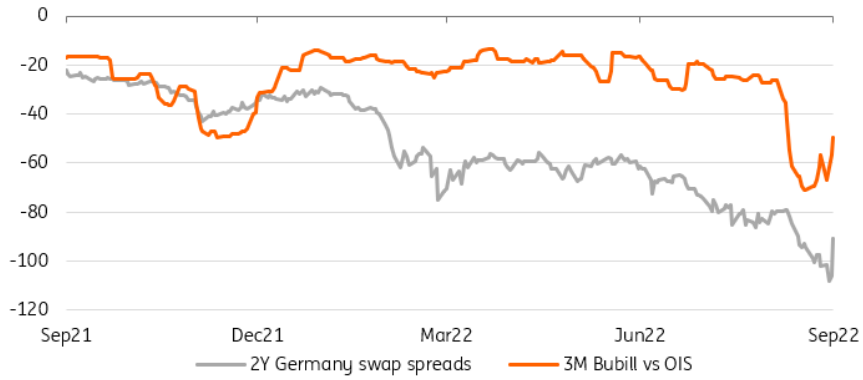
EUR curves set up for inversion

Against that hawkish backdrop, President Lagarde specifying that the stated expectation to "raise rates over the next several meetings" will mean hikes at the next two, three or four meetings, looked like an attempt to prevent market hike expectations from running all too wild. Markets now see a 50% probability of another 75bp in October. The pace is then expected to slow, but by the end of Q1 the ECB is seen increasing the deposit facility rate to at least 2.25% before pausing – timing thus in line with Lagarde's specification.

> *Near term do not exclude further upside to rates led by front-end speculation*

Reflecting this ramp-up in hike expectations the broader EUR curve has bear-flattened in reaction to the meeting. Near term we would not exclude further upside to rates, led by front end speculation. For the long end that still means we do not dismiss the possibility of the 10Y Bund yield touching the 2% handle. We remain wary of the ECB's still rose-tinted outlook for the European economy. While our economists are now seeing the ECB to hike by another 75bp in total this year, they still see energy crisis pushing the eurozone into a recession eventually. That means the ECB may not deliver quite as much as is currently priced. After all, the ECB is employing a meeting-by-meeting strategy, its outlook to hike for the next several meetings is based on current information – and that is subject to change. We think the ECB's aggressive front loading sets the stage for EUR curves to eventually invert.

The squeeze on short-dated German paper is finally easing



Source: Refinitiv, ING

Temporary relief for the collateral scarcity issue

We have highlighted the potential for government cash management to aggravate the current collateral scarcity issue given a 0% remuneration cap for government deposits held at the central bank. The ECB has acknowledged the issue and its potential to impede the transmission of its policy changes into the market. The 0% cap is replaced by a cap at the deposit rate or €STR, whichever is lower. It was this decision that elicited the largest market reaction, including a tightening asset swap spreads.

> *The change is only valid until the end of April next year*

The caveat is that this change is for now only valid until the end of April next year. Until then government debt agencies have time to think of alternatives for their roughly €500bn in central bank deposits. While fears of an immediate crunch on the back of a hike and sudden shift in these deposits is alleviated, the scarcity issue is not going away. We will be watching for hints of how debt agencies will adjust, which might already become evident when bill issuance calendars are updated for the upcoming quarter. Running large cash buffers will have to be weighed against the costs starting to bite next year.

Large rate hikes also coming from the BoE and Fed

The upward pressure on rates from monetary policy remains broad-based. Markets are bracing for the Bank of England to potentially follow the lead of the Fed and now the ECB in deploying 75bp hikes. While our economist is still inclined to see the BoE hiking by only 50bp, the new government's extra support measures are proving to be a double-edged sword for the Bank which is trying to tame inflation.

Over in the US the Fed's Powell latest comments are seen as supportive for another 75bp hike on 21 September. The need to act now on inflation outweighs any doubts about the economic outlook. To the contrary, robust data of late also provide the Fed with the room for aggressive action, Next week's CPI data should seal the deal for a 75bp hike. While headline inflation rate is seen falling to 8.1%, the core is actually expected to accelerate again.

Today's events and market view

For now the upside to rates propagating out the curves from aggressive policy tightening intentions remains in place. Not only does the ECB's stance leave room for markets to price in more, but markets are also bracing for large hikes from the BoE and Fed over the coming weeks. But beware, that is only a near term view.

The main focus of today will be on central bank speakers with final comments before the Fed's quiet period kicks in coming from the Fed's Evans, Waller and George. European market may see their share of the usual post ECB meeting commentary and reports, though also Lagarde herself is scheduled to speak today.

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