

## Rates Spark: hike on, hike off

The front-end is the tail wagging the fixed income dog. Curve flattening may seem contradictory to rising inflation swaps, but we think it is justified by central bank caution. Upward pressure on yields is everywhere, but more likely to be located at the long-end of the EUR curve, and at the front-end of the USD curve



### Front-end yields: wagging the fixed income dog

It should be obvious by now that the market's centre of attention is on the (perceived) need for central banks to get ahead of the rise in inflation. In some jurisdictions, we think near-term market hike expectations have gone too far (eg, in the UK, and arguably in the Eurozone), in others we think they should move further (eg, in the US). What is clear is that front-end rates are now the most important part of any yields curve. They are the proverbial tail wagging the dog: when hike conviction increases, the long-end tends to flatten, and vice versa.

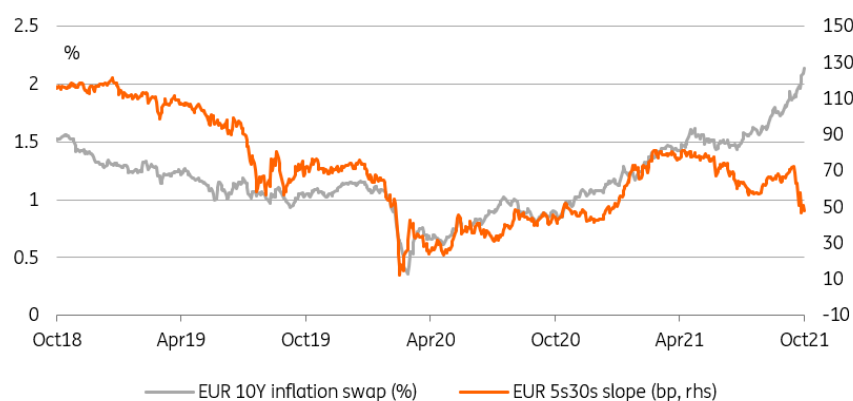
## Long-end curve flattening is the logical consequence of hikes coming into sight



Source: Refinitiv, ING

This relationship is relatively intuitive to anyone looking at curve dynamics during previous cycles: as hikes approach, the curve tends to flatten progressively, led by the back-end. [This is why we expect USD 10s30s to flatten first](#). The tendency of the curve to flatten as measures of expected inflation, for instance swaps, rise is less intuitive. In effect, the message is that higher inflation would push central banks in aggressive tightening moves. So far so simple, but the uninterrupted rise in inflation swaps also suggest that the market does not believe their ability to keep it under control.

## Curve flattening as inflation swaps rise suggests central banks' inability to tame prices



Source: Refinitiv, ING

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*Markets doubt central banks' willingness or ability to withdraw accommodative measures in short order*

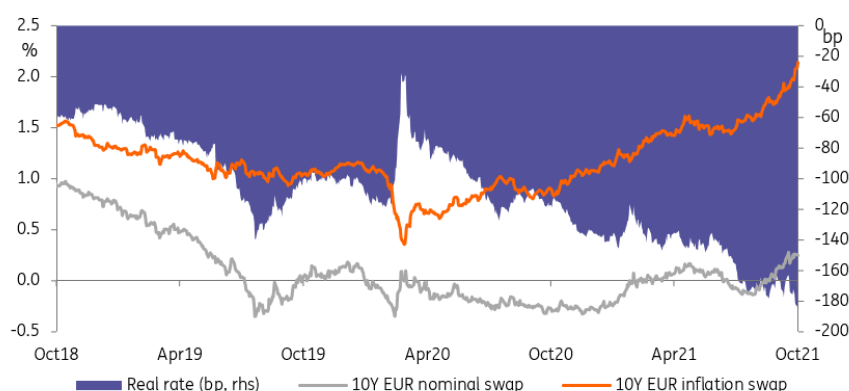
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There are merits to that argument. Firstly, to the extent that inflation is due largely to supply constraints, demand-cooling measures such as interest rates hikes are not an obvious palliative. Further, markets doubt central banks' willingness or ability to withdraw accommodative measures in short order. Here we can point at the example of the Fed that would presumably have to rush tapering if it were to hike rates earlier than mid-2022. Along the same line, the ECB has two QE programmes to unwind before it can contemplate hiking rates. If the two face runaway inflation, this could leave it time to settle at elevated levels.

## EUR: rising pressure moving to the long-end

The similarities from one jurisdiction to the next are striking, but differences do exist. Macro news flow has taken a turn for the worse in the Eurozone with a decline in sentiment indicators, and indeed [the potential for stagnating German growth in Q4](#). This contrasts with the stabilisation and rebound in US data after the Covid-19-induced slowdown in Q3. Together with what we think is potentially too dovish Fed market pricing, we see more risk of a widening of USD-EUR rates differentials. By the same token, we would expect curve flattening impetus to be stronger in the US.

## The drop in EUR real rates makes it easier for the ECB to reduce bond purchases



Source: Refinitiv, ING

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*Easy financial conditions could give the ECB licence to reduce purchases further*

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This doesn't mean that EUR rates should remain insulated from the global higher rates trend, only that the rise should be more moderate. On the one hand, near-term hike expectations should receive a rebuttal from the ECB this week, but the impact would be to displace upwards pressure to long-end rates. What's more, many of the ECB's financial condition indicators are flashing green: low real rates, tight spreads, and [easy credit conditions in its Bank Lending Survey](#). Taken together, they could give the ECB licence to reduce purchases further, as it did in September, although this will likely wait until December.

## Today's events and market view:

GBP rates will be focused on the UK autumn budget, and attached Office for Budget Responsibility (OBR) forecast. Most measures have presumably been leaked to the press already, so the focus will be on the change in gilt issuance, and on the extend of fiscal tightening going forward. We think this should prove a key impediment to the BoE hiking more than twice, and thus help GBP bonds regain their footing.

The sole tier one economic release on the calendar today is US durable goods orders.

In supply, Germany will auction €2bn 16Y debt.

### Author

**Padhraic Garvey, CFA**

Regional Head of Research, Americas

[padhraic.garvey@ing.com](mailto:padhraic.garvey@ing.com)

**Benjamin Schroeder**

Senior Rates Strategist

[benjamin.schroeder@ing.com](mailto:benjamin.schroeder@ing.com)

**Antoine Bouvet**

Head of European Rates Strategy

[antoine.bouvet@ing.com](mailto:antoine.bouvet@ing.com)

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