

Rates Spark: How not to rock the boat

The ECB meets today. The press conference will be an exercise in avoiding the tapering debate but rates markets are increasingly focused on rate hikes. Record US inflation comes as demand for carry trades is on the rise.



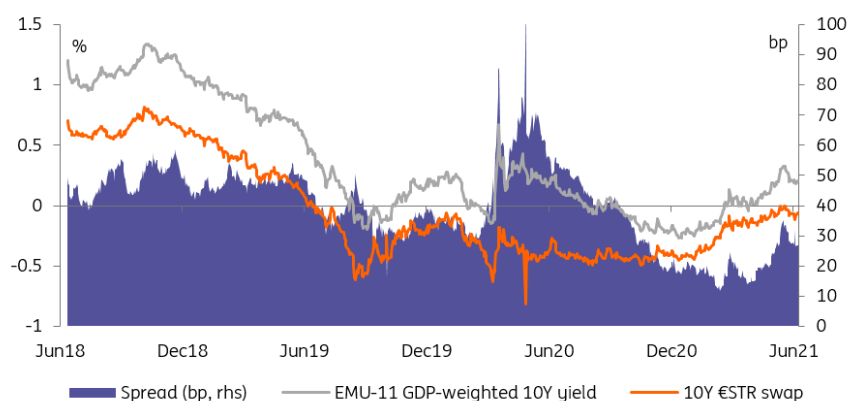
Source: Shutterstock

ECB: all lights flashing green

The ECB can breathe a sigh of relief as it meets today. Most economic indicators are flashing green: the vaccination campaign is on track, optimism is at a record high, and reopening promises solid economic growth in the second half of the year. The same is true on the financial front: government yields and swap rates are low, even more so when compared to inflation, and credit spreads are tight.

In that context, it wouldn't be entirely surprising if the ECB decided to pare back the raft of measures it has in place to support the economy, but [our economics team thinks they won't](#). Fair enough. As ECB officials have argued in the past, the cost of removing accommodation too early outweighs that of removing it too late. There is also the fact that most see the risk of an inflationary spiral as negligible.

Government yields and swap rates are well contained, especially compared to inflation



Source: Refinitiv, ING

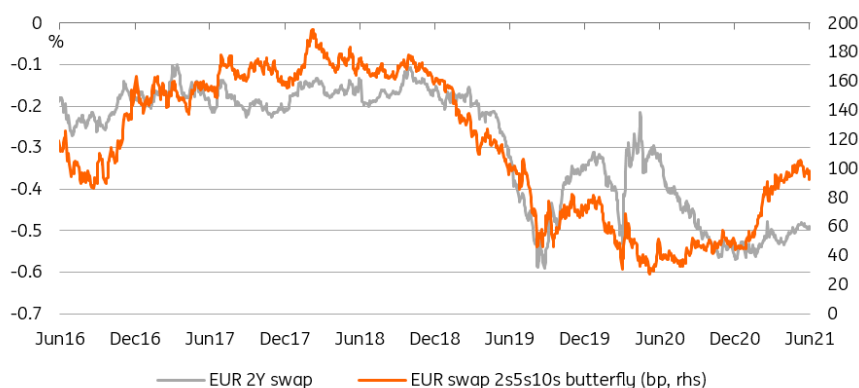
Strong demand for bonds but beware of economic forecasts

That state of play has triggered renewed interest in carry trades, especially in higher-yielding markets. In Eurozone sovereign bonds, this has happened as Italy and Greece opportunistically returned to primary market with syndicated deals, with Italy also due to carry out auctions today. Tight sovereign spreads should be sustained in our view, in fact we see 10Y Italy-Germany crossing 100bp later this year, with the help of the ECB. The same cannot be said of low 'core' interest rates as the recovery takes hold and boosts appetite for riskier assets.

Tight sovereign spreads should be sustained

Of course this meeting presents its own set of risks. With markets hooked on monetary stimulus, any hint of withdrawal later this year could upset the current status quo. This is particularly true as markets were led to expect the ECB to delay the tapering debate by another quarter. Any hint, wittingly or not, to the contrary could still send EUR rates into a tailspin. This is particularly true in light of the rally observed across EUR bond markets this week.

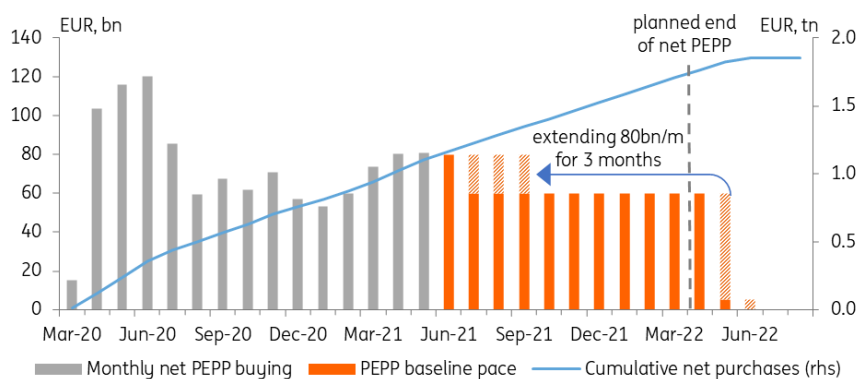
This level in the EUR 2s5s10s butterfly is normally consistent with higher rates



Source: Refinitiv, ING

One corner of EUR rates markets that isn't entirely discounting ECB inaction is the belly of the swap curve, shown with the EUR 2s5s10s butterfly above. Increasingly, maturities relating to the few years starting in 2023 are pricing the beginning of a sustained hiking path by the ECB. This timing implies roughly two years for the ECB to end both asset purchase programmes (PEPP and APP), not a decision it will take lightly. It also implies inflation returning sustainably to target by the time of the first hike. In that respect inflation forecasts published today, especially relating to 2023, will have a strong signalling value, even if we expect President Christine Lagarde to be wise enough to dismiss any tightening discussions.

More PEPP buying now means less is left for later



Source: ECB, ING

Today's events and market views

Even if it is misguided with a medium term outlook in mind, the strength of demand for carry trades makes us side with those expecting further drops in interest rates. All of this could end in tears in case of an upward surprise in US CPI today, for instance if the YOY headline measure rises above 5%. However, price action these past few days have shown a strong bias toward ignoring economic data.

Italy (3Y/7Y/20Y) and Ireland (16Y/24Y) will carry out auctions today, a timely affair after this week's rally has taken rates lower and spreads tighter, and ahead of the ECB meeting.

Authors

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@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>.