

Rates Spark: Italian jitters ill-timed for the ECB

The discount for a 100bp rate hike from the Fed has faded considerably, and we fully agree with that move. We continue to argue that 75bp is enough, based on what we know to date, and based on signals we see in the bond market. Widening Italy/Bund spreads put the spotlight on the ECB's anticipated reveal of its anti-fragmentation tool next week



Source: Shutterstock

US pipeline inflation pressure hits 11%, but expectations and core are easing

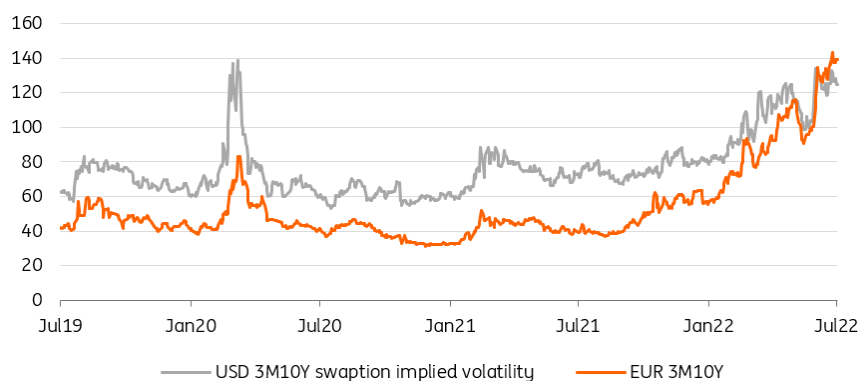
We got an 11% handle on US PPI headline inflation yesterday, but core inflation is down, as was in fact the case for core CPI on the previous day. The market reaction was for inflation expectations to ease further down. The 2yr breakeven is now approaching 2.9%. That was 4.5% a month ago! The 10yr breakeven is approaching 2.3%, and also down slightly post PPI. Most of this argues in favour of the Fed sticking with a 75bp hike, and not caving with 100bp.

The curve structure is also showing a separation from a 100bp hike. The inversion on the 2/5yr segment intensified post the CPI yesterday, suggesting that longer tenor market rates are not getting bullied higher by this; which makes sense as inflation expectations have been falling.

The 2/5yr inversion is also holding at post the PPI number, as is the evolution of outright 5yr richness to the curve (albeit mild). No fireworks after this number so far. But there is a separation between the money market discount edging towards a 100bp hike versus the bond market discount out the curve that argues more for a steady 75bp hike.

Either way all of this price action continues to argue that the peak for market rates is in, with inversion (especially on the 2/5yr) suggesting that an acceleration in hikes is in fact not the way to go.

EUR rates are displaying higher volatility than their US counterpart



Source: Refinitiv, ING

EUR curve to follow in the UST's footsteps?

In yesterday's rates sell-off episode Bunds actually underperformed US Treasuries. It makes sense considering that it is the European Central Bank which has to catch up in its fight to contain inflation. At the same time we would think the eurozone is more exposed to recessionary risks which should limit the relative upside in long-end yields. But as EUR rates are proving more volatile than their US counterpart we suspect that poor market liquidity is doing its part in amplifying current market moves.

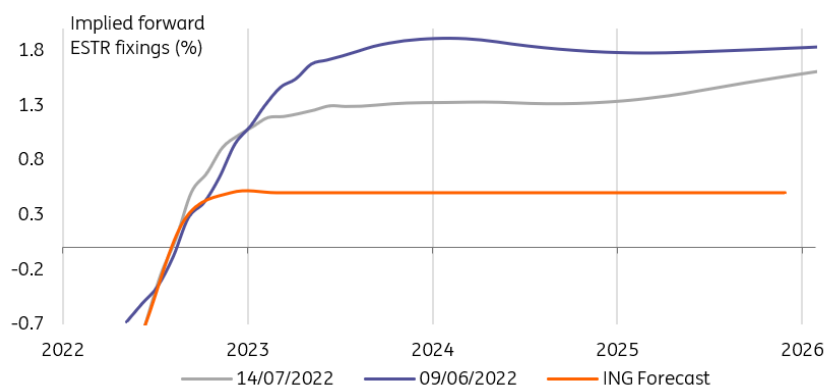
poor market liquidity is doing its part in amplifying current market moves

As the curve bear flattened the front end is pricing a growing chance of [a larger than 25bp hike from the ECB next week](#). Some 35bp were priced at points yesterday, some 165bp in total by year-end. The forwards curve is not showing a humped shape, ie, no expectations of a quick pace of tightening to be followed up with rate cuts.

However, we find it premature to make a call for the EUR curve to follow the US curve's lead towards a structural bear flattening. To us that would also require the ECB actually delivering on the markets expectations of fast-paced policy tightening. We doubt the ECB will be in a position to push through a hiking cycle as aggressively as priced with the economic window of opportunity

closing fast.

Markets are pricing a fast pace of tightening for the ECB



Source: Refinitiv, ING

Italian political jitters at the worst of possible times for the ECB

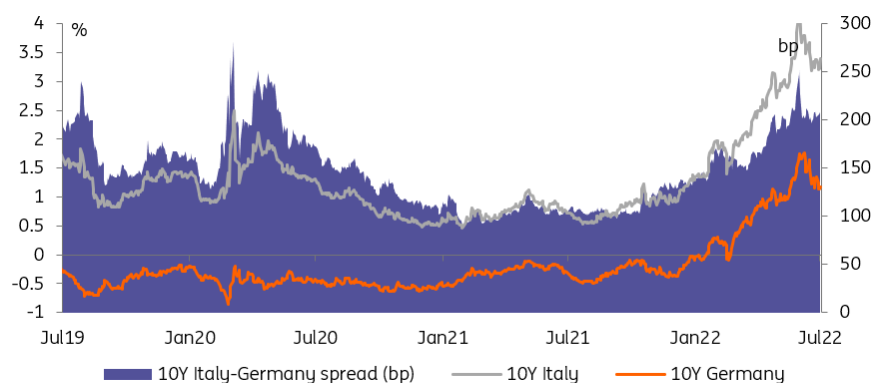
One of the more salient market moves in EUR rates space was the widening of the BTP/Bund spread. The 10Y spread was at times trading close to 20bp wider and it is now well above 200bp again, i.e. in the 'danger zone' of 200-250bp that has prompted verbal interventions from the ECB in the past. With a view to the ECB meeting next week this also pushes the topic of the anti-fragmentation tool into the foreground again. It is not just the timing that is unfortunate for the ECB, but also the nature of the latest spread widening, being rooted in the current political crisis in Rome.

one can hardly speak of unwarranted widening in the current political situation

The ECB is expected to flesh out more details of its new tool with which it aims to tackle unwarranted widening of sovereign spreads. However, one can hardly speak of unwarranted widening in the current political situation, which could tie the ECB's hands at this stage. To make things worse, spelling out too strict conditionalities of the new programme could exacerbate an already fragile situation. But so could staying more reserved on the key details confronting a market that ideally longs for another 'whatever-it-takes' from the central bank.

Though it may not yet be the end of the Italian unity government as this [will likely only be decided in the coming week](#). In any case, political trust will be damaged and for now the possibility of an early election in autumn still looms large.

Political uncertainty adds widening pressure to Italian bonds



Source: Refinitiv, ING

Today's events and market views

US rates should be in the driving seat as markets gauge the size of the Fed's next step(s) and data today providing some of the remaining puzzle pieces. The University of Michigan consumer confidence index had recently fallen to an all-time low, but the inflation expectations series is likely to be more closely followed. Its spike last month was seen by many as the trigger for the Fed to signal it was going to hike by a larger 75bp in June.

The Fed's Bostic and Bullard are scheduled to speak on the economic outlook and monetary policy.

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>.