Rates Spark: Inflation concerns outweigh

An extraordinary countermove has followed on the heels of Tuesday's rates rally. As inflation concerns outweigh, central bank rate hikes are being priced back in

Markets reverse rally as Fed sticks to course

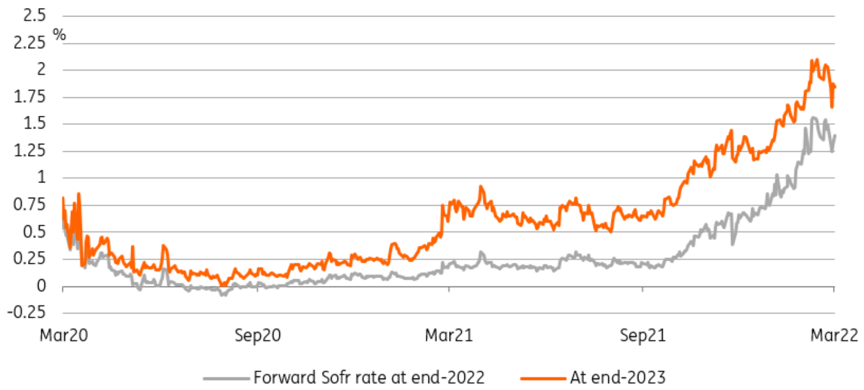
It is an extraordinary turnaround: the 10Y UST yield is back at 1.9%, thus completely paring Tuesday's rally down to 1.7%. Money markets are back to pricing more than 140bp of Fed tightening this year.

> *Powell: 50bp hikes remain a possibility if inflation does not ease as expected*

Fed Chair Powell had signaled in yesterday's testimony to that the macro backdrop still warranted a hike of the interest rate at the upcoming FOMC meeting even if the Ukraine conflict had increased the uncertainty surrounding the outlook. He supported a 25bp hike in March and flagged 50bp hikes remained a possibility later if inflation did not ease as expected, though he still cautioned that there was no preset course.

Other Fed officials have been more explicit, such as Bullard who called for a "rapid withdrawal" of accommodation. The Fed's Evans describing the global backdrop as "complications" the central bank had to navigate may seem a misplaced euphemism, but it underscores the Fed's view that there is enough distance between the US and conflict in Ukraine to justify sticking to the tightening course.

Money market hike expectations bounce back



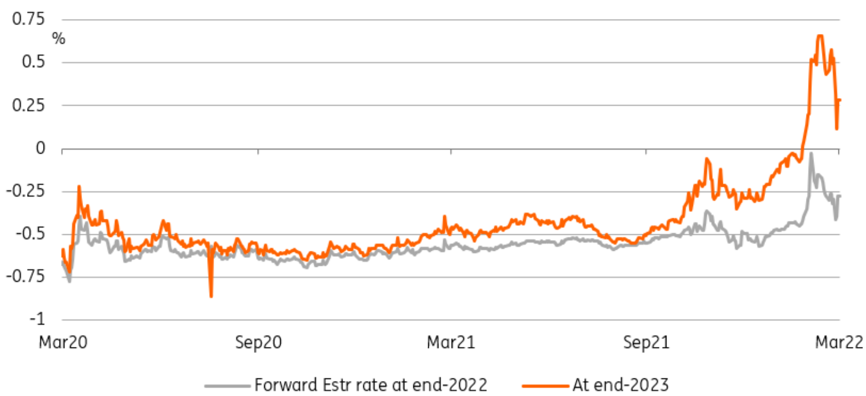
Source: Refinitiv, ING

Markets take note of ECB caution, but do not see the bank on hold

European rates also ended the day higher with the 10Y Bund yield moving back into positive territory. There is still some distance to the levels seen at the start of the week, but the refocus on the inflation issue is all the more notable given the relative closeness of the conflict.

Amid calls for caution the ECB has also given off more assuring signals, that the immediate fall-out for the economy was manageable thus far. The financial system had limited exposure and funding markets were seeing no liquidity squeeze ECB's de Guindos said. Indeed, related market stress indicators such as the 3m EURUSD cross currency basis have started to come off their wide yesterday and the ECB's weekly dollar liquidity providing operation allocated yesterday has seen no noteworthy increase. More importantly, the ECB has proven in the past that it has the means to tackle liquidity issues quite efficiently.

Back to discounting a full 25bp by the ECB before the year is out



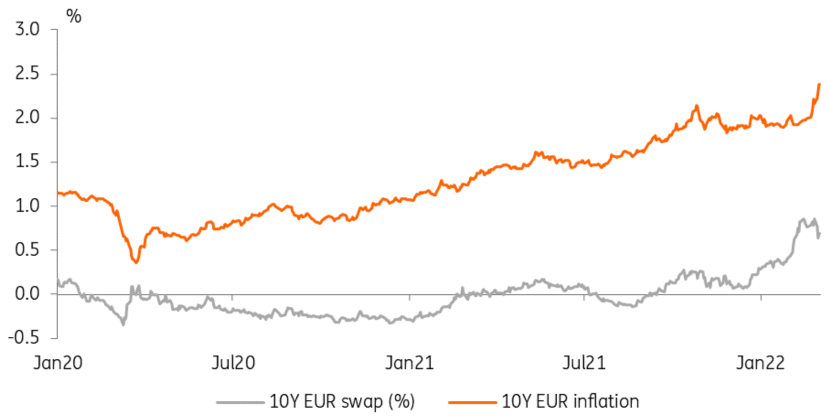
Source: Refinitiv, ING

It is inflation that remains the greater concern – for the central bank as for markets. 5y5y EUR inflation swaps had traded at times close to 10bp higher yesterday before settling just above 2%, for the first time since the very start of the year. Yesterday's Eurozone flash CPI had printed another record at 5.8%, surpassing market expectations. New Bundesbank President Nagel urged to keep the eye on the goal, which is policy normalisation.

The analogue to pricing a more aggressive tightening is waning ECB support for peripheral markets

Money market have brought forward the timing of the first ECB hikes again, from 2023 previously towards almost fully discounting a 25bp hike by December this year. The analog to pricing a more aggressive tightening path is the waning central bank support for peripheral bond markets – the 10Y Italy-Germany bond spread crossed above 150bp again as it rewidened by around 5bp. Note that this is still off from recent peaks, though. Markets may interpret comments such as Chief Economist Lane's that new policy instruments could be considered if needed as sign that the ECB is not turning a blind eye towards spread widening dynamics as the exit from net asset purchases is becoming more concrete.

Also longer rates turn around as inflation concerns rise



Source: Refinitiv, ING

Today's events and market view

It is becoming clear that central banks still have eyes on the ball when it comes to inflation, but markets may stay torn between the flight to safety and the need to price the tightening of policies ahead. Today will see the second part of Fed Chair Powell's testimony before Congress and data should provide more indication of the robust economic backdrop with ISM non-manufacturing being the main focus.

The ECB will release the accounts of the 3 February meeting which predates the escalation of the Ukraine-Russia conflict. Nonetheless it may still provide more insight into the hawkish rethink that Lagarde displayed at the press conference.

In data Europe will see the release of final Eurozone PMIs which also includes first readings for Italy and Spain, but the survey timing means that the latest geopolitcal crisis is not covered by the data. Primary markets will see longer dated bond auctions from France of up to €10bn as well as auctions from Spain, including a new 7Y bond, a green bond tap and a inflation linked bond tap for up to €6.25bn in total.

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