

Rates Spark: inflation, inflation, inflation

The European Central Bank was merely the prelude to next week's Fed and Bank of England meetings where policy tightening is expected to be announced. Against this backdrop and with high inflation to remain in the headlines, the ECB's feeble attempt to push back against market pricing proved futile



President of European Central Bank Christine Lagarde walks on path in front of the ECB building. Frankfurt, Germany

Source: Shutterstock

The ECB's unconvincing pushback

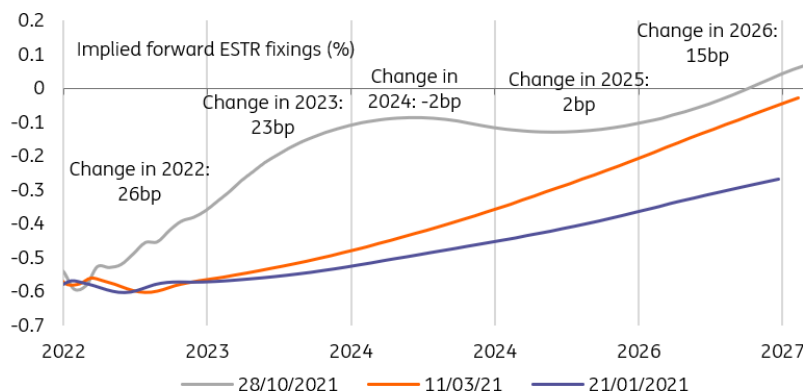
ECB President Lagarde neatly summed up in three words what is front and centre of market concerns and has also dominated discussions at the Council meeting – inflation, inflation, inflation. Our economists have summed up the meeting [here](#).

Some Governing Council members think inflation could stay above the ECB's target in 2023

While admitting its inflation forecast is likely too optimistically low, upon dissecting its drivers the

ECB still comes to the conclusion that high inflation will be transitory. And according to that analysis the currently implied lift-off by markets is inconsistent with the forward guidance, so Lagarde said. Caveat being that no one can tell for sure when supply chains will be unclogged, when energy prices will stabilize. And those second-round effects in wages will have to closely monitored, too. In that sense no one is any smarter as only time will tell who is right.

Pushback against 2022 hikes misses the point that they are coming sooner or later



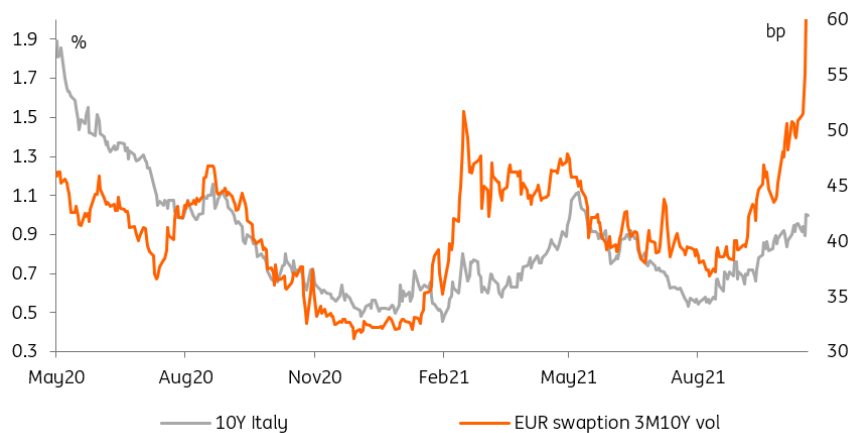
Source: Refinitiv, ING

According to a Bloomberg background report on the meeting even some Governing Council members think inflation could stay above the ECB's target in 2023. And if not even the Governing Council can bring it on itself to directly and openly rebuke market pricing of early rates hikes – “it is not for me to say” Lagarde said on the topic – one cannot blame markets for hardly paring their aggressive pricing in the wake of the press conference.

We would still very much challenge the notion of hikes already happening in 2022

While we would still very much challenge the notion of hikes already happening in 2022, we do note that periphery bond spreads appear to have finally woken up to the possibility of ECB asset buying support waning faster than anticipated. The key 10Y Italy/Bund spread widened by around 7bp on the day, although concurrent supply activities may be partially to blame, too. We think spreads should be most sensitive to any changes in the prospects of ECB asset purchases.

Higher volatility and peripheral yields are logical consequences of ECB tightening



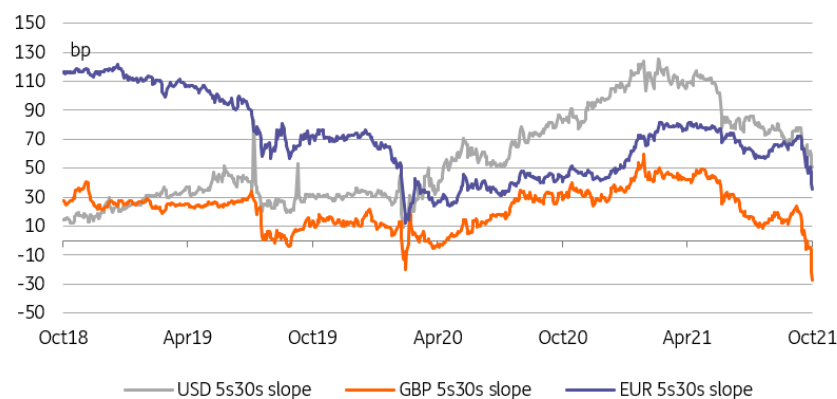
Source: Refinitiv, ING

Fed and BoE will keep policy response to inflation in the headlines

As inflation and policy tightening is going to remain in the global headlines for the foreseeable future the upward pressure on rates will persist with the tendency for curves to flatten. In EUR it may be only slower than elsewhere, but it will likely be caught in the slipstream as global central banks announce their policy tightening next week.

That the Fed will announce the beginning of tapering its bond purchases [looks like a done deal our economists think](#). But the currently flagged timeline of having bond purchases end by mid-year could even be accelerated as inflation pressures are still set to rise and economy itself is exiting the third quarter soft patch. As such still more room for the belly of the yield curve to lead the way higher.

Curve inversion illustrates fear that tightening might be damaging for the economy



Source: Refinitiv, ING

Markets are convinced that the BoE will hike rates next week after the BoE made clear that inflation was its chief concern. While we believe the market is overestimating the extent of the subsequent policy tightening, it may take some time for that correction to materialise.

Among all the aggressive pricing of policy responses there is also the notion of policy errors in the making

But we do note that among all the aggressive pricing of policy responses there is also the notion of policy errors in the making resonating in curve moves and shapes. Perhaps most obvious in the hump shape of the UK money market curve. It sees the Bank Rate peaking above 1% by end 2022/early 2023 before gradually trailing lower again. Long end curve flattening, outright yield drops as front ends price in more tightening can reflect similar concerns, especially in the case where real yields are pushed lower and thus long term growth expectations as occurred over the past weeks in EUR rates.

Today's events and market views

The ECB meeting may have been an early culmination of market scare and we may even get more policy makers on the wires with more attempts to push back against aggressive market pricing. But eventually the eyes will turn to the Fed and BoE next week where actual policy tightening is expected. As such we might just have seen a short-lived breather in rates, especially in EURs where supportive technical factors are set to fade after month end.

Inflation will also remain in the headlines with the release of the Eurozone October CPI flash estimate. [German data](#) yesterday pointed the way – higher still – with a 4.5% y/y reading, up from 4.1% in September. The market consensus for the Eurozone is a further increase to 3.7% y/y from 3.4%. Also on the card is the advance 3Q GDP release with the consensus looking for a 2.1% q/q growth.

The US will see the release of the Fed's favoured inflation measure – the PCE deflator – seen coming in at 4.4% y/y after 4.3% in September.

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