Rates Spark: leaving zero behind

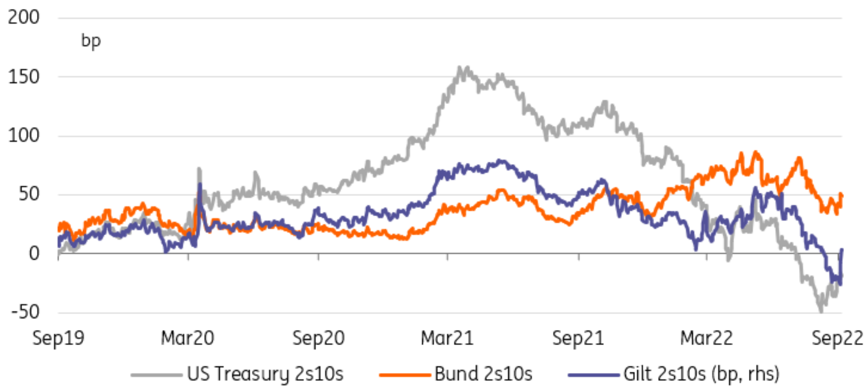
It will be a key moment for the ECB to embed its new reaction function in the market's thinking. But delivering on the expected 75bp hike would set the stage for curve inversion, with the economic reckoning still to come. Going back to a positive depo rate will also warrant a closer look at the plumbing of short term rates markets.

Setting the stage for curve inversion

The ECB meeting today will be key for interest rates. We have already laid out our thinking that the 75bp hike that markets are now bracing for would set the stage for EUR curves to invert, first the swap curve and eventually also the German Bund curve, as it becomes clear that the ECB's hawks have won the front-loading argument and are willing to take more economic pain down the road. As front end rates are pushed higher, the longer end would increasingly have to account for more severe economic outcomes. While the ECB has officially moved away from rates forward guidance towards a meeting-by-meeting policy setting approach, the market will still extrapolate a new reaction function from the size of the move and other elements of today's communication, such as the forecasts.

Irrespective of the size of today's interest rate hike, it will be another milestone on the ECB's path to normalising monetary policy. The negative interest rates policy (NIRP) has already ended, but after this hike also zero interest rate policies (ZIRP) will be left behind. Many will be taking particular note of the plumbing in money and repo markets when this threshold is passed. After many years of negative interest rates, the market structure has adapted to these extraordinary policy circumstances - the question is how easily can that be flipped back.

A 75bp hike would bring the German curve closer to inversion



Source: Refinitiv, ING

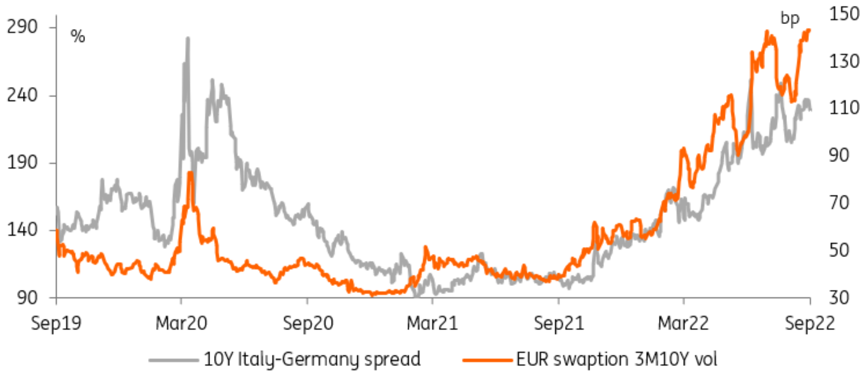
What we will be watching in today's ECB press release and press conference

- **50bp or 75bp?** Markets are leaning towards a 75bp hike, pricing a 65% probability of such an outcome. The next logical step then would be to price in another 75bp hike in October. The Fed experience has shown it can be difficult to revert back to smaller steps. Currently markets have in total 125bp priced over the next two meetings. Given the looming energy crunch our economists still see good arguments for a more measured approach, leaning towards a 50bp hike today.
- **Rose-tinted staff forecasts?** The new forecast will play an important role in gauging the ECB's new reaction function. ECB's Schnabel had called for a 'forceful' response even at the risk of lower growth and higher unemployment. Our economists highlight two key points: How negative or positive will the ECB be on the eurozone's growth outlook for the winter and what are the inflation projections for 2024. Larger downward projections in both

regards would point to a less aggressive rate hike trajectory.

- **Quantitative tightening now?** Hints have been dropped – subtly so in the ECB accounts and less subtly by some hawkish council members - to at least start discussing the forward guidance on reinvestments after the rates forward guidance has already been abandoned. While a logical next step in the policy normalisation process, the counterargument is that it could still pull the rug under sovereign spreads also with crucial elections in Italy just a few weeks away. The aim to eventually reduce the balance sheet could be counteracted if this that meant that the Transmission Protection Instrument would have to be activated – buying bonds again.
- **Adjusting back to positive policy rates?** The move into positive policy rates will lay bare some changed incentives for market players that may not be entirely desirable also in the eyes of the ECB. Think of the TLTRO remuneration, where the large hikes now create an arbitrage opportunity for banks. As potential remedy the ECB had floated a trial balloon a while ago of tweaking the tiered deposit rate or changing the operations conditions retroactively, but the discussion has died down since.
- **Government deposits still capped?** More pressing may be another issue highlighted by the decision of two government debt management offices (DMOs) to no longer lend out their securities against cash, the reason being the 0% remuneration cap on government deposits at the central bank. But the effect is that the collateral scarcity created by the ECB's vast buying programmes is only becoming more severe. The ECB may be propmpted to intervene in this case. After all it was the one to introduce the cap when it entered negative interest rates. While it will have to weigh the prohibition of monetary financing it could consider loosening the limits and makingg a larger portion than currently eligible for a market-rate remuneration - maybe less controversial than lifting the 0% cap itself, affecting the entirety of government deposits. It could also dodge the politically loaded bullet of government deposits by tweaking the terms of its existing securities lending programme to more effectively address the severity of collateral scarcity issues in some markets, particularly German bonds.

Sovereign spreads are particularly at risk from a hawkish ECB



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Today's events and market view

The ECB hawks have managed to push the market towards expecting a 75bp hike today. Backing down may send the wrong signal given the greater weight that has been given to current inflation dynamics. But delivering on expetctations would also be a clear signal to markets that more is still to come. The front-end end could price in even further tightening for this year and next. The longer end may also still move higher, even if lagging.

That however is the near term view. Even if some of the government interventions on energy prices may delay the time of reckoning, the economic outlook is already clouding over as we move towards winter. We struggle to see Bund yields remaining at current, or indeed higher, levels in the midst of a recession, and as we think the ECB will eventually fail to deliver on the hikes priced by the curve.

Away from the ECB today's other main event will be Fed Chair Powell's comments at a conference on monetary policy. With the Fed's "quiet period" ahead of the 21 September FOMC meeting kicking in on the weekend, it is the last opportunity to steer market expectations. Other speakers later in the day are the Fed's Evans and Kashkari. Data will see the release of the weekly jobless claims.

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