

## Rates Spark: Light relief for euro bonds

ECB President Lagarde's latest intervention helped calm the most aggressive hawkish pricing. We think yields are still headed above 0% as the ECB does away with negative rates policy. A nod to peripheral spreads is welcome, but the ECB would do well to get ahead of further widening by spelling out its strategy more clearly

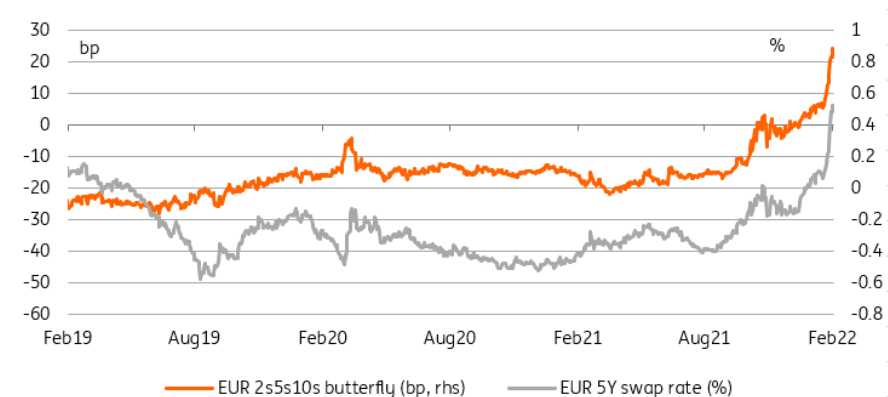


ECB President Christine Lagarde has said the central bank believes inflation will be manageable

### Lagarde doesn't rush to a conclusion on inflation...

Price action so far this week shows that the weekend hasn't helped soothe nerves on euro bond markets. A key cause for concern is the lack of pushback by the doves against market expectations of hikes in 2022, a point of view that is still defensible if inflation was expected to return to below 2%, within the European Central Bank's (ECB's) forecasting horizon. Even ECB President Christine Lagarde's more measured tone on the outlook for inflation at her EU Commission testimony yesterday proved to be only a temporary relief.

## Lagarde's comments didn't impact the tightening priced by intermediate rates



Source: Refinitiv, ING

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*Financial markets have long since taken a view on the inflation outlook*

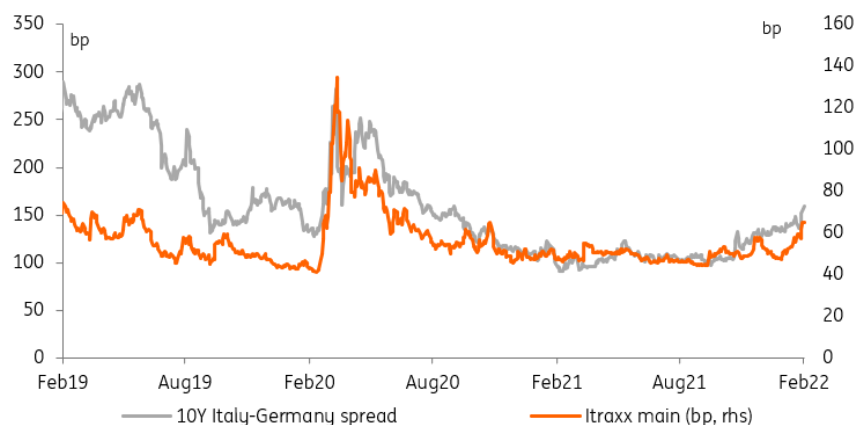
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The problem is that financial markets have long since taken a view on the inflation outlook, and last week's ECB press conference gave them a glimpse of a world where the ECB shares their concerns. Even with Lagarde's subsequent reassurances that the ECB still believes inflation will be manageable, their understanding of its reaction function wasn't corrected: the ECB would change its rates guidance and end quantitative easing (QE) early if it is proven wrong on inflation.

### ... but it may overestimate the resilience of the peripheral bond market

What Lagarde's testimony to parliament achieved is to put the focus back on sovereign spreads developments. Her nod to the ECB's transmission mechanism, even if deemed not yet at risk despite wider spreads, is a sign that the ECB is not out of touch with the market. The tools offered to guard against further spread widening lack in firepower, however. It is unclear how fast and how far the ECB could rebalance its existing bond portfolio by buying more peripheral bonds through reinvestments.

## The ECB is not yet concerned about its transmission mechanism



Source: Refinitiv, ING

Overall, Lagarde's latest intervention could prevent front-end euro rates from jumping to even more hawkish conclusions, but this will not stop euro bond yields from mechanically rising above 0% in the coming months, where we think the ECB's deposit rate, their effective floor, should be by early next year.

### *Peripheral bonds are staring down the barrel of monetary tightening*

We think that conclusion holds for peripheral bonds, which are staring down the barrel of monetary tightening without much special treatment. The question in our view is twofold. First, how far do spreads have to widen for the ECB to deem the tightening of financial conditions too fast in some countries compared to others? Second, will it be too late by then? We do not have an answer to the first question, but the ECB has shown that it can underestimate the importance of the second.

### Today's events and market view

Today looks like a fairly dry one in terms of European economic releases, but this isn't where investors' minds are. Pablo Hernández De Cos and François Villeroy de Galhau, respective governors of the Spanish and French central banks, are scheduled to speak. Given the heightened sensitivity (see above) of euro bond yields to ECB comments since last week, they could constitute one of the main flashpoints of this session.

In the US, small business optimism is expected to continue its gradual decline. As often, their assessment of labour market conditions and pricing power will be more closely watched than the headline.

Euro sovereign and supranational bond supply is relatively light this week but we're particularly interested to see if last week's change of tone at the ECB is denting appetite for bonds further. Germany is due to sell inflation-linked bonds via auction, while the EU is

expected to sell bonds via syndication in the 5Y and 30Y sectors.

The US treasury will kick off this week's supply exercise with the sale of 3Y T-notes.

## Authors

### **Padhraic Garvey, CFA**

Regional Head of Research, Americas

[padhraic.garvey@ing.com](mailto:padhraic.garvey@ing.com)

### **Benjamin Schroeder**

Senior Rates Strategist

[benjamin.schroeder@ing.com](mailto:benjamin.schroeder@ing.com)

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