Rates Spark: Mark my words

The ECB should clarify how it will address higher inflation and higher yields at today's meeting. Both are hawkish risks that would compound growing confidence in the recovery and accelerate the rise in EUR rates

Source: Shutterstock

ECB: Plenty of communication challenges for today

Today should prove an interesting one for the European Central Bank.

As is customary every quarter, the ECB will release a new set of economic forecasts that should, according to our economics team, see greater inflation and lower growth than previously anticipated. The former poses a communication challenge in its own right: as headline inflation rises towards the ECB's 2% target, it would do well to signal that it will look through this increase. This is easier said than done, as we expect it will occur at the same time as a post-Covid-19 recovery. Data later this year could make the level of accommodation provided by the central bank incongruous.

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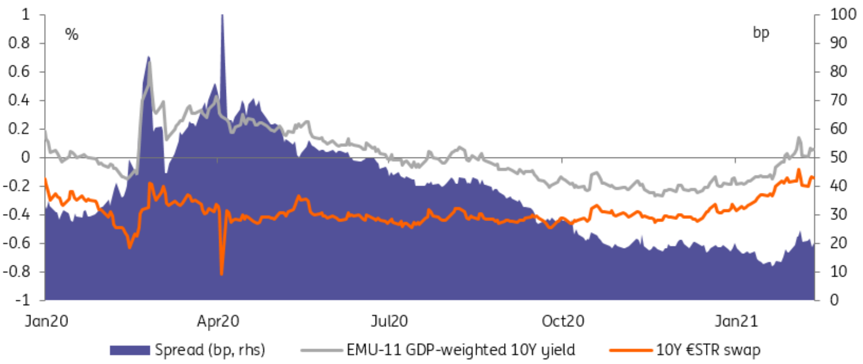
The second communication challenge for the ECB will be to clarify what it means by 'favourable financing conditions'. We're not expecting a definitive conclusion today but the 'holistic' approach it promised is hardly compatible with defending a specific level in government bond yields. Instead, we think its insistence on using a wide range of indicators could have the effect of downplaying the importance of the recent bond market sell-off.

EGB yields have stabilised, and still sit below their 2020 peak



Source: Refinitiv, ING

The most bonds can hope for is a signal of a temporary increase in asset purchases

The recent jump in yields should not be altogether absent from the ECB's communication. It is very possible that president Christine Lagarde will express concerns at the rapid rise earlier this year. All in all, the rise has so far been contained, and average European Government Bond (EGB) yields are still sitting well below their March 2020 peak by virtue of the strong tightening in sovereign spreads.

In our opinion, the most bonds can hope for is a signal of a temporary increase in asset purchases, we fail to see it making a meaningful dent in the rise in yields we're expecting for later this year.

Today's events and market view

The saving grace going into today's ECB meeting is that expectations have been well managed, be it by contradictory public comments, or by a failure to intervene (so far at least) strongly against higher yields. In an environment where markets are pricing the post-Covid-19 recovery with more certainty, lack of action will continue to skew rates higher.

In the morning, Ireland and Italy will sell 10Y/50Y and 3Y/7Y bonds respectively. In the afternoon, the US Treasury will sell $24bn of 30Y T-bonds. Encouragingly, price action around yesterday's soft 10Y auction was robust. A notable short base and the fact that the sale was well flagged helped the market get over the challenge.

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