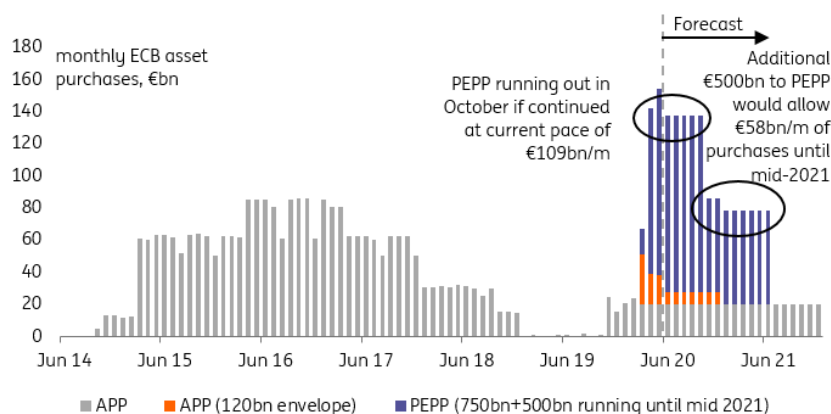


## Rates Spark: ECB today, and risk-on assessment

We review the main ECB policy changes expected today, and their long-term market impact. More QE would help limit the rise in interest rates. Carry-driven investing should tighten spreads further. Meanwhile, steepening from the back end is taking hold from the US. We don't think rates want to go higher, but it's a least resistance path on continued risk-on



Source: ECB, ING

### Germany announces additional stimulus

After extended talks, Germany's grand coalition announced an additional fiscal stimulus package of €130bn for 2020-21 - including a temporary drop in VAT, electric vehicle incentives, more financing for corporations, and digital investment. The headline figure is greater than the €80-100bn that was floated in the press earlier this week. At face value this is good news for the German economy and should add to the higher yield impetus gripping markets this week. Even if there is uncertainty as to how it will be financed, with new borrowing or by reallocating existing expenses, we see no point in fading a further rise in yields in the near term.

### ECB meeting: what to expect

ECB day is upon us. There will be plenty for investors and market participants to ponder today so we provide a short overview of our main expectations in 3 categories:

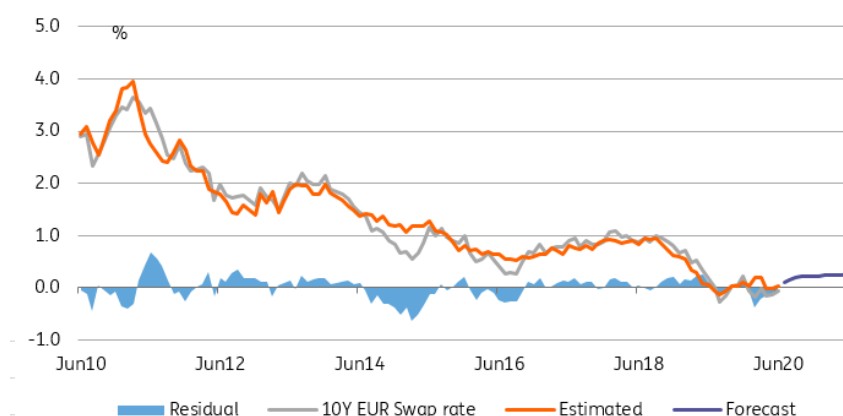
- Economic forecasts: Lagarde already said they will lie somewhere between the base and worst case scenarios identified after the April ECB meeting. Germany and France were among the countries downgrading their national growth forecasts this week. Some Governing Council (GC) members already said that economic developments since April justify adding easing.
- Headline policy measures: Our expectations is for an additional €500bn to be added to PEPP's bond purchase target. We do not foresee a change in policy rates nor a modification of the numerous liquidity facilities put in place since the start of the pandemic.
- Policy tweaks: Our colleagues in the economics and credit strategy teams think 'fallen angels' could be added to the list of bonds eligible for purchases. There is also a possibility of the tiering multiple being raised from 6 times required reserves currently. This would be a double-edged sword in our view.

For more details and for a complete rationale we refer our readers to the [ECB preview](#) published by our economics team.

## Market impact: managed rise for EUR rates

We have detailed the implication for rates markets in a [preview of our own](#). So far things have played out largely as we expected: 10Y EUR swap and 10Y Bund have reached our short term targets of -0.05% and -0.35% yesterday. Taking a longer-term view, we anticipate that the additional bond purchases will slow, but not prevent, a further rise in interest rates. Our estimate puts 10Y EUR swap at 0.20% at the end of the year, 15bp lower than without the new PEPP increase. Historically (see chart below), this is a rather modest rebound in interest rates but commensurate with the scale of the economic challenge and easing measures taken by the ECB.

## 10Y EUR swap rates to rise only modestly thanks to QE



Source: Bloomberg, ING

## Carry-driven demand to tighten sovereign spreads

Whilst we did anticipate the improvement in sentiment and thus the rise in 'core' interest rates, the widening of Italian spreads on the back of the jumbo €14bn 10Y syndication carried out yesterday caught us by surprise. We do not think this changes the macro picture materially as it means further progress towards Italy's funding target for the year. We estimate it has now carried out 54% of its total 2020 bond issuance. News that Conte intends to request €20bn from

the EU's SURE program should also be welcomed by the market.

If anything, the confirmation of a strong bias in favour of peripheral debt in the PEPP purchase data for Mar-May20 period reinforces our view that sovereign spreads are on a tightening path.

Practically, this should be driven by the return of carry-oriented investors now that rates volatility has eased. The next leg of Italy-Germany spread tightening to 150bp should be slower however.

## Lower rates volatility makes carry trades more attractive



Source: Bloomberg, ING

It should be said that medium term risks around this central tendency are resolutely skewed to the downside. Sure, the worst of the pandemic and its economic impact may be behind us but a better than expect path for growth likely won't cause the ECB to withdraw easing. The threat of a second wave later this year in the pandemic remains real. Risks come from financial markets too. We are increasingly nervous about the degree of optimism displayed in certain corners of the world and a reassessment would cause interest rates to dip materially.

## Risk-on and the prognosis for rates

Finally, the weight of the risk-on has acted to force core yields higher. It is just a nudge for now, but we are watching the US 10yr in particular which is now in the 75bp area. We identify net steepening pressure from here should risk-on continue, with front ends anchored. A trend to 1% would accelerate the possibility of yield curve control. But then again that depends on whether the risk-on mood has credibility.

For now we doubt the strength of the "V" that it is imputing. But, should economies perk up in the coming months, it would be difficult for the Fed to materially obstruct a rise in longer yields. Yield curve control works best where there has been a build in angst and debt that requires maintenance of ultra-cheap funding costs.

But if the rise in yields reflects pure macro enthusiasm that is a whole other story. Where we struggle here is with respect to the structure of the curve. As it steepens in a reflationary manner, the belly continues to richen. The latter is not consistent with a material uplift in yields. Hence we expect this to be a localised rise in yields.

Suddenly the yield curve control discussion has become more nuanced. In any case, steeper

curves continue to make sense for as long as the risk on mood continues. We'll make the next call when that process is complete.

## Today's events: ECB, Spain and France auctions

Ahead of the ECB meeting, Spain (3Y/5Y/10Y/15Y) and France (10Y/50Y) will auction bonds.

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