

Rates Spark: Markets aren't over central banks yet

Central bank tightening may have dropped from the list of market worries but the effect of hawkish comments are increasingly being felt in riskier assets. Lagarde and Powell today could tip market sentiment. We expect 10Y Italy-Germany spreads to test 250bp

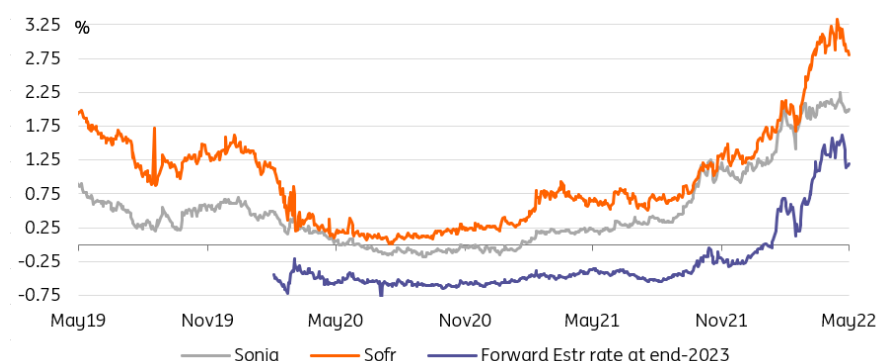


European Central Bank president Christine Lagarde and US Fed chair Jerome Powell

Are markets no longer scared of central banks?

With both Fed chair Jerome Powell and European Central Bank (ECB) president Christine Lagarde both due to speak, it is worth asking if central bankers have lost their ability to strike fear in the minds of investors. The well accepted fact of central bank tightening is that financial conditions need to tighten for inflation to be brought back until control. But with growth concerns mounting, markets might increasingly be tempted to ignore central bank rhetoric and to bet that recession will interrupt their tightening cycles.

Markets are increasingly sceptical of central bank tightening



Source: Refinitiv, ING

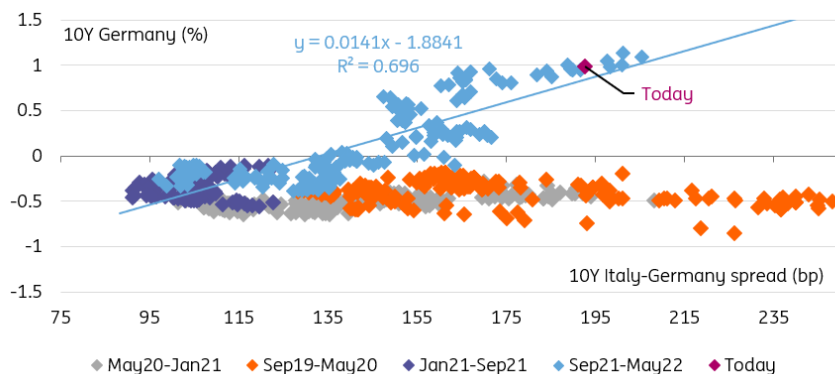
The Fed in particular is on its front foot and has a point to make

We think it is dangerous to stand in front of a central bank at the onset of a string of hikes. After all, US 'peak inflation', if it has indeed peaked, says nothing about the pace at which it will converge to target. The Fed in particular is on its front foot and has a point to make if it wants to avoid a de-anchoring of inflation expectations. In that environment, higher rates still remains the correct macro call, with our best guess for a peak to occur in 3Q 2022. The main risk to this view is that long-end bonds seem to have regained their ability to attract safe-haven demand.

No change in ECB tone and an acceleration of spread widening

We hold no such conviction for the ECB. For one thing, we find market expectations have run well ahead of what it has time to deliver before the outlook worsens. This limits upside to front-end rates even before the ECB has delivered its first hike, even if it is way too early to expect a change of tone. Banque de France governor Francois Villeroy opened a new front in the expectations war yesterday by expressing concerns about the inflation impact of a lower EUR. That there was little follow through in the market shows that most expect this to remain a fringe view.

Italian spreads widened with higher rates... and are set to accelerate



Source: Refinitiv, ING

The ECB's spread pain threshold is wider than we first assumed

The lower the credit curve one goes, the less predictable the impact of central bank tightening. This has led to an accelerated sell-off in Italian bonds. For the first phase of widening, the effect of higher core yields (for instance Germany's on the chart above) on spreads has been relatively linear, but we expect things to accelerate. We have no concern about Italian debt sustainability in the near term, but the ECB's reluctance to disclose details of its purported financial fragmentation facility risks unnerving investors. It seems like its pain threshold is wider than we first assumed, so we expect [another leg wider in the Italy-Germany spread to 250bp](#) before the central bank steps in.

Today's events and market view

After the UK employment figures, the European releases calendar contains the second reading of Eurozone 1Q GDP. Things will liven up in the afternoon with US retail sales, industrial production, and the housing market index.

Central bankers feature prominently among the list of potential market movers. Chairman Jerome Powell caps a long list of Fed speakers. ECB president Christine Lagarde is also on the schedule.

Germany is scheduled to sell 2Y bonds, adding to Finland's 21Y auction. The UK will sell 30Y debt.

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