

Rates Spark: More divergence between US and European rates

The Fed and Bank of England hiked this week, but the contrast in tone was striking with the BoE turning decidedly more cautious. Nonetheless, there should still be room for markets to overshoot on hike expectations and rates to move higher, but likely with USD in the lead and European rates lagging. Curves may still flatten on lingering growth concerns



Sterling front end rallies on cautious BoE, but the hikes discount remains aggressive

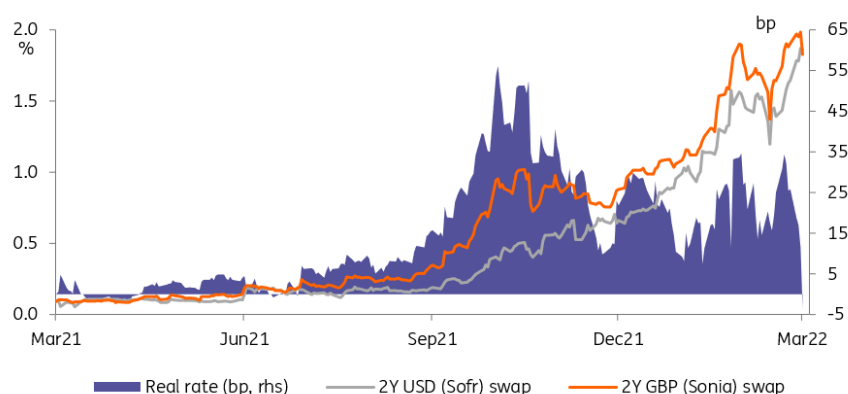
Both the Federal Reserve and Bank of England hiked rates this week, but the tone that the central banks have struck was quite different. While the Fed had surprised with an aggressive dot plot and brushed aside fears of recession, the [BoE struck a decidedly more cautious note yesterday](#).

Not only was the BoE's split of votes a sign of greater caution – it was split 8-1 with one vote for keeping rates on hold. The MPC was also concerned about the future hit to spending from higher energy prices. Premised on the market's pricing of hikes going into the meeting the BoE forecast that inflation would now fall below the 2% target within the forecast horizon.

Market pricing remains aggressive with overnight rates seen just shy of 2% by year-end

The sterling curve has already reacted with front-end rates dropping sharply in the wake of the meeting with the 2y SONIA swap almost 20bp down on the day. The 10Y rate was down 8bp, effectively steepening the curve. Money market pricing remains aggressive though as overnight rates are still seen just shy of 2% by year-end – at the moment our economists see only one more hike this year. The market's scepticism about the growth outlook remains confined to the continued inversion of the yield curve.

2Y Sonia dropped below 2Y Sofr for the first time since July 2021



Source: Refinitiv, ING

ECB stresses gradualism as "fossilflation" and "climateflation" transition to "greenflation"

The European Central Bank had similarly struck a more cautious tone last week, even if it progressed further on its path to policy normalisation. At the ECB watchers conference, executive board member Isabel Schnabel echoed this tone, highlighting that “fossilflation” – acute amid the geopolitical situation – and “climateflation” were adverse supply shocks that required a more finely balanced strategy as the monetary policy trade-off implies that the central bank cannot stabilise growth and inflation at the same time.

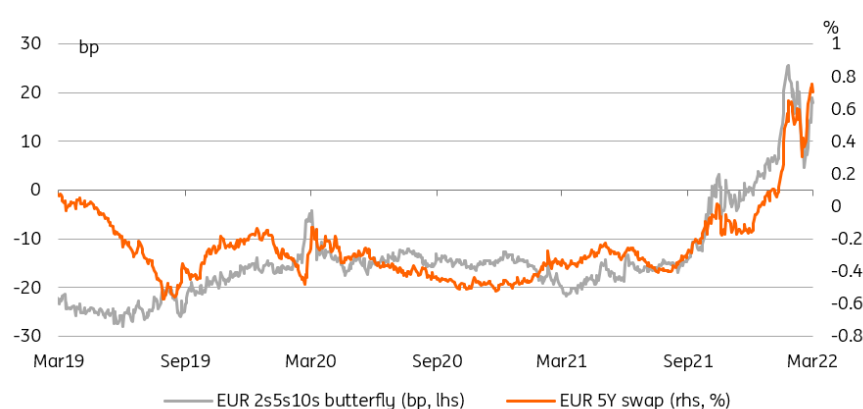
With no signs of de-anchoring inflation expectations, the ECB can allow itself a gradual approach to policy normalisation for now. Once inflation drivers turn toward “greenflation” however – ie, investment and demand-driven price pressures – then it will be put into the position of stabilising output and inflation simultaneously. It gels with ECB President Christine Lagarde stressing last week that the Bank had indeed not accelerated the normalisation process.

Gradualism notwithstanding, there is still little in the way of

overshooting on hike expectations

But then there are voices of those like Dutch central bank's Klaas Knot, stressing that inflation remains the dominant worry. He would not rule out two hikes this year and saw no need for making only small 10bp hikes. Gradualism notwithstanding, this suggests that there is still little in the way of markets overshooting on their hike expectations for now. Obviously, the war is adding noise, but it also magnifies worries over whether the eurozone economy will withstand a higher rates regime – here as well we think it should mainly manifest itself in the flattening pressure on yield curves.

A 'greenflation' positive demand shock would imply a higher EUR 5Y swap



Source: Refinitiv, ING

Today's events and market view

One of our main takeaways from central bank meetings over the past two weeks is that of divergence between US rates on the one hand and European rates on the other. The BoE yesterday and ECB the week before and in subsequent comments have struck a more cautious note that contrasted with the Fed's confidence in its outlook.

Mind you, the general direction in all these markets should still be higher barring a larger geopolitical escalation. But we think that EUR and GBP rates should not follow as fast, not least because market pricing of their paths is already aggressive compared to the two central banks' communication. In the meantime, lingering growth concerns over economies' capacity to stomach higher key rates are amplified by the geopolitical uncertainty. This is likely to keep the flattening pressure on curves.

There are only a few data releases today with existing home sales in the US being the main release. We will also hear from the Fed's Neel Kashkari, Michelle Bowman and Tom Barkin, but the focus could return to geopolitics where US President Joe Biden will talk with China's Xi Jinping today.

Author

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.