# 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

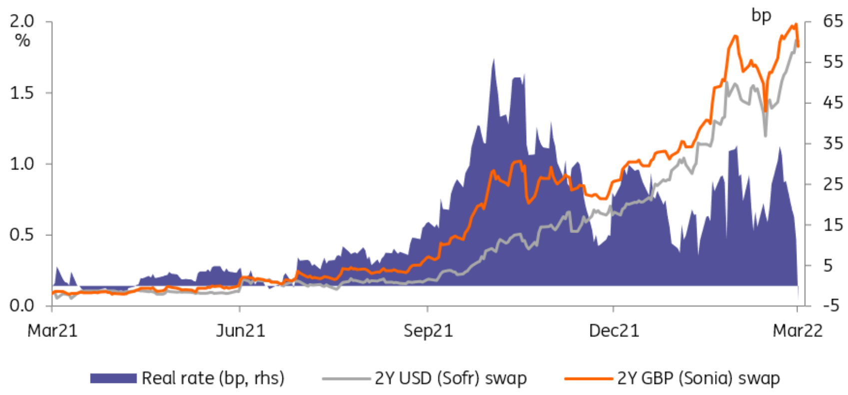
Both the Federal Reserve and Bank of England hiked rates this week, but the tone that the central banks have struck was quite different. While the Fed had surprised with an aggressive dot plot and brushed aside fears of recession, the BoE struck a decidedly more cautious note yesterday.

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"

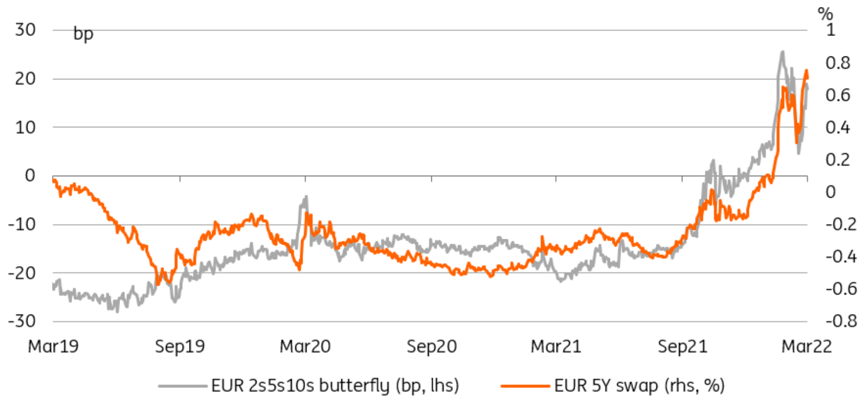
The European Central Bank had similarly struck a more cautious tone last week, even if it progressed further on its path to policy normalisation. At the ECB watchers conference, executive board member Isabel Schnabel echoed this tone, highlighting that "fossilflation" – acute amid the geopolitical situation – 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.

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