

## Rates Spark: More sacrifices, flatter curves

We will remember Jackson Hole not just for Powell's hawkish speech, but also for the ECB gearing up its own hawkishness – 75bp hikes are not just for the Fed. Even if just an attempt to invoke the market's help to do the heavy lifting of tightening financial conditions, near term it means more curve flattening. Accelerating inflation still justifies the means



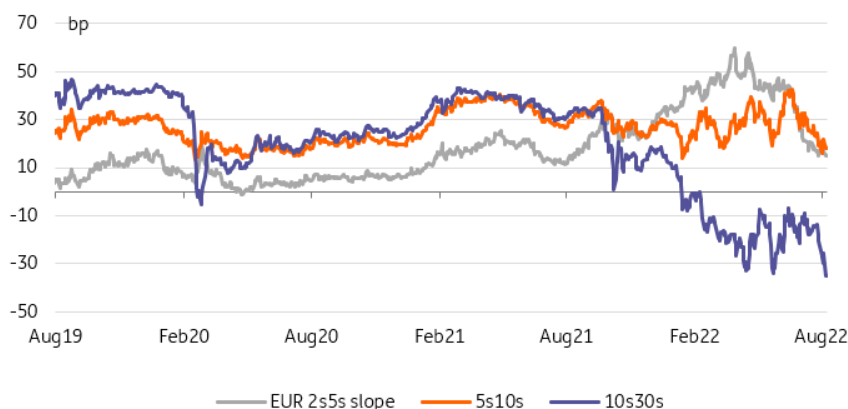
### Hawkish ECB communications shift bear flattens the curve...

EUR money markets have clearly set their sights on a 75bp hike at the September meeting after the string of hawkish comments over the weekend. The ESTR OIS (euro short-term rate overnight indexed swap) forward for the September reserve period is now at 65bp, implying a 60% probability for a larger move.

It was the European Central Bank's Robert Holzman, Martins Kazaks and Klaas Knot who all hinted more-or-less explicitly at a 75bp hike being on the table while others have called for more forceful action. France's François Villeroy appears to suggest more frontloading with a call for showing determination now to avoid "unnecessarily brutal" hikes at a later stage.

The significance of that hawkish communications shift was underscored by the ECB's Isabel Schnabel who warned that greater sacrifices may be needed to bring inflation under control. And indeed the ECB's current official economic outlook certainly still looks overly optimistic against the backdrop of a deepening energy crunch. This all spells further yield curve flattening as the ECB looks more prepared to hike even into a downturn.

## The barrage of hawkish ECB comments means more EUR curve flattening is on the cards



Source: Refinitiv, ING

## ...but may signal more reliance on the market to do the heavy lifting

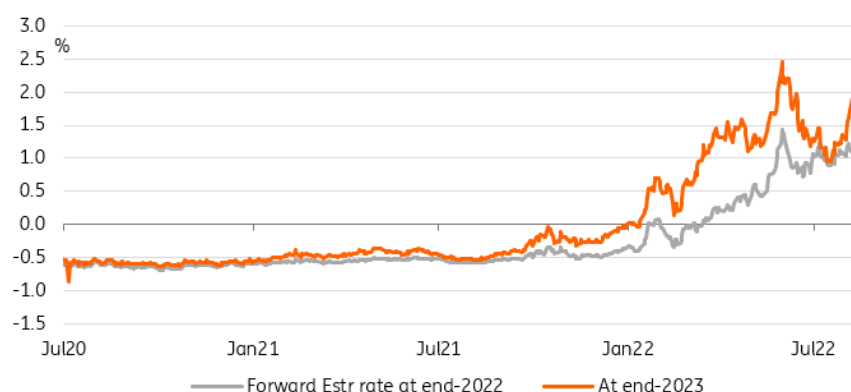
While acknowledging further normalisation is appropriate, the ECB's chief economist Philip Lane struck a more balanced tone. In light of high uncertainty, he argued for a steady pace of hikes to the terminal rate. Smaller hikes would be less likely to cause adverse side effects and make it easier to correct course. Under the current circumstances, we suspect that 50bp would fit his idea of "steady" and "small".

He also notes that policy works through its influence on the entire yield curve. After the July rate hike, higher market rates have meant that the monetary tightening that has already occurred is far greater than just the first policy rate increase. In particular, he notes that mid and longer-end segments of the yield curve are most important for determining financing conditions in the economy and that these are more sensitive to expectations of the terminal rate than the precise path of policy rates towards it.

That insight leads us back to one possible aim of the more hawkish communications twist: let the market do the heavy lifting of tightening financing conditions. As long as inflation risks are skewed to the upside, hawkish talk is likely to persist. And as long as the market plays ball, it may not necessarily translate into an even larger 75bp hike.

However, one can also argue that when relying on hawkish talk it is even easier to eventually correct course than it is with a strategy of "smaller hikes". At this point, we still think that the ECB will significantly underdeliver compared to what markets are pricing. The crucial question is just when this notion will dawn on markets.

## The EUR swap curve prices front-loaded hikes in 2022



Source: Refinitiv, ING

## ECB quantitative tightening on the back burner?

It appears that a discussion on quantitative tightening might not be as imminent, which should also come as a relief for periphery bonds. Accelerated ECB rate hikes and political uncertainty in Italy have already brought the benchmark 10Y spread of Italian bonds over German Bunds back towards 230bp. Bringing quantitative tightening to the table could tip the fragile balance towards more widening, even after the introduction of the Transmission Protection Mechanism. But it is quite notable that amid the latest hawkish push on rates, Italy's spreads have actually managed to eke out a small tightening versus Bunds.

The Council's views on quantitative tightening seem not quite as aligned as their view on rates. After being brought up last week by the Bundesbank's Nagel and also by subtle hints in the ECB meeting minutes, the ECB's Olli Rehn now said it was too early to publicly discuss quantitative tightening. While Kazaks said it could be discussed, he added it was too early to implement.

### Today's events and market view

The reason for the ECB's hawkish turn will become more obvious today. As markets are looking for a further acceleration in inflation, all eyes are on the German and Spanish readings today ahead of tomorrow's eurozone flash CPI release which the consensus sees heading to 9%. The core rate is seen accelerating to 4.1%. Also to watch are the business climate indicators today, economic sentiment and consumer confidence, all of which are expected to come in softer.

The 1y1y ESTR forward is back to 2.13%, though that is still short of the peak seen in June when it topped 2.5%. It might still push higher from here, but the long end should increasingly lag.

In primary markets, Italy will reopen the 5Y, 8Y and 10Y sectors as well as a floating rate bond for a total of up to €8bn.

## Authors

### Benjamin Schroeder

Senior Rates Strategist

[benjamin.schroeder@ing.com](mailto:benjamin.schroeder@ing.com)

### Padhraic Garvey, CFA

Regional Head of Research, Americas

[padhraic.garvey@ing.com](mailto: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 <http://www.ing.com>.