Rates Spark: No rest for the wicked

Inflation concerns are a problem for fixed income markets but it is a return to positive economic surprises that will prove the most potent driver of higher rates in the coming weeks. As the ECB diverts the focus away from the amount of its purchases, we think sovereign spreads should re-widen.

euros and a strong economy

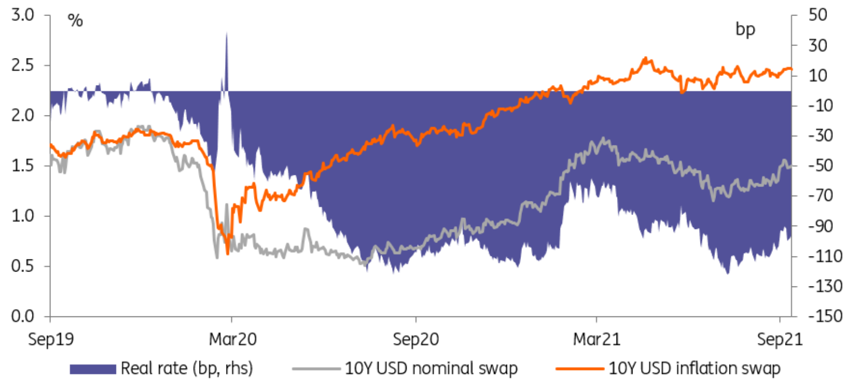
Better economic data collide with inflation scare

It is clear in our mind that the coming weeks, and perhaps months, will see no let-up in inflation worries. Only once base effects fade, once the winter spike in energy cost has fed through, and once the market has a reasonable idea about possible second-round effects into wages, will it drop off the list. The latest spike in oil prices on insufficient production increases caused debt markets to rattle further yesterday. If this happened in a vacuum, all would be fine for debt markets. Front-end rates would price a slightly more hawkish path for central bank policies but the long-end would flatten in earnest, reflecting the trade-off between earlier tightening and a higher terminal rate.

Persistent inflation fears come at a time we're expecting an *improvement in economics news flow*

The problem is that persistent inflation fears come at a time we're expecting an improvement in economics news flow, inflation notwithstanding. Where markets had doubts about the Fed's, and other central banks', ability to tighten much at all, an improvement in econommic surprise indices will help focus minds on this possibility. This is what the bear-steepening thesis centres on. In countries where the near-term inflation spike presents a more significant threat to the growth trajectory, perhaps in the UK, we are more sceptical about the market's ability to price tighter policy than currently.

Better economic data will be instrumental in lifting 10Y USD above 1.5%



Source: Refinitiv, ING

ECB: less focus on flow is not friendly to the periphery

Whether or not it is inflation related, recent ECB speeches contained important insight on how it sees its policy choices ahead of the December meeting. The focus, we are told, should be less on the volume of purchases at this stage of the programme, and more on the signal for base rates that protracted purchases carry. It is true that the stock effect of the existing bonds portfolio matters more to the overall level of rates than the future purchases as both QE programmes will be brought to an end in the coming years. The counter argument is that volume purchased also carry a signalling message in that it takes longer to stop large monthly purchases.

Sovereign spreads should be more sensitive than core rates to a lower purchase rates in 2022

But looking at the impact of purchases on base rates is only one part of the story. The sensitivity of fixed income markets to monetary policy increases as credit quality diminishes. The implication is that sovereign spreads should be more sensitive than core rates to a lower purchase rates in 2022. So far, markets have only priced the impact on earlier rate hikes, but sovereign spreads have remained well contained. As the April 2022 French election approaches, we think nervousness about lower monetary support will add to widening pressure on spreads.

Today's events and market view

Of today's PMI prints, only Spain's and Italy's are first readings, and thus liable to surprise the market. Aside from French industrial production, the main item on the European economic calendar is August PPI. The annual figure should rise to 13.5% but, importantly, the monthly rate should decelerate compared to July.

Arch-ECB hawk Robert Holzmann is due to speak today. President Christine Lagarde follows in the afternoon.

Later in the afternoon, the main US release will be the ISM services. The employment component will be a key input in market expectations ahead of Friday's job report. Inflation developments are also keeping fixed income markets on tenterhooks, so a further increase in the price component would be most unwelcome, and contribute to lifting 10Y Treasury yields durably above 1.5%.

There is a decent amount of sovereign debt being sold this week, starting today with Austria (5Y/10Y) and Germany (linkers).

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