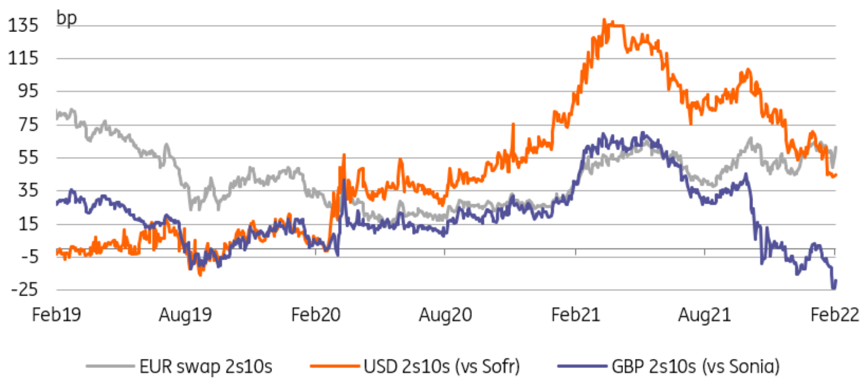
Rates Spark: Bond market - no rest for the wicked

The ECB has dented already soft demand for bonds. Board member Schnabel's views on QE have veered to the hawkish side in recent months, so we expect another challenging session for bonds. Our medium-term forecast of 0.50% for the 10Y Bund could be reached earlier than we thought

Supply is taking its toll on bonds

We wrote yesterday that limited supply this week would nonetheless be a good opportunity to assess if the ECB's change of tone has done much damage to bond demand. The answer seems to be that it has. Although the number of deals coming this week is too small a sample to draw conclusions on how auctions/syndications statistics are evolving, price action around deal announcements and pricings is telling. So far this week, the EU has sold €5bn 30Y debt, and Spain mandated banks for a deal in the same sector (probably for around the same size, see below). Germany is also selling 30Y debt today, and there is a risk of a long-end Belgian deal materialising in the coming days. This long-end skew in supply has coincided with a steepening of the EUR curve.

The EUR curve steepening is hard to understand when looking at its USD and GBP peers



Source: Refinitiv, ING

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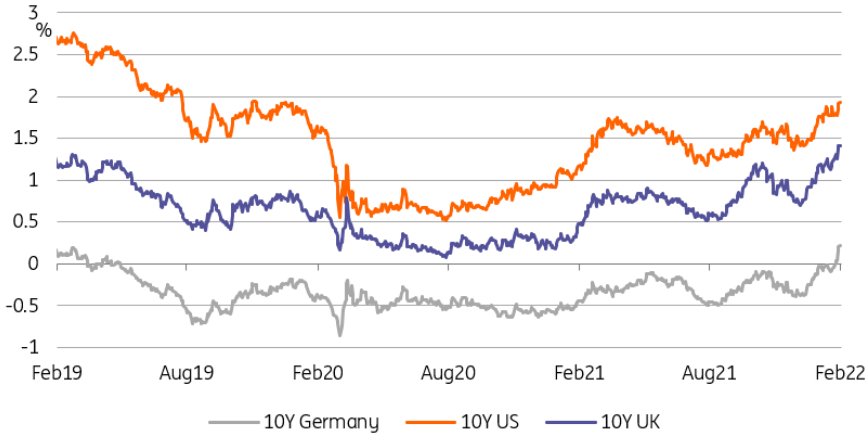
Linking supply and the bond sell-off requires a leap that we're quite willing to take, in current context. The ECB turning more hawkish, and our high conviction call that it will do away with a negative interest rate policy by some time next year (the market is pricing that move by the end of this year), should in theory result in a bear-flattening of the EUR curve. And indeed, this is what happened after last week's meeting, as well as to the USD and GBP curve when their respective central banks approached the start of their hiking cycles.

Expect no warm words from Schnabel, 10Y Bund heading towards 0.50%

The main event for euro bonds today will be Isabel Schnabel's Q&A session. She has penned many speeches and analyses on the future of QE. She was one of the first officials to link asset purchases to worsening bond market liquidity and to inequality. The ECB board member was also one of the first to point at the programme's diminishing returns. In light of her recent hawkish views on QE, we wouldn't be expecting much soothing comments from her, and neither should the bond market. Even with his in mind, heightened sensitivity around ECB communication means a further rise in yields today is entirely possible.

More reassuringly perhaps, Banque de France governor Villeroy hinted late yesterday that markets may have overreacted to the latest ECB communication, especially in their timing of the first rate hikes as soon as the middle of this year. This remains the most likely form of verbal support ECB speakers can offer.

10Y Bund is converging fast towards 0.5%, our medium-term target



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Where does this leave rates? The upwards direction of travel is clear to us. A 0.50% yield in the 10Y Bund seems a realistic medium-term forecast to reflect our view that ECB rates will soon rise above zero, and that continued economic growth will justify two further hikes being priced by the curve. Markets have been quick to adjust to the brand new world of higher interest rates so we wouldn't be surprised to see this level reached earlier, even if we think it should come with a flatter curve.

Today's events and market view

Data releases are pretty thin on the ground today but central bank communication is sure to make up for it. From the ECB, Schnabel is due to answer questions on Twitter. She has been at the forefront of technical discussions on the usefulness of QE since her appointment, so her opinion will be closely followed (see section above). Around the same time, Huw Pill of the BoE is also due to speak. Mester and Bowman, of the Fed, complete today's line-up.

German is scheduled to sell 30Y bonds, to which Portugal will add 7Y and 10Y auctions. In addition, Spain has mandated banks for a 30Y syndication. Earlier deals in this sector suggest the issuer will attempt to raise €5-6bn, although choppy market reductions might account for a less ambitious size.

The US Treasuries continues this week's sales programme with a 10Y T-note auction.

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