

## Rates Spark: Pivotal week

The market is out on pivot watch going into this week's Fed meeting, But the short-lived rates rally following the European Central Bank meeting highlights that sustainable declines in rates also need to see actual declines in inflation

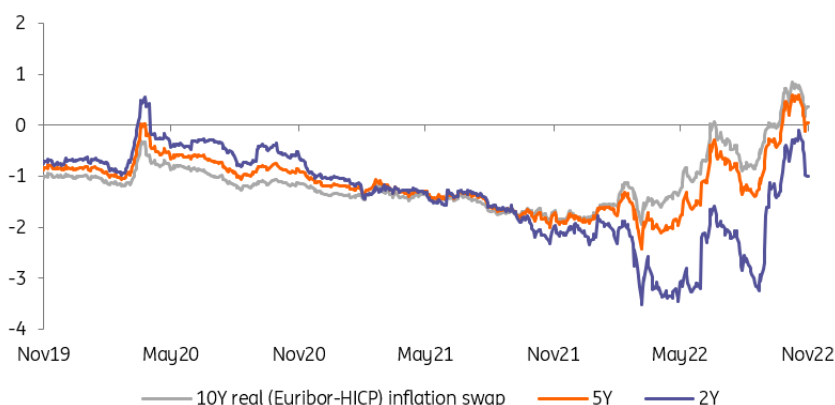


### The post ECB rates rally proved short-lived...

The rally on the back of the ECB meeting has proved short-lived. First preliminary country inflation data out of the member states already pointed to another inflation increase, and it was eventually confirmed in yesterday's euro area flash CPI which saw an acceleration to a hefty 10.7% year-on-year.

It is no wonder that over the past few days we have already seen some of the ECB's better known hawks come to the fore to state that the ECB's next move will still have to be sizeable – the Dutch central bank's Knot thinks December will be a decision between 50bp and 75bp. The market is currently seeing equal chances for both, but it is notable that the forward rate for December has actually tracked quite closely to 2% since mid-September. The volatility has indeed been more in the expectations for 2023.

## Central banks cannot afford to see real rates moving back to negative along with double-digit inflation



Source: Refinitiv, ING

### ... and may serve as cautionary tale for any post Fed rally

Clearly, the greater volatility also follows as the ECB is now using a meeting-by-meeting approach. But the central bank will still have an eye on the longer rates, which Chief Economist Lane had pointed out were the more relevant rate for many corporates to determine financial conditions. France's Villeroy had suggested that the ECB could take into account among other things a forward real interest rate as a measure of tightening already delivered. Take for instance a 5y5y forward real rate – after all the ECB had already had quite a fixation in the past on the 5y5y forward inflation swap – then this measure only turned positive late in August to reach 1%, but only to decline 50bp since early October again.

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*Bund yields should remain anchored above 2%*

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We doubt that the ECB is keen to see such a measure relax already considerably before having clear evidence of inflation retreating more lastingly. There are still too many risks surrounding the inflation outlook with the latest data showing that the supply side shock continues to ripple through to broader price dynamics. The upshot being that a sustainable dovish rally in market rates will have to see evidence of declining inflation first. Until then Bund yields should remain anchored above 2%.

Of course, all eyes are on this week's Fed meeting. But the ECB's experience may also hold a cautionary lesson for US rates markets that already seem primed for the Fed to hint at a slower pace of tightening after this month. While the Fed may leave that option on the table, there is still the possibility that in the end the data still fails to provide the Fed with necessary assurance to follow through. A rates rally on a dovishly perceived Fed could still prove short-lived without the underpinnings in the subsequent data.

## Today's events and content block

Month end has passed which also means that one of the more technical tailwinds for rates markets surrounding the monthly rebalancing of index trackers will abate. And note that the German debt agencies recent increase of own holdings by €54bn was relevant for the rebalancing – perhaps one factor contributing that kept shorter-dated Bund yields from participating in the swap rates' further upward correction yesterday.

Sticking with the technical factors, today will only see German linker supply, but this week's upcoming longer maturity bond auctions from France in particular could now move into focus already. Note that today many eurozone countries will also observe the All Saints holiday.

US markets are bracing for the Fed tomorrow. In data they will have to digest ISM manufacturing, where an anticipated decline closer towards the 50 threshold could increase chatter about a pending recession and thus also support the market's pivot narrative.

The Bank of England is due to start its gilt sales with £0.75bn in the 3-7Y sector today.

## 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)

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