

Rates Spark: reflation capitulation

The Fed met in June with the 10yr at around 1.5%. Its now 20bp lower. Not a huge move, but psychologically big all the same. Price action suggests more reflation trades are being shed. Even a more dovish interpretation of the ECB's inflation mandate would not help reflation hopes in our view. Worse still, the June ECB minutes might push the curve flatter.



Source: Shutterstock

FOMC - more liquidity discussions, on both ends of the spectrum of the repo market

We would have been a tad confused if there had been a big (in fact any) reaction to the Fed minutes on the bond market, as the Fed did not know that the bond market would do what it did when they met in mid-June. The bond market discount in itself is an important input for the Fed, and will impact what they do on both tapering and rate moves (in particular the latter), so if they met today it might well have been quite a different discussion. Hence the minimal move in bonds from the minutes makes complete sense.

The minutes contained further discussion on the establishment of permanent repo facilities

The minutes contained further discussion on the establishment of permanent repo facilities, one for domestics and one for foreigners. The genesis of this is ongoing desire to improve the architecture of liquidity circumstances. The domestic version for example would be at 25bp, flat to the fed funds ceiling, with eligible collateral restricted to US Treasuries. Similar terms would be in place for the foreign version, but both are open to change and still in draft form.

This framed a discussion on currency liquidity circumstance, where in contrast the reverse repo facility has featured as a taker of liquidity (not a provider, as the permanent repo facility would). Circumstances were driven by banks encouraging some non-operational deposits to shift into money market funds, a rump of which went back to the Fed's reverse repo window. Lower bills supply and a spend down by the Treasury too were contributory factors to the liquidity boost. More of the same was expected ahead.

The minutes noted that a moderate technical adjustment in rates was warranted

The minutes noted that a moderate technical adjustment in rates was warranted, with a view to coaxing the effective funds rate a tad higher as it had fallen to 6bp. Hence, the 5bp hikes in the rates on excess reserves (10bp to 15bp) and the reverse repo facility (zero to 5bp), although there was little material discussion on any preferred outcome here in terms of liquidity circumstances. At the press conference Chair Powell was equally non-committal on this.

See more on the FOMC minutes [here](#).

Further capitaluation in reflation trades globally

That there was no let-up in the global curve flattening ahead of the FOMC minutes is a hint that the move is driven more by old positions being closed out rather than by new ones. How much residual reflation trade was there after the June hawkish turns was always an open question. It seems that this position unwind is occurring at the worst of times: when macro expectations are being pared back, and when market liquidity is drying out ahead of the summer.

Don't look to the ECB for rescue

There may still be hope out there that residual reflation trades could be saved by the ECB's strategic review. By all accounts, the central bank's governing council meeting this week will conclude on a more dovish definition of its price stability mandate. The current 'close but below 2%' inflation target carries an implicit bias that is understood to be behind past hawkish policy mistakes. For instance in 2008 and 2011, but also the premature withdrawal of QE in 2018.

Target or ceiling? EUR inflation swaps have been below 2% for almost a decade



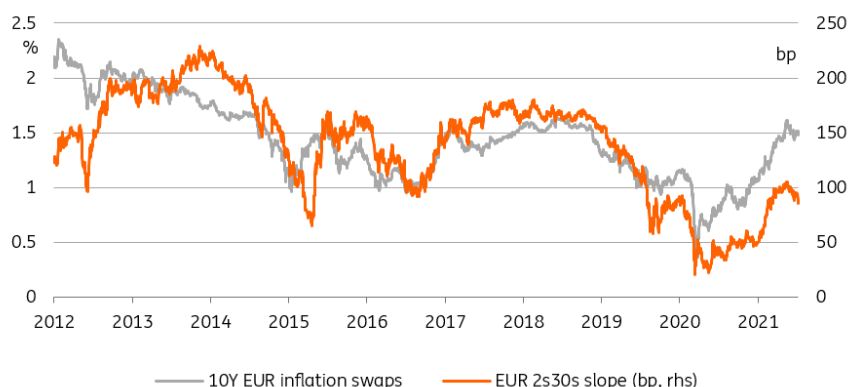
Source: Refinitiv, ING

This doesn't mean the ECB will land on its own version of Fed's flexible average inflation targeting (FAIT). As the new strategic direction at the Fed is credited for much of the success of reflation trades between last summer and Q1 2021, it is understandable that some eye this week's ECB discussions with interest. Basing a strategy on this seems akin to grasping at straws in our view. Press reports yesterday evening suggested that the ECB will give itself more flexibility in case of inflation overshoot, but stop short of an actual commitment to make up for past inflation misses, as would be the case with FAIT.

Press reports yesterday evening suggested that the ECB will give itself more flexibility in case of inflation overshoot

Indeed, FAIT probably represents the more dovish end of the spectrum of conclusions it could announce at a press conference today. A less consequential but more likely option would be to describe the 2% target as 'symmetrical', ie requiring as much urgency when inflation undershoots 2% as when it overshoots it. This would undeniably be seen as a dovish turn but one that rates markets have already priced in our view. Draghi first included this wording in official ECB communication in mid-2019, and was pushing for the change as early as 2016.

The ECB faces an uphill battle to raise inflation and to re-steepen the curve



Source: Refinitiv, ING

An even more moderate conclusion would be to do away with the 'below' in the 'close but below 2%' phrasing, which we think would be considered an outright disappointment by rates markets, and further curve flattening.

Today's events and market view

The minutes of the June ECB meeting will be parsed for signs of disagreement about the extensions of PEPP purchases at an elevated pace (widely understood to be €80bn/m) until September. Based on public comments made since the meeting, we do not think the decision was strongly opposed.

Hopes for more clarity on the pace of purchases beyond September risk being equally disappointed. Economic assessment ranks lower on the list of market priorities, but any concern about the pace of inflation or wage growth would get some airplay. The risks are thus skewed towards a hawkish market reaction that would push up intermediate rates up but could, at the margin, exacerbate the global curve flattening since June.

The ECB will announce the outcome of discussions (see above) on the interpretation of its price stability mandate at 1pm CET. The announcement will be followed by a press conference.

Ireland will auction 5Y/10Y/14Y debt.

The main release in the afternoon will be US jobless claims. The release calendar is otherwise fairly empty.

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