

Rates Spark: Riding on inflation

US inflation is today's key release, where upside surprises could push markets further toward pricing a 50bp Fed hike in March. EUR rates also hold more upside, with no official attempts yet to row back on the hawkish turnaround. Periphery bonds still look most exposed if the European Central Bank rushes to the exit



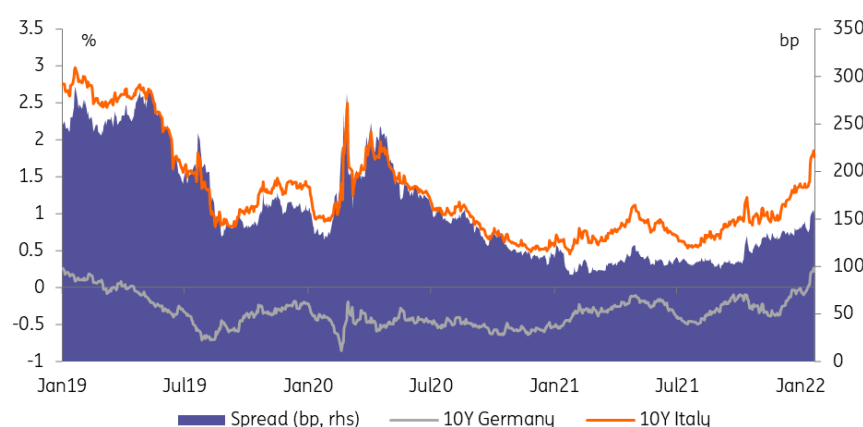
EUR rates are still on an upwards trajectory

European bond markets have seen a bit of relief with the benchmark 10y Bund yield edging back towards 0.2%. We suspect that at least some of that relief is supply-related, though notably long end rates have lagged somewhat – perhaps indications of a possible ultra-long new issue from Belgium still being eyed. But this should not distract from the fact that last week's hawkish ECB has set markets on track for higher rates. And there have not been any official attempts yet to row back on the key takeaways of the press conference.

There have been no official attempts to row back on key takeaways of the ECB press conference

President Lagarde had suggested that revisions to the forecasts in March could go hand in hand with a new guidance for asset purchases, opening the possibility for a first hike already this year. It is acknowledged that uncertainty surrounding the inflation forecast is unusually high amid pandemic effects and structural changes (green transition for instance). But if that weren't enough of a problem, some ECB policymakers are reportedly losing faith in the forecast models themselves, as was underscored by a Bloomberg story yesterday. If policymakers fear being wrong footed by their own forecasts, who is to blame markets' aggressive pricing of ECB tightening?

Italian spreads over Bunds have risen to their highest levels since mid 2020



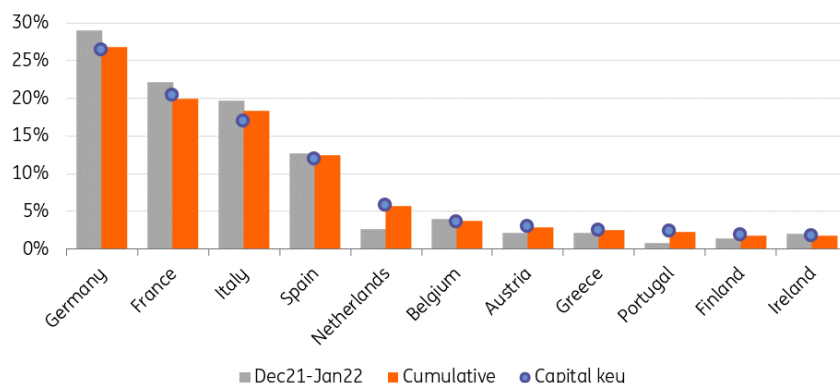
Source: Refinitiv, ING

ECB's accelerated tightening still leaves the periphery exposed

The ECB has apparently seen the need to deviate from the capital key more recently

As a consensus forms around the need to rein in stimulus, one crucial question for bond markets remains how the ECB will deal with periphery markets. They have become dependent on the central bank's asset purchase programmes over the years. The past two months' data published this week suggests that the ECB has seen the need to deviate from the guiding capital key again more recently as net purchases from the pandemic emergency purchase programme (PEPP) saw a skew towards Bunds, French bonds and Italian bonds – one could read this as the ECB leaning against the upward dynamics in rates and spreads.

Distribution of PEPP net asset purchases suggests ECB leaned against recent months' market dynamics

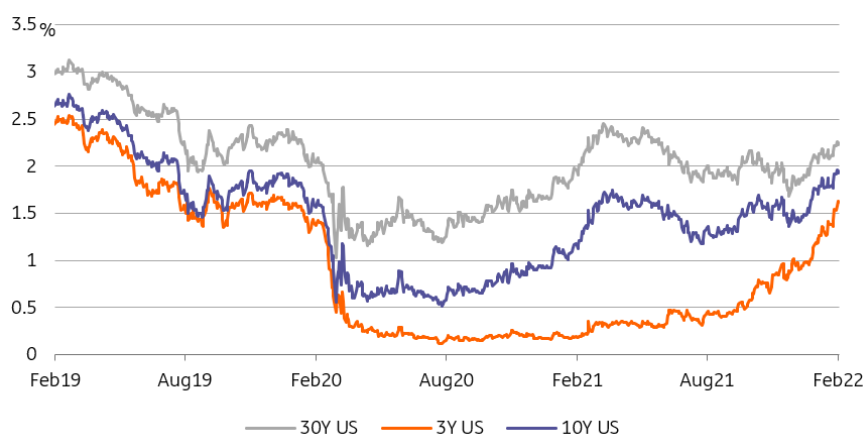


Source: ECB, ING

The ECB's first active line of defense after the end of net-QE is the flexible use of reinvestments

The ECB is projecting confidence so far, as Isabel Schnabel was the latest to reiterate that the ECB will “ensure that policy is transmitted into all parts of the euro area.” But looking beyond the end of net asset purchases the ECB appears to be pinning its hopes on the already large holdings of bonds, that this will dampen the widening pressure on bond spreads. The hope is also that the Next Generation EU support and reform programmes have increased resilience of markets. The ECB's first active line of defence after the end of net asset purchases would be the flexible use of reinvestments, but it appears there is limited willingness to commit to anything beyond that. As long as that is the case we think that periphery spreads remain exposed to further widening amid expectations of accelerated policy tightening.

The 10Y treasury auction saw good demand as yields approach 2%



Source: Refinitiv, ING

Today's events and market view

Focus will shift back to the US, with the key CPI release today. Our economists expect another record for year-over-year inflation at 7.3%, the highest since 1982, while the core rate is seen rising to 5.9%. Upward surprises may further push markets towards pricing a 50bp hike by the Fed in March.

The EUR rates markets will still have their time in the spotlight with a slew of ECB officials on the wires today. Chief Economist Lane speaks on a panel about supply chain disruptions – eyes will be on him not least as he is the main defender of the ECB's inflation models, if only for the lack of any better options. Other speakers are VP de Guindos and Banque de France's Villeroy. The dovish skew in today's speakers list might help bonds consolidate yesterday's post-supply relief rally but we think the medium term direction of travel is clear, rates are headed higher.

Markets should also take note of the EU Commission's forecasts – including inflation – which will be released today given how much rides on the ECB's new projections due in March. Bloomberg reported this morning that the new draft forecast see 2023 inflation at 1.7% although markets have taken official inflation projections with a generous helping of salt in recent months.

The US Treasury will conclude this week's supply slate with the sale of 30Y T-bonds. We had flagged this week's supply as important gauge for market sentiment. Just ahead of another likely record US CPI reading last night's 10Y US Treasury auction drew record demand from non-dealers, suggesting that levels close to 2% are luring investors back into the market.

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