

Rates Spark: Robust monetary policy

Lagarde is the latest of a string of central bankers warning against drawing too many conclusions from a single inflation reading. Her warnings, and those of her peers, would make higher eurozone inflation readings today and tomorrow a more market-moving event than a lower print



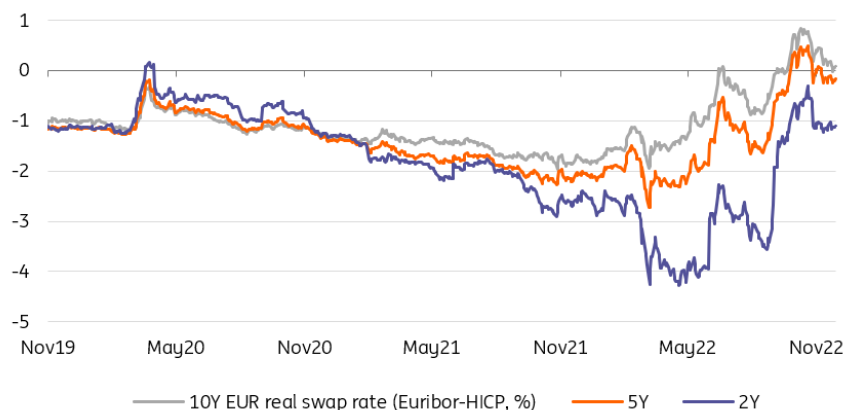
Don't read too much into a single inflation print

The European Central Bank is fighting hard to prevent markets from undoing the tightening of financial conditions that has been achieved this year. Even once inflation is on a downward trajectory, and once the eurozone is in a recession, any central bank would be loath to let market interest rates dip too quickly, lest inflation fails to fully converge with its 2% inflation target. But this is a consideration for once inflation is already on a downward trajectory. The November inflation readings (Spain and Germany today, the eurozone tomorrow) could bring a down tick but might not be enough to conclude that inflation has peaked.

November inflation readings might not be enough to conclude that inflation has peaked

This, at least, was the view expressed by ECB President Christine Lagarde in her testimony in front of the European parliament. The core of her message is not new: the ECB will continue tightening policy even as the economy weakens into 2023. This may require taking rates into restrictive territory. This is a vague concept but that is widely understood to mean the deposit rate rising above 2%. Between the lines, it seems the central bank's communication is increasingly preparing markets for a recession, and for the risk that hikes have to continue regardless.

Even after inflation has peaked, the ECB faces an uphill battle to keep real rates positive



Source: Refinitiv, ING

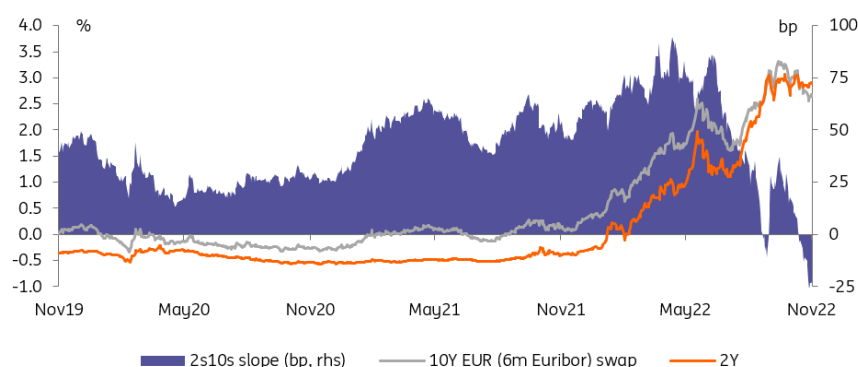
Robust control suggests the ECB should err on the hawkish side

That rates 'may' have to rise above 2% may come across as a quite moderate stance when compared to the Fed's relentless insistence that over-tightening presents less risks than under-tightening. There is also a growing contingent of hawks who argue for forceful action in fighting inflation, illustrated by Isabel Schnabel advocating a 'robust control' approach to monetary policy where the ECB would minimise the risk of even more drastic action in the future if inflation fails to quickly converge to target.

The likelihood of a further 75bp hike has crept up with the curve now attributing it a 50% chance

Until recently, this was not seen as a contradiction with the ECB hiking 50bp at the December meeting, after a cumulative 200bp of tightening since July. The likelihood of a further 75bp hike has crept up with the curve now attributing it a 50% chance. We still think a smaller move is most likely but CPI prints today and tomorrow could make 75bp a clearer market favourite outcome. The result would be a further flattening of the EUR curve relative to its USD equivalent, and also an unwind of the rally in risk assets that last week took Italy-Germany 10Y spreads to their tightest level since the spring.

A high inflation print today would flatten the EUR curve further



Source: Refinitiv, ING

Today's events and market view

Today's batch of Spanish and German inflation data are a prelude to the release of the eurozone-wide indicator tomorrow. Both EU-harmonised measures are expected to tick down compared to the previous months. The European data docket also features EU confidence indicators, including consumer confidence which is a final release.

Given the scale of the rally in bonds and risk assets into this week's inflation print, we think the most impactful outcome would be an upside inflation surprise. Combined with repeated hawkish ECB and Fed warnings, we expect rates to be skewed upwards today and for the rest of the week.

Supply takes the form of the Netherlands selling an 8Y bond and Italy 10Y and floating rates notes.

Conference board consumer confidence is the main US release today, alongside mortgage applications and house prices.

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