

Rates Spark: Some encouraging signs for the ECB

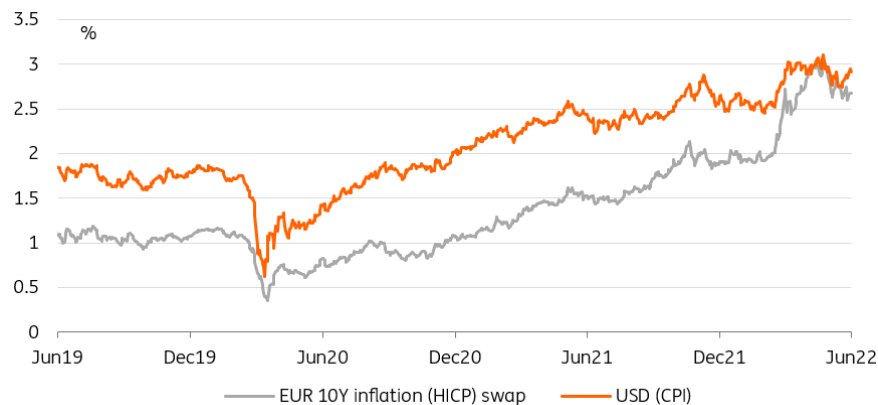
Contained inflation swaps and peripheral spreads suggest the European Central Bank is not in as tough a spot as most fear. These are still early days and we think the ECB will have to deliver both on hopes of a spread management facility, and on the hikes the market is pricing this year. Question is: will it make enough progress this week?



Early signs of inflation swap divergence

The past few sessions have delivered a head scratcher in the form of diverging long-term inflation swaps in the US and eurozone. At face value, this runs counter to the thesis that eurozone inflation is less under control due to the ECB being further behind the curve than its US counterpart. So far, markets were under the impression that by acting aggressively, the Fed managed to keep a lid on inflation expectations and thus on long-end rates. 10Y US CPI swaps crossing the 3% threshold (although break evens remain below that level at around 2.7%) is likely to give the Fed some sleepless nights, and would imply a more hawkish rhetoric going forward.

EUR inflation swaps suggest the ECB is more in control than it looks



Source: Refinitiv, ING

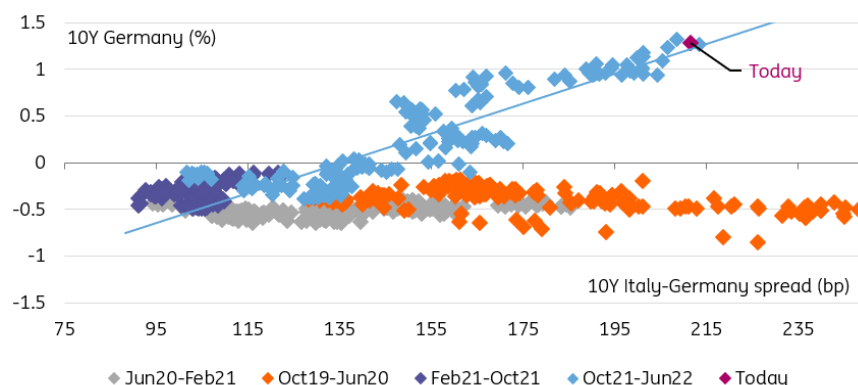
Even long-dated swaps tend to trade on short-term developments

At the ECB, we are inclined to attribute the drop in inflation swaps to the sharp re-pricing of ECB hike expectations. In a sense, this is a questionable assumption given that much of the eurozone's inflation is externally-generated, but even long-dated swaps tend to trade on short-term developments. There is also a growing assumption in financial markets that second order effects will add to inflation pressure. Ironically this also comes at a time the EUR yield curve remains stubbornly steeper than its USD equivalent both now and where it was at the same time into the Fed's hiking cycle.

At least one corner of the rates markets is showing some optimism

Meanwhile, Italian bonds are on a tear. There was little reaction on Monday to reports in the Financial Times that not only is there a proposal on the table at the ECB to prevent market fragmentation (central bank speak for a widening of credit spreads, especially in government bonds), but also that a majority of the governing council is ready to support it. It is hard to attribute the subsequent tightening to hopes of ECB intervention given the time lag. And yet, we're inclined to think prospects of ECB intervention (or not) hold the key to near-term sovereign spread developments.

Peripheral spreads tend to widen when yields rise



Source: Refinitiv, ING

Warm words from the ECB tomorrow would go some way towards calming spreads volatility

Warm words from the ECB tomorrow would go some way towards calming spreads volatility but we doubt they will be enough to convince private investors to return to peripheral bond markets in droves. When net purchases stop, the shortfall in demand will have to be made up by investors in the private sector. This is not impossible but the best way to convince them to is to reduce the risk associated with the peripheral bonds, or to offer greater yields. In the long-term, a more unified EU economic and fiscal architecture could achieve that risk reduction but, in the near term, the burden falls once again on the ECB's shoulders.

Today's events and market view

There is little on the events calendar so far this week but this hasn't prevented rates volatility from picking up a notch. We think the approaching event risks, in particular the ECB, could prompt a short-covering rally in the coming days but a resumption of the yields upside looks inevitable as long as the global growth outlook holds.

Markets will have one last day of low apparent event risk tomorrow before Thursday's ECB and Friday's US CPI. The main data release will be the final reading of the eurozone's 1Q GDP. This being the third iteration, chances of a surprise are relatively limited. In the afternoon, investors will look to MBA mortgage applications for further signs of a slowdown in the US housing market.

On the supply front, Germany and Portugal will sell bonds in the 10Y sector. This will be followed in the US session by the Treasury selling 10Y notes. On the other side of the bid-ask spread, Italy's treasury will buy back short-dated bonds today.

Author

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.