

Rates Spark: Testing market hawkishness

The Fed's more proactive inflation fight contrasts with a more cautious ECB stance, but the latter is confronted with higher uncertainty. We lay out three possible scenarios judging that in most cases, the further upside to rates looks limited. Inflation dynamics will remain key for rates while signs of softening growth have been duly ignored lately.

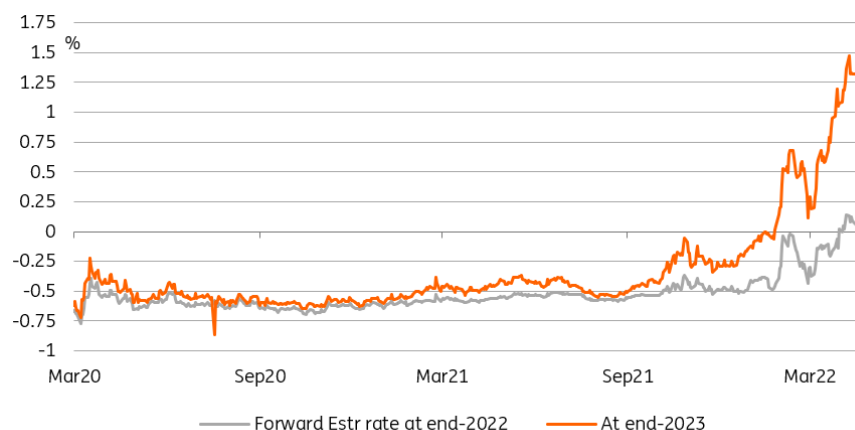


Hawkish pricing is here to stay for now

ECB President Lagarde reiterated the official mantra of data dependency, gradualism and maximum optionality. However, by now even a few officials less known to be hawks such as Luis de Guindos and Pierre Wunsch have brought into play a first rate hike in July. It appears hawkish sentiment is gaining more traction within the Council amid persistently high inflation, and markets have quickly adjusted towards discounting an almost 80% chance of a rate hike in July.

While markets have few qualms pushing short to medium maturity rates higher, there are some signs of fatigue when it comes to longer rates. Just yesterday the higher yields on the back of the aforementioned ECB comments were at least in part pared later in the session, leaving the curve with a notable bear flattening. Tellingly, it took the cue from US markets to lift the 10Y yield towards 0.95% again.

The ESTR curve reflects the ECB's latest barrage of hawkish comments



Source: Refinitiv, ING

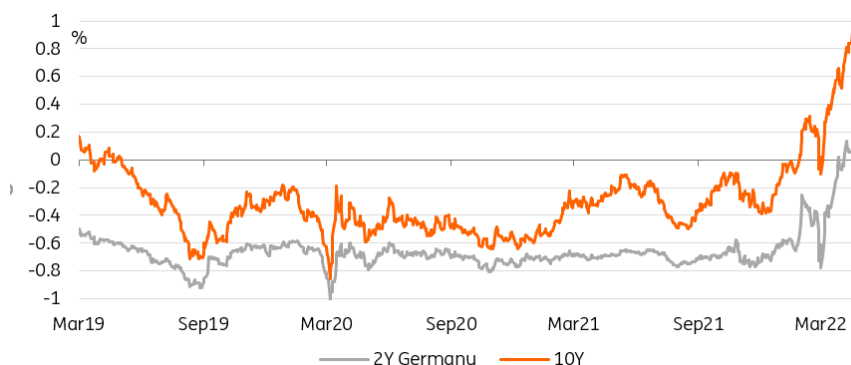
Laying out possible ECB scenarios

We will get the Eurozone PMIs today, which should paint a more nuanced picture of the economic outlook as the Ukraine war and higher energy and commodities prices start to bite. So far, markets have largely ignored the signs of a softening macro backdrop in their drive higher. In our view, one key test for the hawkish pricing will be next week's Eurozone inflation estimate for April. The headline is seen coming off its 7.5% peak, albeit only slightly. In the past, there has been a tendency to underestimate inflation dynamics, but a cooling of inflation is in our view a precondition for hawkish pricing to ease.

We see long end rates ending the current year little changed from now, that is the 10Y Bund at 0.9%, but declining in 2023 to 0.7%

Such easing would be needed for markets to realign with [our economists' baseline scenario](#). This sees the ECB hiking rates in September for the first time followed by a further hike in December and another two next year, bringing the deposit rate to 0.5% by the end of next year. In that case we would see long end rates ending the current year little changed from now, that is the 10Y Bund at 0.9%, but declining in 2023 to 0.7%.

10Y Bund yields look set to spike above 1% before going back to 0.90% in late 2022, and 0.70% in late 2023



Source: Refinitiv, ING

The currently aggressive pricing leaves little further upside in long end rates

Of course there are also the hawkish and dovish scenarios that need to be considered. The hawkish scenario is close to what markets are currently pricing at the front end, but it could still lead long end rates above 1.25% this year we think. The dovish scenario that brings back macro fears would see the ECB stop after bringing back the depo rate to zero. Long end rates could end the year considerably lower from now. Looking at these scenarios in sum through the lens rates markets, the currently aggressive pricing leaves little further upside in long end rates in our view.

Today's events and market view

The main data event are the flash PMIs. For the Eurozone the consensus expects services to fall 0.6 points to 55 and manufacturing to drop 1.6 points to 54.9 as higher prices and the war in Ukraine impact sentiment.

In the recent past signs of a softening macro backdrop have not kept markets from pricing in even more hawkish ECB paths with inflation concerns being front and center.

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