Rates Spark: The battle to keep policy tight

At Sintra, hawkish central bankers meet a deteriorating economic outlook, and face their diminished ability to tighten financing conditions. Inverted curves and lower real rates may be the counterproductive product of their single-minded focus

The European Central Bank Forum on Central Banking will take place from 26 to 28 June in Sintra, Portugal

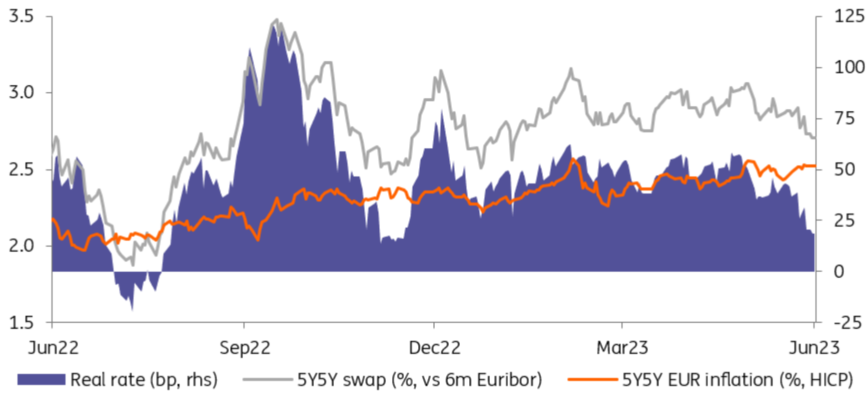
Hawkish messaging is only credible if the economy holds up

As the European Central Bank's (ECB) Sintra conference get underway, central bankers will have their eyes firmly on two important checks on their recent hawkish charge. Firstly, a deterioration in economic outlooks, illustrated by the plunge in Germany's Ifo index published yesterday, limits the credibility of any aggressive hawkish tone with markets fearing a recession. Secondly, it is not altogether certain that, in isolation, a more hawkish central bank results in materially tighter financial conditions.

> *The central banks' sphere of influence typically doesn't reach very far up the curve*

The first concern can in theory be addressed by a single-minded focus on backward-looking inflation. This is the strategy adopted by most central banks, also justified by their poor track record in forecasting inflation. By and large, this strategy has been successful in delaying rate cut expectations, but the central banks' sphere of influence typically doesn't reach very far up the curve, so the economic outlook still matters. Dhingra and Tenreyro have an easier job communicating the Bank of England's stance when they speak today, given the UK's entrenched inflation problem. Things are more challenging for Lagarde given the deterioration of European economic data.

Long-end EUR real rates have declined since May, hardly a tightening of financial conditions



Source: Refinitiv, ING

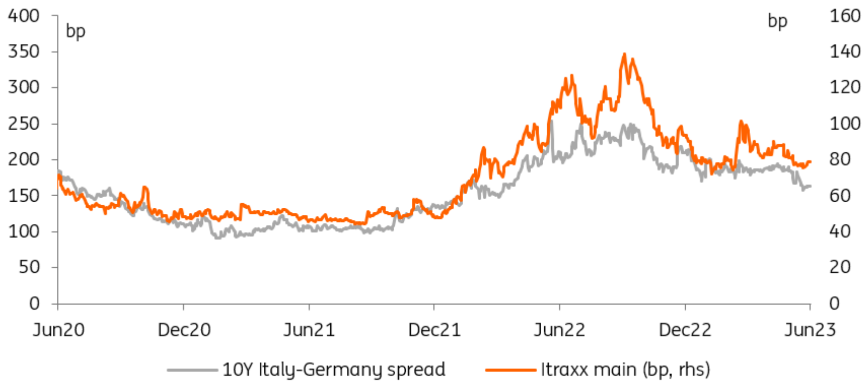
The monetary policy dilemma when markets won't listen

The second, related, point is that it is debatable how much central banks can really tighten monetary policy on their won in a data-dependent regime. There has clearly been a reappraisal of global central banks' reaction functions in June, but the result has been much flatter yield curves. To the extent that this is a symptom of higher short-end rates and unchanged long-end rates, this is a net tightening of financial conditions, an albeit a disappointingly limited one. The problem arises when, even as short-end nominal rates rise, long-end real rates drop. Taking EUR 5Y5Y real rates as an example, they have dropped 40bp since their peak a month ago, hardly a tightening of financial conditions.

Tighter sovereign and credit spreads suggest the cost of funding remains affordable for the economy

What's more, risk assets have taken the recent change of central bank tone in their stride, see for instance the spectacular tightening of sovereign spreads. The ECB may well gush that its policy stance is well transmitted, tighter sovereign and credit spreads suggest the cost of funding remains affordable for the economy. This is good news, but also suggests that a more hawkish stance is needed to yield results, but with increasing downsides. This is the choice faced by central bankers at this week's Sintra conference: chase the diminishing returns of a hawkish stance, or accept that a lot of the financial variables responsible for ultimately supressing inflation are beyond their control.

Risk assets have taken the more hawkish central bank tone in their stride



Source: Refinitiv, ING

Today's events and market view

The data calendar this morning is dominated by Italian sentiment indicators, followed in the afternoon by US durable goods orders, house prices, new home sales, conference board consumer confidence, and the Richmond Fed manufacturing index.

The ECB's Sintra conference is underway with interventions scheduled by President Lagarde, and Dhingra and Tenreyro from the Bank of England. More curve flattening is on the cards if central banks continue to push the hawkish envelope, at the expense of a slowing economy. This may take the form of a bear-flattening, however, given the recent fall in rates.

The weekly ECB MRO allotment will be in focus as the facility might be used by some banks to finance the repayment of TLTRO loans.

Bonds supply will come from the Netherlands (30Y), Italy (3Y/7Y), and the UK (10Y Linker).

The German federal state will publish its third quarter funding update.

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