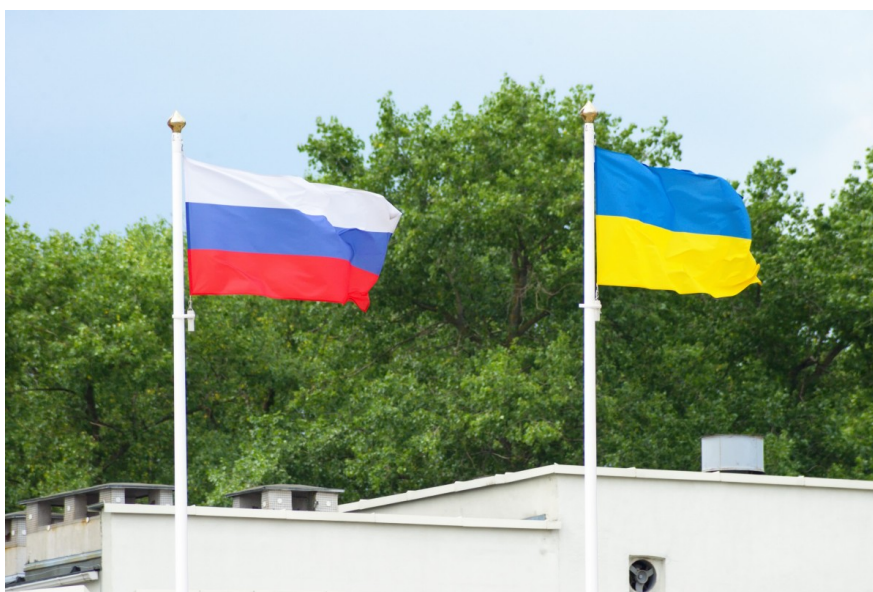


Rates Spark: The bear in the room

Fears of wider conflict in Ukraine have added to safe haven flows overnight. In rates – caught between geopolitics and accelerated monetary policy tightening – swings in risk mood should play out in longer tenors.



Russia and Ukraine flags

ECB: more "flexibility" and "optionality" amid a murky outlook

The crisis adds to an already greater than usual uncertainty – also for monetary policy outlooks. Its impact on prices and growth will be assessed at the March meeting, ECB's Villeroy said yesterday, but even then it may well be that the outlook for potential sanctions and energy price dynamics remains murky. Not without reason he stressed that "flexibility" and "optionality" were key and of even greater importance in light of the crisis.

EUR markets have few reasons to back off from their front-end pricing

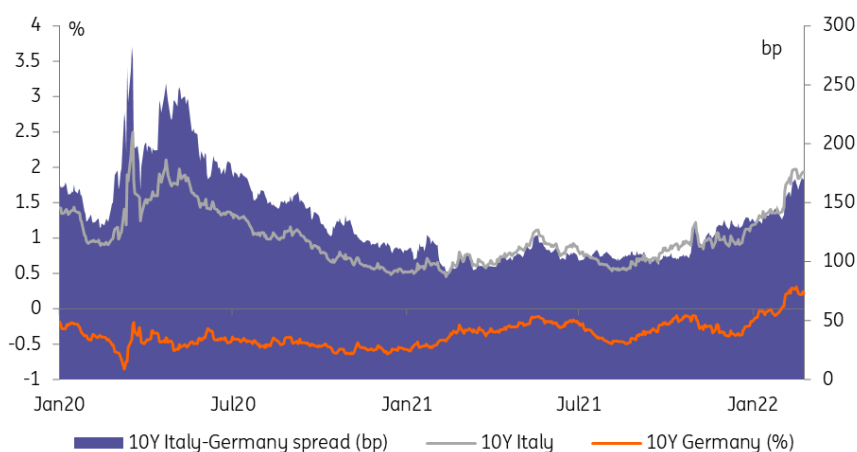
But front-end pricing of rates has proven relatively sticky. The ECB is still widely anticipated to change its guidance on asset purchases to make room for a rate hike this year. It is currently fully

discounted for October. And when dovish ECB members like de Cos indicate that lift off conditions may be met earlier than currently seen, EUR markets have few reasons to back off from their front-end pricing.

It is no surprise to us that the prospect of ending asset purchases and greater volatility is continuing to hurt Italian sovereign bonds. With tomorrow's bond auctions likely weighing as well, the 10y spread over Bunds pushed above 170bp yesterday. De Cos at least hinted that the ECB is aware that using the flexibility of PEPP reinvestments may not be enough, remaining "vigilant" on the topic.

But it was only ECB's Stournaras last night who spelled out more explicitly what may be needed in the face of the geopolitical crisis. He favours not to announce an end to APP in March. It should be kept open ended, adding flexibility by removing the guidance that net purchases would end "shortly" after a first rate hike.

ECB is showing more awareness of rising sovereign spreads



Source: Refinitiv, ING

BoE to markets: Don't get carried away

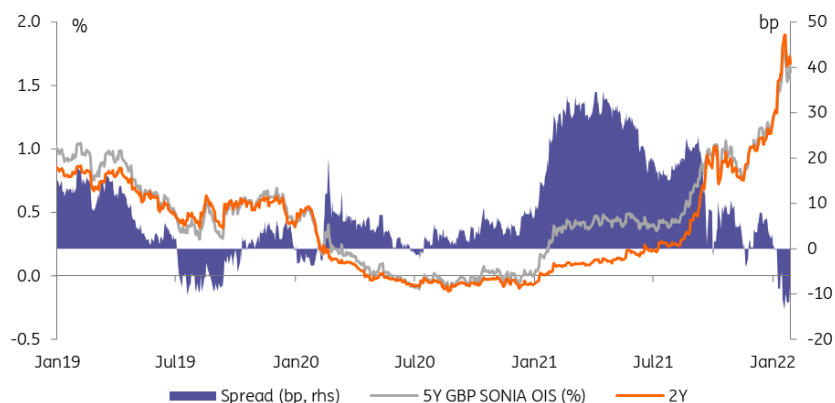
But then there is also the notion that market expectations had gotten ahead of themselves already before latest escalation of geopolitical tensions. That being the case for the UK rates markets which still discount at least five 25bp rate hikes from the Bank of England (BoE) before the year is out. We also remain of the view that the hump shaped SONIA OIS forwards curve – a steep increase in rates this year followed by rate cuts thereafter – still plots an unhealthy policy path.

the hump shaped SONIA OIS forwards curve still plots an unhealthy policy path

Yesterday's BoE testimony to the Treasury select committee saw Bank officials pushing back against the steep curve again. It was as clear as it gets if one does not want to put numbers to it. And while it was not the first time we have witnessed such pushback, Governor Bailey stating that

the market should “not get carried away” did see front-end rates come off and the sterling curve bull steepen as a result - 2s10s by some 4bp.

The 2s5s SONIA curve has been inverted amid aggressive hike expectations



Source: Refinitiv, ING

Cheap area of US curve taken down with ease

The 5yr auction saw another impressive indirect bid, following on from a similarly impressive bid at the 2yr yesterday. It is indicative of a firm foreign bid to US paper. The 5yr area of the US curve is cheap, but has been re-richening in recent weeks. We expect this process to continue. The overall tone remains bearish though, as the 10yr has edged back towards 2% despite the additional geopolitical uncertainty. The front end too continues to brace for rate hikes to come from the Federal Reserve, as the 2yr holds now at 1.6%. It is quite a mixed set of circumstances, as there is a good bid at auctions, yet yields have a tendency to head higher. Many players will use such auctions as an opportunity to average in over time. The 7yr is up for auction today, as we'd expect a firm reception for this too.

Today's events and market view

Geopolitical headlines should remain the driver of risk sentiment and thus longer rates.

Away from that market pricing of tightening cycles will be evaluated against the backdrop of further central bank comments. From the Fed, Barkin, Bostic and Mester will speak. Of particular interest, also with an eye on the worrying dynamics of Eurozone periphery bonds, should be ECB Schnabel's participation in a panel on “unwinding QE” at a BoE conference.

In data the focus is on the US where we will get the second 4Q GDP reading and initial jobless claims data. The supply focus is also on the US with the sale of US\$50bn in 7y notes in the evening.

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