Rates Spark: The end is nigh

Omicron may not be the end of the world, but inflation is surely seeing an end to central bank purchases. That is the upshot of the final guidance provided by ECB speakers ahead of next week's crucial meeting. Thus positive news on the pandemic front is putting pressure on sovereign spreads and political events early next year are adding to concerns.

Source: Shutterstock

As critical central bank meetings draw closer Omicron is still making the headlines. As the severity of the illness and vaccine efficacy are being assessed, any results are still preliminary and come with many caveats. Firm conclusions will only emerge as more data becomes available alongside the further spread of the new virus variant. It is indeed quickly spreading, leading to more restrictions in public life such as in the UK.

But the recent Covid news also offer a glimpse of hope. At least enough for rates to focus on the inflation issue at hand and to surge higher again yesterday, also with curves steepening noticeably for a change after flattening pressure had prevailed. Bund asset swap spreads extended their tightening.

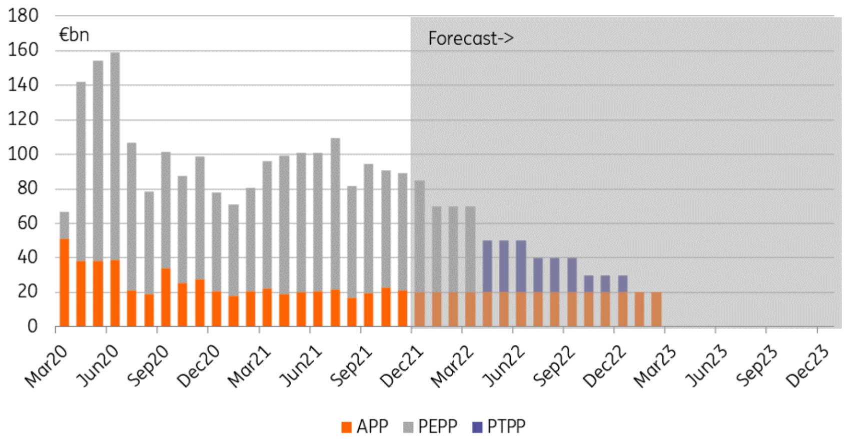
Omicron is unlikely to prevent the ECB from scaling back QE

ECB speakers have reiterated their confidence that the ECB is now better equipped to deal with Omicron and that it will not derail the economic recovery. There have also been voices again calling for more time to assess the next steps, this time from ECB's Rehn. But more optionality can cut both ways and inflation remains the larger issue at hand for central bankers.

Optionality can cut both ways and inflation remains the larger issue at hand

The ECB's Schnabel made the case for phasing out asset purchases as the recovery gains traction - stick to this tool for too long and unwanted side effects will eventually outweigh. She pointed to asset price inflation and market functioning - with a nod to the current year-end collateral scarcity issues and the problem of moral hazard. With her also dismissing the notion floated by the ECB's Holzmann that the sequenced exit as predicated by the forward guidance could be altered, the upshot remains that the ECB is quickly moving closer to at least significantly scaling back its net asset purchases.

ECB looks set to phase out net asset purchases



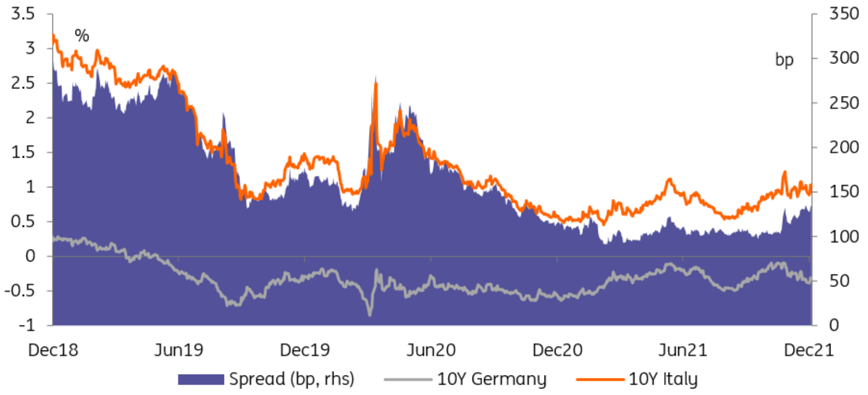
Source: ECB, ING

Italian politics move into view again

It was central bank buying support that had benefitted periphery sovereign bonds most. Against a backdrop of support dwindling it comes as little surprise that the widening pressure on spreads persists. The 10Y Italy-Bund spread is again close to its widest levels for the year and erased a brief tightening streak on the back of last week's rating upgrade.

It also does not help in this environment that markets are reminded of the upcoming election of the next Italian President in January. Mario Draghi is seen by many as a prime candidate, but giving up his premiership could risk destabilizing the current national unity government that oversees the implementation of the EU's recovery plan. Taken together, we think these risks will push 10Y spreads to 150bp early next year.

Wider Italian spreads reflect waning ECB support, and political risks



Source: Refinitiv, ING

Today's events and market view

Markets will take central bankers' guidance and are now left to interpret it against the backdrop of developing Omicron news flow. But we think beyond any short term resteepening on positive news, lies more curve flattening as policy tightening is priced back in.

Today's only notable data and primary market events come from the US. We will see the release of initial jobless claims data as well as a reopening of the 30Y bond by the US Treasury.

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