

Rates Spark: The dovish Charge of the Light-touch Brigade

Thursday's ECB rate decision is apparently on a knife edge. This should also tell you that there is a very broad range of possible hike outcomes by year end, do not dismiss anything. The upshot is higher front-end rates volatility, especially with the explosion in swap spreads and collateral shortage



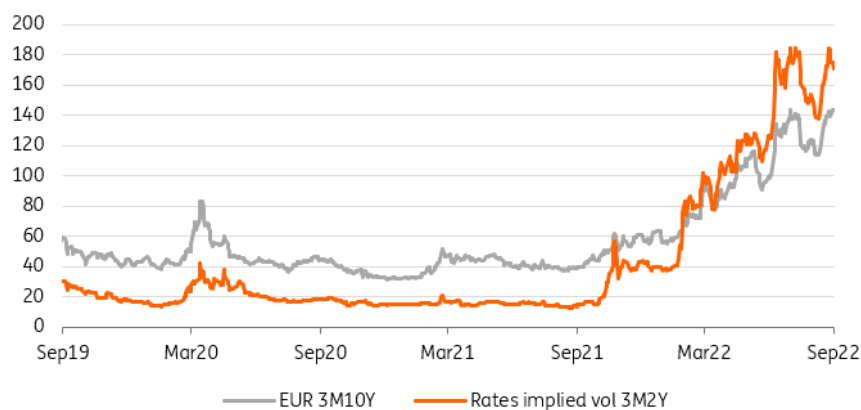
ECB doves out in force, but enough to force a 50bp hike?

Despite the ECB's pre-meeting quiet period being in full force, it seems doves have mounted a last minute, and coordinated, push to [a more gradual approach to policy normalisation](#). Fabio Centeno, Yannis Stournaras, and to a lesser extent Martins Kazaks and Edward Scicluna, seem to push back against the barrage of hawkish comments that have coloured ECB communication in the past few weeks. The disagreement on the face of it does not seem insurmountable, but they highlight that whatever policy decision is taken tomorrow, a 75bp hike is not yet set in stone.

A 75bp hike is not yet set in stone

The main takeaway from our four doves (for the purpose of these comments at least) was that they did highlight the policy trade-off between fighting inflation and safeguarding growth, something the hawks, and other central banks such as the Fed, have been at pains to dismiss. Ultimately ECB forward guidance, for it hasn't abandoned the idea of steering market expectations despite what it says, should be taken with a pinch of salt by markets. In addition to a wide range of opinions today, the range of possible economic outcomes into this winter should in turn convince markets that it is very difficult to predict ECB policy even a few meetings into the future.

2Y implied EUR rates volatility has overtaken 10Y



Source: Refinitiv, ING

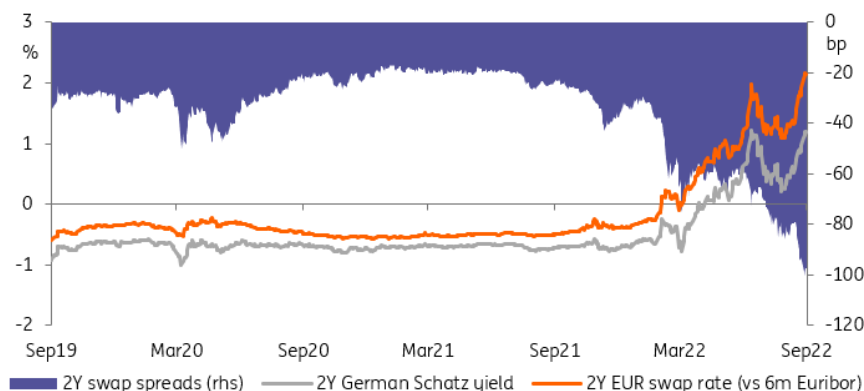
Don't get wedded to any specific ECB outcome, and expect more volatility

The implications are twofold. First, even out-of-consensus calls [like our own for only another 75bp of hikes this year](#), are far from impossible if the economy takes a turn for the worse between this meeting and the next. On the other hand, more hikes than the roughly 150bp priced for this year, let alone next, are definitely possible, especially if governments expand support measures for energy consumers. The second implication is that rates volatility at the short-end is definitely warranted, more so than for longer maturities which should rely mostly on much slower-moving estimates for long-term equilibrium interest rates.

Rates volatility at the short-end is definitely warranted, more so than for longer maturities

On the topic of front-end volatility, the explosion in swap spreads is gaining more attention in rates markets. The 0% rate cap on government deposits at the ECB (or at national central banks) means [some national treasuries have suspended their repo operations](#) as they will soon get a much worse rate on their deposits than the interest rates they are paying on repos. Similarly, we expect national and sub-national treasuries to prefer parking their excess cash into short-term securities rather than earning nothing by placing it at their domestic central banks. Both effects are worsening the collateral shortage, and widening swap spreads.

The collateral shortage is widening the gap between bond yields and swap rates



Source: Refinitiv, ING

US 10yr continues to journey towards 3.5%

The rise in US market rates and the pressure it places on wider core rates continues. The US economy is clearly refusing to lie down, with yesterday's ISM number a reminder of this. The structure of the curve has moved from being a bullish one for bonds to quite a neutral one (positioning of the 5yr to the curve). But it has not quite switched to outright bearish positioning. This continues to imply that a rise in the 10yr back towards the high hit at 3.5% in June remains on the cards, but not necessarily a big rise beyond that (so far).

The US economy is clearly refusing to lie down

The 2yr is already there (at 3.5%), and the market has 3.75% to 4% as an end game for the Federal Reserve. The risk going forward is that the market decides to edge this even higher. The fact that risk assets are lower will not worry the Fed here. The key thing is whether the system can take it. Based off where banks can print commercial paper as a spread over the risk free rate, the system remains in good shape (as that spread remains exceptionally low). The rising rates environment has more to go, and that also forms the background music as the ECB faces its own key decision on Thursday.

Today's events and market view

Bank of England governor Bailey and other members will appear in front of the treasury select committee. It is hard to imagine the questions and answers not being heavily interpreted by markets with an eye on next week's policy meeting.

Germany will add to long-end supply this week with a 15Y auction worth €1.5bn. This is the last scheduled euro sovereign bond sale of the week so we expect the long-end to trade better afterwards.

Eurozone Q2 unemployment and GDP will feel dated and the economic focus will likely be

on US July trade in the afternoon instead.

There is a long list of Fed speakers today including Thomas Barkin, Loretta Mester, and Lael Brainard.

Authors

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

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