

## Rates Spark: The next leg higher

Inflation should remain the dominant driver of EUR rates well beyond the upcoming ECB meeting, although we note a shift in dynamics amid the latest leg higher. The US Treasury curve set-up suggests we might not have seen the turning point yet



### The ECB doves' road map outlines a bare minimum

ECB President Lagarde and Chief Economist Lane had been unusually explicit when laying out the road map for the next meetings – announcing the end of net asset purchases at the upcoming June meeting and a follow-up with 25bp hikes at the July and September meetings are the “benchmark case”.

In the final days ahead of the communication black-out period starting today, this attempt by the dovish wing of the ECB Council at reclaiming control over the narrative was upended by the higher-than-anticipated inflation readings.

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*The road map does not keep the market from further extrapolating the trajectory*

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Their road map may have dampened market willingness to further price in 50bp hikes, especially at the explicitly referenced July and September meetings – for the July ECB meeting the respective forward traded some 34bp above the current level of overnight rates so actually only a tad higher than before the inflation data – but it does not keep the market from further extrapolating the trajectory.

For the December meeting the forward overnight rate now stands 110bp above current levels. It reflects the expectation of a 25bp rate hike at each of the four remaining ECB meetings in 2022 after June – with chances that of one the hikes turns out larger. Further out the 1Y1Y ESTR forward rate rose more than 30bp over the course of the past week to above 1.5%. After all even Lagarde pointed out "progressive further normalisation toward the neutral rate."

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### *All gradualism goes out the window if inflation turns 'ugly'*

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It does pose the question where the aforementioned neutral rate resides with Council members this week pointing to levels anywhere between 1% and 2%. For now this is also why the ECB continues to call for "gradualism". With no way of pinning down the neutral rate one has to feel its way towards it – "small steps in a dark room" as the ECB's Panetta titled one of his speeches late in February. But even this arch hawk is aware that all gradualism goes out the window if inflation turns "ugly" and expectations become unanchored. In the wake of the recent inflation surprises and also the uncertainty surrounding Europe's energy situation, markets will increasingly have to account for that scenario. Whether it will be realised in the end is another question. It is not our base case and markets should eventually price a shallower trajectory.

## **Notable shifts in dynamics amid the latest EUR rates sell-off**

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### *10Y Bund ASW breaks with the directional widening trend*

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Further out the curve rates have also shifted higher, longer term growth concerns not outweighing yet. The 10Y Bund yield has closed in on the early May intra-day high of close to 1.19%. However, there are some notable shifts of dynamics in the latest sell-off. Note that 10Y Bunds have underperformed versus swaps, ie, the ASW spread has actually tightened amid rising rates, breaking with the directional widening trend dominating before. What is more the 10Y Italy-Bund spread widened back towards 200bp at the same time that the Bund ASW tightened, counterintuitive to a flight-to-safety link one would expect.

It is still early days, but one could be tempted to attribute this to the ECB's quicker retreat now also impacting Bunds, such as an end to APP reinvestments in the not-so-distant future having to be factored in.

## **US Treasury curve set up still points to higher rates**

The narrative of a possible Fed pause in September had helped to support risk assets while keeping

a lid on rates ahead of the Memorial Day holiday in the US. That lid, however, was lifted yesterday by a surprisingly solid [ISM manufacturing report](#). Don't mind the fall in the employment component, our economist puts this down to the supply factors. The same factors which should also see the non-farm payrolls tomorrow at least "optically" disappoint.

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*The turning point in rates may have not been reached just yet*

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The US 10Y Treasury yield is pushing back towards 3%, hitting 2.95% yesterday. But it was the belly of the curve that bore the brunt of the sell-off with the 5Y area now 20bp higher versus last week's lows. As we have noted last week, with the 5Y Treasury looking cheap (and now even cheaper) on the curve, the 2Y-5Y curve continuing to show resistance to flattening, we think the turning point in rates may have not been reached just yet.

## Today's events and market view

Ahead of the official US jobs data some will turn to the ADP report for additional hints, but its track record at predicting the official release is patchy at best. For current job market dynamics the weekly initial jobless claims data will be a guide.

Despite yesterday's solid ISM and the upcoming jobs data tomorrow, the economic backdrop remains in flux. It will not be the end to the discussion surrounding the Fed taking a pause after the next two 50bp hikes. As such, Fed speakers will continue to grab the headlines, though for today we only have Mester scheduled to speak about the economic outlook later in the day.

Amid ever-growing inflation concerns in the Eurozone the PPI will likely make the headlines, with a 38.2% year-on-year rise expected. The ECB speakers scheduled for today, France's Villeroy and Spain's de Cos, are likely to refrain from commenting on the upcoming policy decision given the pre-meeting blackout period started today.

In Eurozone supply France will be active with the sale of 10Y, 15Y and 30Y bonds for a total of up to €10.5bn. Spain sells 3Y, 7Y, 9Y and inflation linked bonds for up to €5.25bn.

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