

Rates Spark: The plot thickens

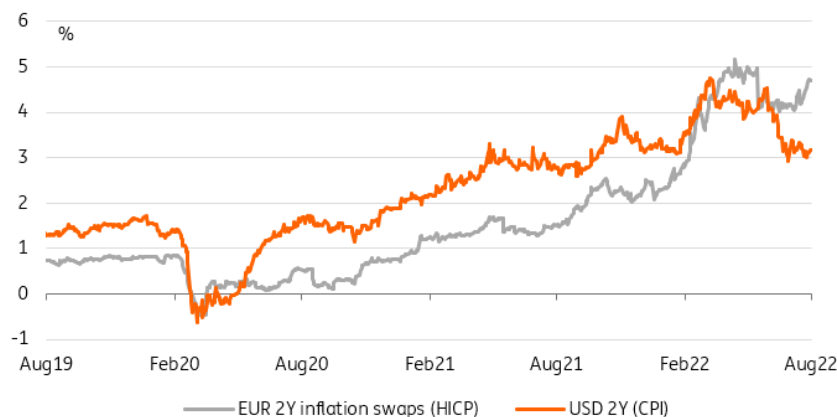
If you think the US doesn't face enough policy challenges, try Europe. We doubt European markets would react well to either a more hawkish or more dovish European Central Bank. Curve flattening, and lower Bund yields, is our base case for now



Goldilocks doesn't travel well to Europe...

The struggle by the Fed to tighten back financial conditions as markets perceive a pivot around the corner should not distract from the even greater policy challenge faced by the ECB. [As our economics team noted](#), adverse news are raining thick and fast on the eurozone, unlike the water needed to bring up the Rhine River levels. A European recession is now part of the economic consensus. It is no longer a question of if, nor of when, but of how bad things will get over the winter months.

Swaps are pricing inflation under control in the US, but surging in Europe



Source: Refinitiv, ING

In a related development, eurozone inflation expectations, as priced by swaps, have further diverged from their US equivalent. Whilst this probably owes in large part to higher energy prices, this throws an even greater policy challenge to the ECB. Even if it hikes 50bp in September, the meeting and accompanying forecast should see it finally acknowledge the dismal economic prospects facing the eurozone. Call that taking a leaf out of the Bank of England's playbook. Even if it persists in seeing the world through pink-tinted goggles, European markets will struggle to see that glass half full.

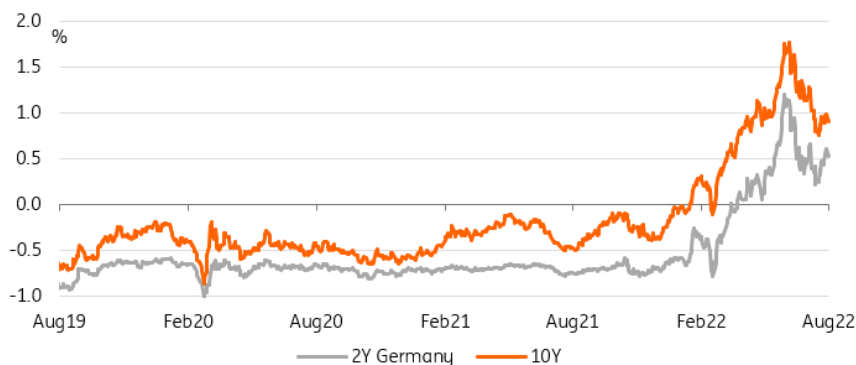
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Indeed, the ECB faces the unenviable task of choosing between tightening financial conditions to fight an inflation problem it is ill-equipped to resolve, or to stand pat in the face of higher-than-expected inflation. As the Fed's experience has shown, perception of a more dovish central bank (aka a pivot) can actually result in higher inflation expectations, higher rates volatility, and higher long-end rates – hardly a favourable backdrop for risk sentiment.

... and she has some questions about Bund valuations

At this stage of its hiking cycle, it is possible that the ECB continues to bang the hawkish drum in order to salvage some inflation-fighting credibility. The US experience suggests that the curve should flatten on such headlines. The difference is that the ECB is earlier in its hiking cycle, and that inflation risks being stickier than in the US. This in turn could make ECB hawkish sound bites more credible to markets.

10Y Bund rallying to 0.6% would also see the curve flatten further



Source: Refinitiv, ING

Risk aversion will continue to exert downward pressure on long-end yields, resulting in a further flattening

Will this propagate to higher long-end rates? Possibly, but we think the burden of proof lies with those arguing for a change in market dynamics. For now, we think risk aversion will continue to exert downward pressure on long-end yields, resulting in a further flattening. The counter argument is whether all the bad news is already in the price. Bunds travelled back to 1% last week temporarily and a bottoming out of the Zew expectations today could indicate that peak negativity has been reached. Still, our Bund yields forecast for early 2023 is 0.6% as it seems too early to argue that eurozone recession fears are already priced in.

Today's events and market view

The Zew survey of investors offers, as always, a read on market sentiment early in the month of August. Bloomberg consensus has the widely-followed expectations component stabilise at low levels. This comes after a week where bonds struggled to rally despite a steady drumbeat of bad economic headlines, begging the question of how much bad news is in the price already.

Germany kicks off this week's front-end focused supply slate (the next item is France on Thursday) with a €4bn 5Y auction, adding a technical short-term driver to our curve flattening view.

US data releases feature housing starts and building permits, both important gauges of the housing sector health, and thus of how much will the shelter component of the CPI decline in the coming year. The National Home Builders Association's survey released yesterday clearly point to more weakness. US industrial production will be the last data point for the day.

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