

## Rates Spark: The rates upside remains real

Completing the shift of the market narrative towards growth concerns, bonds are reasserting their role as safe havens. The European Central Bank minutes confirmed the Council's desire to act faster, also with an eye on still ultra low real yields



### Bonds' negative correlations with risk assets consolidates amid growth concerns

As markets continue to trade in a risk-off fashion, bonds have managed to reassert their role as safe havens. The pattern of bond curves consistently rallying flatter as risk assets sell off has only reestablished itself over the past few sessions. In a way this dynamic completes the transition of the market narrative toward growth concerns, away from being dominated by central banks' prospective tightening lifting market rates out the entire curves.

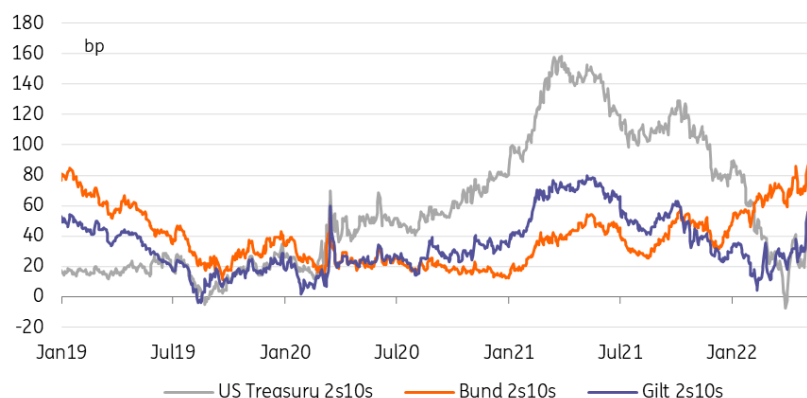
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*bonds have managed to reassert their role as safe havens*

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This does not mean that data releases couldn't shift the focus again. Next week will offer some opportunities with the release of the flash PMI surveys for instance. And if the Fed deems inflation (expectations) are not coming down fast enough, it may well use the FOMC minutes next week to signal more hawkish moves. The 75bp-hike discussion is not entirely off the table. Unlike the ECB, the Fed has used its meeting minutes as a more active communications tool, such as outlining its plans for the balance sheet run-off. We will also watch the PCE deflator, the Fed's preferred inflation gauge at the end of next week.

## Risk-off drives curves flatter



Source: Refinitiv, ING

## ECB minutes, outdated but also highlighting the upside in rates

The ECB minutes have been overtaken by the quick evolution of ECB communication since the last meeting. The indication now is that a majority of the Council is backing ending net asset purchases in June and hiking for a first time in July is already common place. And markets are attaching some probability to hikes larger than 25bp.

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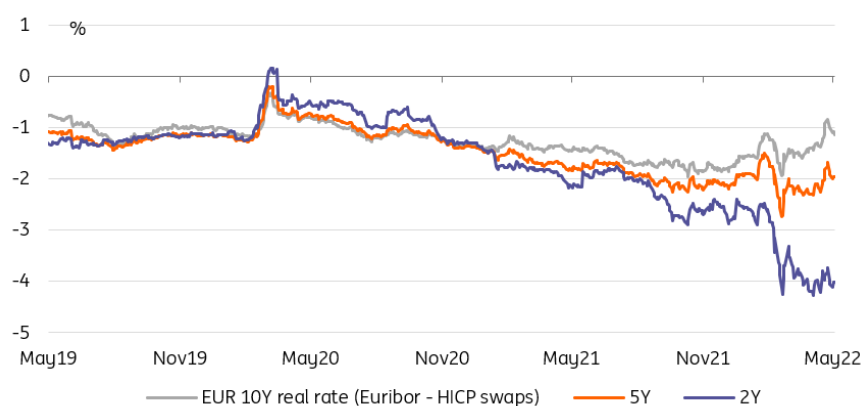
*The ECB has to increasingly grapple with potential de-anchoring of inflation expectations*

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That does not mean that the known objections of the Council's doves are invalid: too fast tightening being counterproductive, weighing on growth without being able to do anything about inflation driven by supply shocks. The line of reasoning still holds and explains market concerns reflected in current curve flattening. But the ECB has to increasingly grapple with potential de-anchoring of inflation expectations with some of the related measures already displaying notable shifts.

This shift in some inflation expectation measures had been outlined by Isabel Schnabel in one of her more recent speeches. She had also highlighted the still very low level of real yields. This hawkish argument was also found in yesterday's minutes, with real yields remaining low while the rise in nominal yields was not enough to dampen aggregate demand and bring down inflation in the medium term.

## EUR real rates have a long way to go



Source: Refinitiv, ING

It is worth noting that back around the April ECB meeting the 10Y swap rate was just below 1.6% versus a current level of 1.65%, although following a decent rally after a brief excursion above 2% earlier this month. Real rates remain deeply negative regardless of the maturity, and if this is a measure considered instrumental at reining in inflation over the medium term, then we may have to reckon with more upside to rates. The important question is whether the ECB will have enough time to realize its goals.

## The ECB's "separation principle" is still lacking detail

The "separation principle" referenced in the ECB accounts states the idea that monetary policy could be set independently from any measures designed to avoid disruptions triggered by any such policy tightening. More specifically to the current situation, Eurozone sovereign bond spreads could be managed while the ECB starts hiking. However, as of now the ECB has still not provided any details on how such a tool could look in practice. Beyond stating the need to keep flexibility and pointing to the potential use of pandemic emergency purchase programme reinvestments, it appears there is no desire to have a broader discussion on the topic just yet.

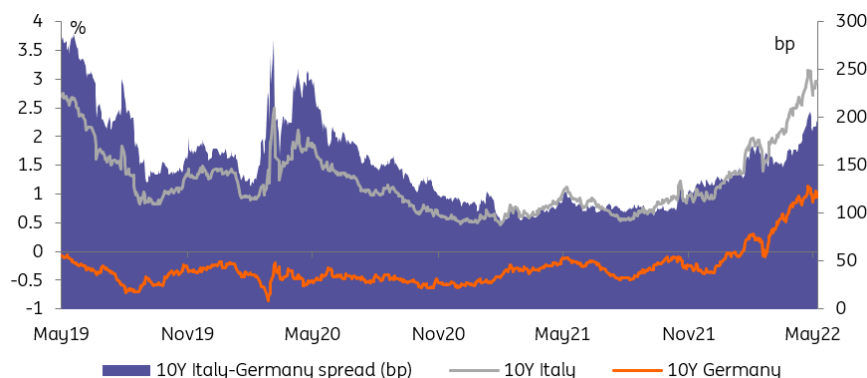
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*With ECB plans still vague, Italian bonds especially remain vulnerable*

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With ECB plans still vague, Italian government bonds especially remain vulnerable. In the current risk-off environment Italian bonds are still positively correlated with Bunds, ie, they do not trade as risk assets, but the spreads have started to widen towards 195bp in 10-year maturities. We still think the market could test out [widening this spread towards 250bp before the ECB steps in](#).

## ECB plans remain vague, leaving Italian bond spreads vulnerable to further widening



Source: Refinitiv, ING

### Today's events and market views

In terms of data and events it will be a quieter session today. The main focus will be on central bank speakers with the ECB's Muller, Kazaks Lane, and Centeno all scheduled for the day. In the UK we will hear from the Bank of England's Chief Economist Huw Pill. Main data of note is the Eurozone consumer confidence.

In this shaky risk environment, we expect bonds to retain their poise. It would take a lot of good news for yield upside to resume at the long-end, but central bankers should keep the heat on shorter rates.

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