

Rates Spark: Two-way risk

Even with downside risk to activity rising, central banks are hedging their bets. This could be a double whammy for risk sentiment, and even safe havens are losing their efficacy. US market rates have decided the only way is up for now, with auction indigestion a part factor. But, we've been here before. Now it's the lure of inflation versus the pull of Covid.



US market rates ratchet higher

Rounded, we're back in the 1.7% area of the US 10yr. We've been here three times in 2021; March, a month ago and again now.

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There have been two themes in play. First, inflation is humming in the background, and at well above the level of nominal rates. Second, there have been a number of tailed auction events in the

past couple of weeks. The last 30yr was an eyesore. The 10yr, 2yr and 5yr also hiccuped. The 7yr yesterday was better, in fact quite good. But it had cheapened up quite a bit from where it started out the week. Either way, there has been at least some sign of reluctance to just take down whatever's on offer.

On the other hand, the flows data of the past few weeks have tended to show inflows into core government paper. If that flips on the secondary market, as it appears to be doing so on primary, then we can sail higher in terms of market rates.

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Many have written off 2% as a runner for the US 10yr, but it's still very much there as a target. Push the fed funds strip out far enough and it does touch 2%. The 10yr yield should really trade at a discount on top of that, in turn with a terminal fed funds rate in the 1.75% area, plus a spread. Nothing new here. It's been the story of 2021. But it's also been quite a grind, and we are still not there as of yet.

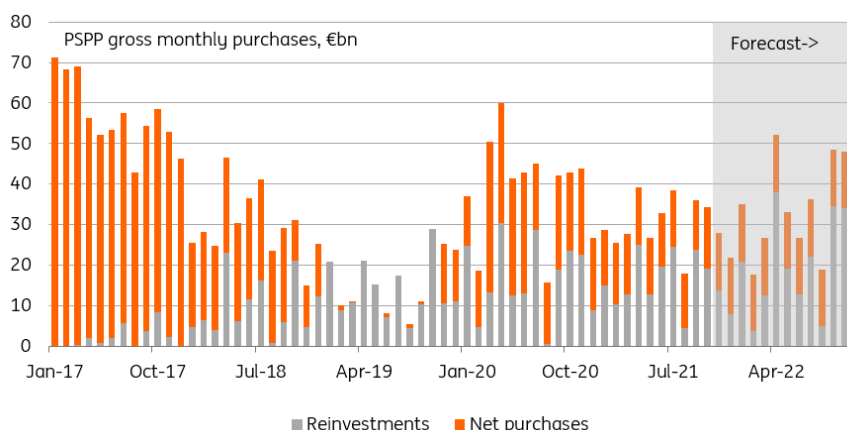
We also have a significant Covid spike out of Europe to contend with, with the risk that some of it gets echoed in the US. For now, the lure of elevated inflation is dominating, with even the Bundesbank talking of 6% inflation. A 2% US 10yr yield looks puny in front of that.

ECB stance: second prize

With each passing day, it becomes increasingly clear that both upside and downside risks to the outlook are mounting. Truth be told, upside risks are mostly seen for inflation, while downside risks primarily affect activity.

When it comes to the 'only needle in the ECB's compass', to borrow a phrase from former President Jean-Claude Trichet, board member Isabel Schnabel made very clear that some factors could prevent inflation from falling back below 2% in 2023. It is beyond the scope of this publication to detail them but our economics team has written [a summary of the interview](#). As they noted, it is as clear a sign as it gets for the ECB to raise the possibility of policy tightening, even if it probably won't occur before 2023.

Reinvestments will become the dominant force in QE purchases



Source: ECB, ING

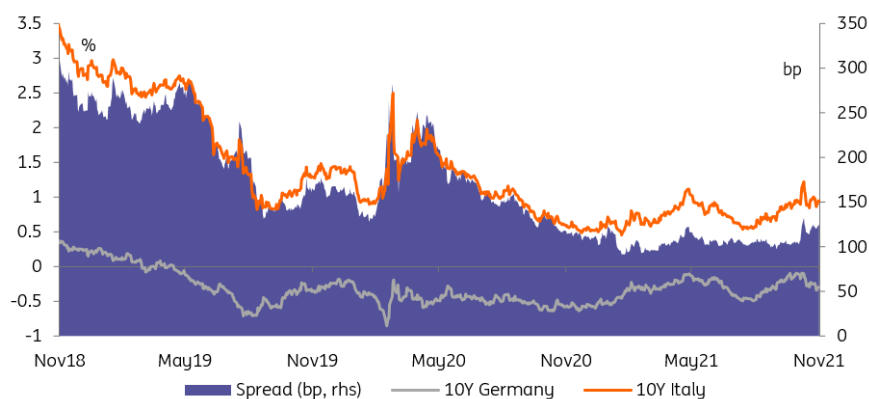
The size of the ECB's holding will ensure meaningful reinvestment flow

But concerns about the ECB's stance could start long before 2023. Schnabel seemed increasingly doubtful of the benefit of extending the ECB's balance sheet through new purchases, stressing instead that reinvestment of existing holdings is the main tool to contain threats to monetary policy transmission. To many in financial markets, this will feel like getting the second prize, but note that the size of the ECB's holdings will ensure meaningful reinvestment flows in the years to come (see for PSPP above). Taken at face value, her comments seem to suggest no PEPP extension, no boost to the APP, and no programme to replace PEPP past March 2022.

Bond markets: without the crutches

We have long argued that EUR spread products are vulnerable as the ECB considers its exit strategy. Given the carry shortfall if investors steer clear of high beta fixed income, reluctance to endorse that view is understandable. There is another risk on the horizon however, that of a deterioration of the economic outlook. Yesterday's PMIs and perhaps today's Ifo, may paint a somewhat rosier picture than what will occur over the winter months if more Covid-19-related restrictions are imposed.

Spread widening has remained relatively limited



Source: Refinitiv, ING

Both fiscal and monetary props under risk sentiment are looking a little shakier than before

Shocks to risk assets have generally proved short-lived this year and last, owing in part to aggressive fiscal and monetary responses to Covid-19. Given the inflation threat, and how it is playing out politically, we think both props under risk sentiment are looking a little shakier than before. It is also interesting that some spectacular market events such as the fall of the Turkish lira failed to provide much of a bid to traditional safe havens such as Treasuries and Bunds, also owing to the more hawkish monetary backdrop.

Today's Events and market view

In the European morning, the German Ifo should be the market's main focus. Admittedly, yesterday's PMI release should have taken the wind out of its sail. On that basis, most will expect a rebound in the Ifo but we doubt its ability to move markets much if this proves correct. Bear in mind also that [the PMI strength masks the risk of a decline in subsequent months](#) if more Covid-19-related restrictions are imposed.

There will be more action on the US data front. Some of the releases (3Q GDP second release and final University of Michigan consumer confidence) will feel slightly dated to investors but others, such as jobless claims and October new home sales, consumer income, spending and PCE), will be more current.

The Fed will also release the minutes of the November FOMC meeting. Tapering is on everyone's mind, so is upside risk to inflation. On the former, there will be special attention to any discussion around the possible acceleration of the taper schedule after December. On the latter, the meeting was prior to the latest upside inflation surprise but any additional sense of urgency on that topic will resonate with already skittish US markets.

Schnabel is the only ECB speaker on the schedule.

Germany will sell 15Y debt.

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