Rates Spark: Wider and flatter

Curves flattened in reaction to the European Central Bank hiking by 50bp already now. And after the ECB comes the Fed, which is set to deliver another sizeable hike next week, supporting an underlying flattening dynamic. Amid political uncertainty Italian bonds need not look to the ECB for help as activation looks far from being imminent

The European Central Bank raised rates by 50bp and Italian elections are scheduled for 25 September

ECB front loading can prolong curve flattening dynamics

The ECB surprised markets by hiking 50bp and going against June's guidance of a 25bp hike. This has signalled to the market a greater willingness to front load tightening, though we will also see a greater dependence on data now that the ECB has effectively abandoned forward guidance.

> *The market sees the ECB squeezing more of its tightening into the upcoming meetings*

The market sees the ECB squeezing more of its policy tightening into the upcoming meetings. The September forward has inched up slightly towards 0.5%, which implies another 50bp is more than fully priced. But having brought forward the 50bp to July instead of leaving an even larger move to September may be read by some as admitting that the window to raise rates is closing fast. The ECB moving towards data dependency is thus a dovish twist.

For now, inflation readings staying stubbornly high and an ECB focused on fighting inflation can keep markets positioned for the prospect of further fast-paced tightening. This had helped overall curve flattening in longer tenors where markets' unease over the broader economic outlook is reflected. Yesterday 10Y Bunds yields actually ended lower, more than reversing the initial knee-jerk reaction higher. And judging from longer-dated inflation swaps maintaining their downward trend, inflation concerns are less of an issue here.

ECB reveals Transmission Protection Instrument with unlimited fire power, but...

The ECB announced it widely anticipated Transmission Protection Mechanism which complements its existing market intervention tools, the flexible Pandemic Emergency Purchase Programme (PEPP) reinvestments and the Outright Monetary Transactions (OMT).

> *For Italy the hurdle to activation looks high under current circumstances*

The new tool has been equipped with ex ante unlimited fire power, but for Italy the hurdle to activation looks high under current circumstances – one can hardly talk of “unwarranted, disorderly market dynamics” when domestic political turmoil is driving Italian bond spreads wider, and also as spread levels are still not entirely out of whack with other credit risk and volatility indicators. That said, those indicators and Italian spreads have started to head in opposite directions of late, and we do see more widening for Italian spreads ahead towards the 250bp area.

> *President Mattarella has officially called elections for the 25th of September*

Yesterday, Italy’s President Mattarella officially called elections for the 25th of September. While much can still change, current polling sees a coalition of centre-right and far-right parties in the lead, and that gives rise to prospects of at least former openly EU-sceptic personalities being in any new government. In the event of Italian bond markets coming under severe stress, the eligibility criteria outlined by the ECB against that backdrop might also give rise to fears that any such crisis will boil down to politics in the end. Not least as the TPI has an exit clause which states intervention could end if the ECB comes to the conclusion that “persistent tensions are due to country fundamentals” – TPI is for everyone but Italy.

As if to confirm that Italian bond holders should not look to the ECB to manage spreads down, Reuters cited ECB sources saying that internal metrics did not show any unwarranted fragmentation in any eurozone country. For now the Governing Council deemed the exiting tool of flexible PEPP reinvestments is enough to contain fragmentation.

Overall it has to be said the ECB maintains a high degree of discretion over how to apply criteria, which have not been spelled out in detail. With regards to implementation the ECB has indicated that TPI purchases will be sterilised, but has left open whether this will be done by selling other assets or issuing term deposits.

Today’s events and market view

The ECB has moved to greater data dependency, so naturally today’s PMIs may come under greater scrutiny. Consensus looks for further cooling of the economy, though sees the index readings staying above the 50 mark.

In any case, with the market likely also having the Fed hike next week on the radar, the long end may again be the better conduit for pricing concerns over the outlook and the flattening dynamic may thus stick around for longer. The question remains when concerns over the outlook will start to permeate into the more immediate pricing of monetary policy tightening. Our economists' expectation remains that the ECB will only be able to deliver 100bp of tightening in total.

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