

Rates Spark: window of opportunity

Central bank speakers take centre stage today. The earlier the Fed acknowledges the policy implication of higher inflation, the less damaging will be any ensuing increase in rates. There is less scope for ECB displays of optimism, but rising inflation swaps tell the story of an improving outlook



Federal Reserve

Source: Shutterstock

A more upbeat Fed now could avoid a panic later

Much has been written by now about this week's US inflation print so we will refrain from labouring the point further. We direct our readers to [our economics team's analysis on the topic](#). In a nutshell, inflation will prove sticky around 3% long after this spring's jump. While our near-3% forecast for 2021 and 2022 sits well above the consensus reported by Bloomberg (respectively 2.5% and 2.1%), we think markets are slowly coming around to our view. Needless to say that US Treasury yields sitting below 2% leave significant room for re-pricing.

Inflation could well prove sticky around 3% long after this spring's jump

How this re-pricing plays out is largely a function of the Federal Reserve's communication. Persistently high inflation is likely to only become a reality in a few months' time, although consensus should adjust faster than this. This gives the Fed an opportunity to prime markets for the policy implications of higher than target inflation (and higher than the 2-2.5% tolerance band under average inflation targeting). The later the Fed acknowledges this, the sharper the market adjustment. This is a key reason in our view why the Fed has let market rates adjust higher in 1Q 2021.

We think the Fed should start the tapering debate earlier rather than later

By the same token, we think the Fed should start the tapering debate earlier rather than later. Its reluctance to acknowledge that Fed Fund rates may be raised well before 2024 is understandable, as it wants to maximise job market gains before tightening policy, but it risks causing the same kind of market jitter as in 2013 when tightening becomes necessary. There is a rump of Fed speakers scheduled today, presenting an opportunity to acknowledge this risk.

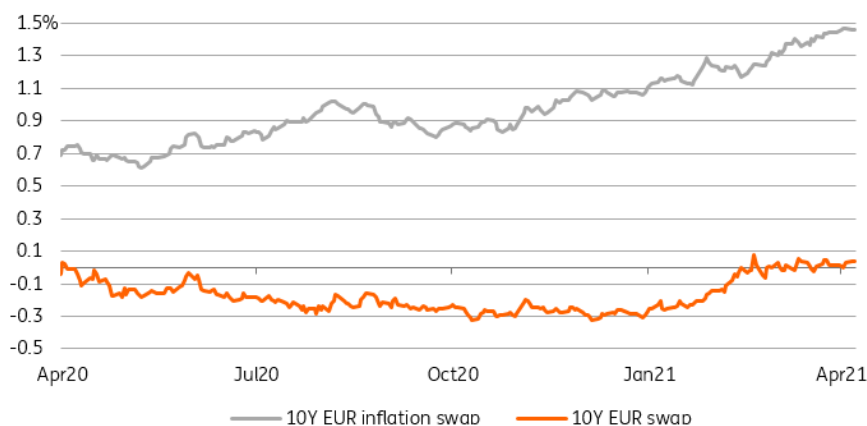
EUR supply relief but rising inflation swaps

The rest of the week could provide a respite to EUR rates after heavy supply yesterday. Due to supportive ECB reinvestments in April, and as a lot of the long-dated deals that could be expected this month have already materialised, the relief may be sustained for a number of days, but we suspect further EUR long-end steepening is in the offing.

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For one thing, this is the part of the curve where we expect the most mechanical steepening as rate hedging needs go into reverse. It is too early to say whether the recent drop in demand for long-dated syndications is a reflection of shorter-duration liabilities after the modest rise in EUR rates this year. However, it would make sense for investors to factor in a modest degree of rates normalisation in their hedging strategies, and so to hold on for higher rates, and lower hedging needs.

EUR swap rates have stabilised, but inflation swaps keep rising



Source: Refinitiv, ING

We detect no wholesale reappraisal of Europe's economic prospects but note that inflation swap rates have been on a steep ascent since the end of February, unlike nominal rates that have paused since March. It stands to reason to us that long-dated nominal rates should adjust higher as a result. Here too, central bank communication will be important.

Nominal rates should adjust higher

There isn't much to expect from next week's ECB meeting but Lagarde's comments will be closely watched today, if only for hints about the pace of purchases after the 2Q surge. A range of opinions has already been formulated, from Klaas Knot signalling PEPP tapering starting in 3Q, to Francois Villeroy stressing that APP could be boosted to make up for a reduction in PEPP purchases. We suspect the best way to avoid further dissent being voiced is to avoid the subject, especially since no decision is due before the June meeting.

Today's events and market view

The window of opportunity for the Fed to catch up to an improving economic outlook is 2Q, but any change of communication will be gradual. Expect more optimism to transpire among the less dovish FOMC members today, while chairman Jerome Powell should toe the party line and refrain from comments on tapering. Still, the balance of risk is for a more hawkish tone to emerge, with associated impulse toward higher rates.

The Eurozone is less far along the road to recovery so we expect less candid comments from the likes of Christine Lagarde, Isabel Schnabel, or Fabio Panetta today. The ECB's self-imposed quiet period starts tomorrow so this is their last opportunity to shape expectations before next week. Barring a display of dovish conviction (likely on the part of Panetta but not from the others) we expect EUR markets to shrug off these comments and to focus instead on the brightening outlook for the economy.

There will be no tier one economic data releases of note but Germany will sell 30y debt. The

EU should also announce its funding plan for NGeu today, the much discussed recovery fund agreed in July of last year.

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