

The ECB's unfinished business to weigh on markets

When the ECB meets for the last time this year, it is likely to give markets a stern warning on inflation. This should push yields up as we see limited downside below 1.75% and 2.5% for the 10Y Bund and swap rates, respectively, even in 2023. For now, the impact on EUR/USD should not prove long-lived. Here are our four scenarios with market implications

	Inflation outlook	Growth outlook	Interest rates	Quantitative tightening	EUR/USD (1.055)	10Y Bund (1.90%)
Current stance	Inflation far too high and will stay above target for an extended period	Economy expected to weaken further in 4Q22 and 1Q23. Downside risks	Depo at 1.50%. Expect to hike further, rate path will be data-dependent	APP and PEPP in reinvestment phase. TPI can be triggered but has conditionality		
Dovish	Medium-term infl. may return to target earlier than previously thought	High risk of a sharper/longer-lasting economic slowdown	50bp hike. Worsening outlook suggests slower pace of tightening	End of APP reinvestments principles discussed but no decision	1.040	1.75%
ING Base Case (neutral)	Unchanged. Infl. to stay high but 2025 outlook at 2%	Unchanged. Risks to the downside, particularly in the near term	50bp hike. Maintaining a fully data-dependent approach	APP reinvest. to be phased out, hint at start in Q1 2023	1.050	1.90%
Moderately hawkish	Dismissing recent drop in inflation, which should stay high for longer	Downside risks to the outlook slightly abated since October	75bp hike. Maintaining a fully data-dependent approach	Announcement of APP QT start in Feb 2023. End of reinvestments '23	1.065	2.00%
Very hawkish	Projections show a more prolonged period of above-target inflation	Risks mostly in the near-term, 2024 projections more upbeat	75bp hike. Pushing back against speculation that peak rate is near	APP QT will start in 1Q23. PEPP reinvestments will end in 2023	1.075	2.20%

Source: ING

A hawkish ECB will push yields up

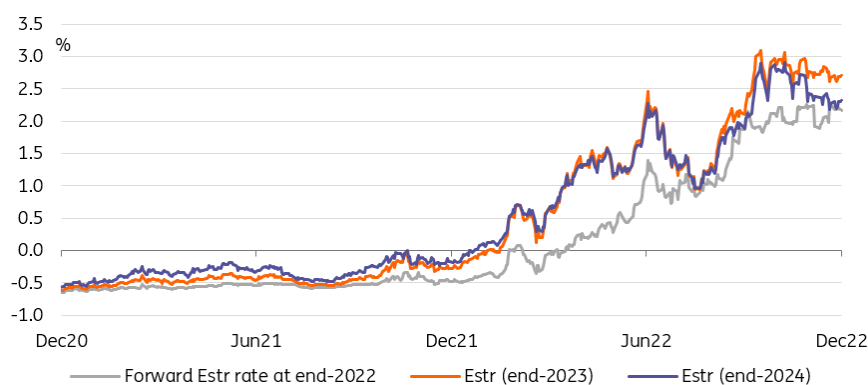
The European Central Bank's job is not yet finished. Far from it. There is still much work to be done on inflation before the central bank can end its hiking cycle, and the drop in market rate expectations in recent weeks means [the risk of a 75bp hike has increased](#). Still, 50bp remains our base case at this meeting although this will likely come with a stern hawkish warning on inflation. This should steer the short-term direction of euro rates. The drop in 10Y Bund yields and 10Y swap rates has stalled above 1.75% and 2.5% respectively, and we think a retracement higher will be triggered by the ECB's tone.

Current valuations don't leave much space for rates to drop further in 2023

This should also set the tone for rates in 2023. As we wrote in our [rates outlook](#), current valuations don't leave much space for rates to drop further in 2023, even in the case of [a deeper-than-expected recession, as our economics team forecasts](#). At around 2.5%, 10Y swap rates are already where we see the ECB's terminal rate in this cycle. This isn't high enough for markets to price subsequent cuts, and so the case for curve inversion is much weaker than, say, in the US. In fact, we think long-end EUR rates should rise by 2024, as the curve re-steepens thanks to quantitative tightening, and possibly on a greater inflation premium.

If there is any downside risk to rates, it is to the front end of the curve. The swap curve implies a terminal rate of 3%, 50bp above our own estimate. This is likely to only affect rates up to the 2Y point, however, as the impact on longer tenors will be dented by the fact that forwards currently price subsequent cuts that aren't likely to materialise.

The Estr swap curve is pricing a 3% terminal rate in 2023, and then cuts in 2024



Source: Refinitiv, ING

The QT dog that didn't bite bonds

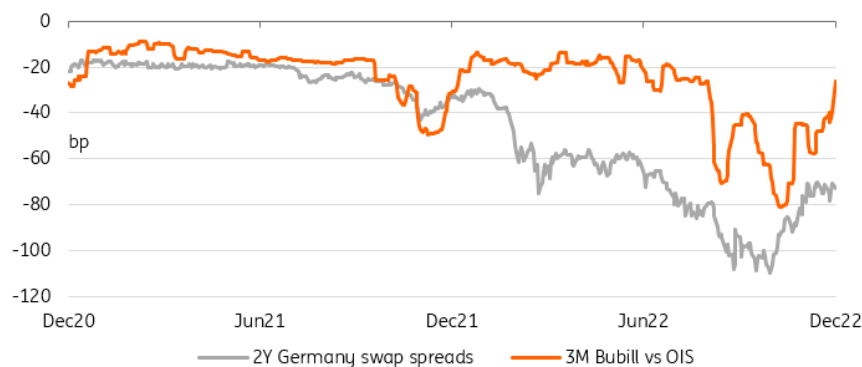
One compromise between the hawks and doves could be that a 'downshift' from 75bp to 50bp is accompanied by a faster quantitative tightening timetable. This meeting shouldn't be about making final decisions on the size or timing of the reduction of its bond portfolio, but about highlighting its guiding principles. Our view is that the ECB will phase out reinvestments of its Asset Purchase Programme portfolio throughout 2023 by gradually removing the reinvestment cap. Perhaps in part because no decision is expected at this meeting, sovereign spreads have failed to react. In fact, they've been happy to tighten alongside the improvement in risk appetite on global markets.

200bp seems a more natural home for 10Y Italy-Germany spreads than any level below

If we're right in saying that core rates are headed higher around this ECB meeting, this implies the same is true for sovereign spreads, and this is before accounting for the risk of a hawkish surprise on QT. In a world where the ECB tightens policy, via rate hikes, by draining liquidity, or via QT,

200bp seems a more natural home for 10Y Italy-Germany spreads than any level below. Bear in mind, too, that January will fire the starting gun on a highly seasonal primary market for bonds. We wouldn't be surprised to see sovereign yields rise relative to swaps in the first quarter before resuming their tightening for the rest of 2024.

Faster TLTRO repayments and more bond lending helped narrow swap spreads



Source: Refinitiv, ING

Balance sheet reduction gaining traction with TLTRO repayments

QT is but the next step in the ECB's plans for reducing its balance sheet. The first steps were already made in October with the revision of the terms for targeted long-term refinancing operations (TLTRO) and giving banks more opportunities to repay these ahead of their final maturities. Taking into account the latest sizeable repayment announcement, the outstanding TLTROs will have declined by €796bn to €1.3tn before the year is out.

TLTRO reductions could provide the doves with leverage to press for less aggressive QT

That should still pitch the level of excess reserves in the banking system at around 4tn, still sufficiently high to leave spot spreads of 3m Euribor over the risk-free ESTR OIS unimpressed. Yet futures contracts are already implying a decent widening towards 16bp by the end of the first quarter of 2023. Lower excess reserves with further repayments will likely make Euribor fixings more sensitive to credit risk again. The more immediate impact surrounding the TLTRO developments has been the easing of collateral scarcity fears, particularly at year-end. The pricing of German sovereign paper versus swaps has started to ease dramatically with the 2Y Schatz ASW spread now close to 70bp after witnessing levels above 110bp in October.

In the overall bargaining between ECB hawks and doves that will take place this week, the TLTRO reduction could provide the dovish camp with leverage to press for a less aggressive approach on QT. But that has to be weighed against the notion that QT may be one of the few levers the ECB has left to steer financial conditions determined by longer-dated rates.

FX: The ECB remains a secondary driver for the euro

The recent rally in EUR/USD has been driven by a combination of a weak dollar environment and a slight improvement in growth sentiment in the eurozone. But, when looking at EUR/USD moves in the second half of 2022, it's hard to isolate a clear and direct impact of ECB policy/rate expectations; we have long highlighted how our quantitative tools show a very small beta of the EUR-USD short-term swap-rate differential to EUR/USD. Recently, this relationship has modestly restrengthened, but in our view, this mostly reflects the positive impact of easing Federal Reserve hike expectations on global sentiment (to which EUR/USD is highly sensitive) rather than a direct impact on the pair.

All of this means that the implications of this ECB meeting on the euro may not prove very long-lasting, and global market factors - like risk sentiment and energy prices - should move back into the driving seat quite rapidly. Still, while the reaction to the latest ECB announcement has been rather contained in the FX market, we could see stronger volatility in EUR/USD on this occasion as markets could receive some guidance on quantitative tightening and new projections will be released at the same time.

Given growing speculation around a 75bp hike, we could see a small negative reaction in EUR/USD should our 50bp call prove correct. However, the downside should be limited if the ECB offers some hawkish guidance on QT.

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