Yields, curve, and spreads: what to expect from the ECB

The September European Central Bank meeting will be key for interest rates. A 75bp hike would invert the yield curve. After an initial spike, it would send the 10Y Bund through 1%, and the 10Y swap through 1.5% next year. Bringing forward quantitative tightening would send tremors through peripheral bonds

Front-loading hikes would invert the yield curve

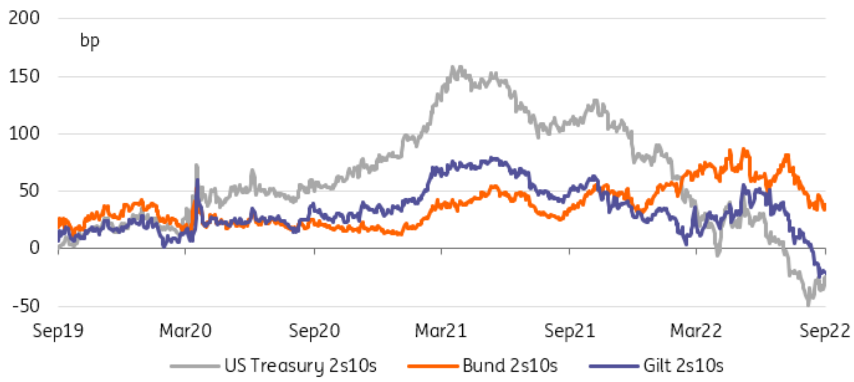
Let us start by stating the obvious, ECB comments have taken a resolutely hawkish turn. Whether it wants to emulate the Fed's front-loading of hikes, or is simply piggybacking on its credibility, officials made the market's base case a 75bp hike at this, or the next, meeting, with a preference for September. If markets are right in thinking that the hawks have won the front-loading argument, then the next logical step will be for the curve to price qin another 75bp hike in October. As the Fed's experience has shown, it is difficult to hike by 75bp to then revert to smaller increments.

The EUR curve will keep flattening, and indeed invert

This is a very different course of events than the one predicted by our economics team. The key blind spot in the above reasoning is, of course, the recessionary wave about to crash onto Europe's shore. In our view, it will be difficult for the ECB to keep hiking rates in the middle of a recession. Even if the word has recently entered central bankers' vocabulary, we think they are guilty of an excess of growth optimism. In short, "it is one thing to hike into a recession, it is a different thing to hike in the middle of one".

This, however, may not be immediately obvious to market participants. If the ECB persists in its rose-tinted view of the world, and if EU energy policy delays the date when harsh economic reality hits home, then the EUR curve will keep flattening, and indeed invert. Taking the German 2s10s slope as an example, a dip from 40bp currently to -10bp in the first quarter of 2023 is the logical consequence of a hawkish ECB in the face of a worsening economic outlook.

Like its US and UK peers, the German curve will soon invert



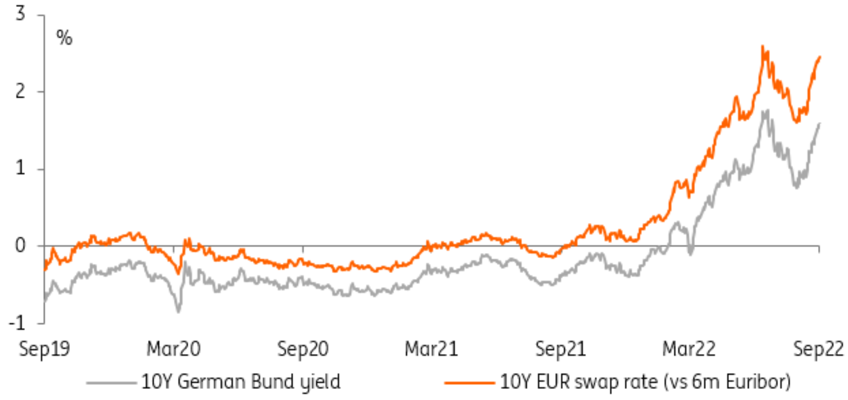
Source: Refinitiv, ING

Upside to rates now, but they will crash down in 2023

This sequencing of events, markets pricing more aggressive ECB hikes and only waking up to a dismal economic outlook later in the winter, also means the upside to Bund yields still remains. This is mostly a near-term view, however. We struggle to see Bund yields remaining at current, or indeed higher, levels in the midst of a recession, and as the ECB will eventually fail to deliver on the hikes priced by the curve.

We expect 10Y rates to dip below 1% in the first half of 2023 until the economic gloom is dispelled. This should only be a temporary state of play as the curve will re-steepen with the return of positive growth in 2024. Our view is thefefore for a sharp reversal of government bonds' fortunes early in 2023. The drop could be even more marked for 10Y swap rates, with a temporary dip through 1.5% at some point next year as our base case.

ECB hikes will push rates up, but the recession will bring them down



Source: Refinitiv, ING

The next worry: quantitative tightening

If hawks are to be believed, the debate on quantitative tightening (QT) is also due to start this year, although not necessarily in September. The minutes of the July meeting already featured an oblique reference to balance sheet forward guidance. In addition to the 'mechanical' reduction the repayment of targeted longer-term refinancing operations (TLTRO) funds will cause, the ECB has committed to keeping the size of its pandemic emergency purchase programme (PEPP) bond portfolio constant until at least the end of 2024. Like its recent rate hike signals, we believe this guidance to be at risk.

> *The ECB should tread carefully if it wants to avoid yet more widening in sovereign spreads*

What's more, an earlier reduction in the size of its asset purchase programme (APP) portfolio is possible. With the exact wording being "an extended period of time past the date when it starts raising the key interest rates", the clock is ticking. Even if it only occurs in 2024, balance sheet reduction will be a sea change in ECB policy. The central bank is still growing its peripheral bond pile thanks to its PEPP reinvestment policy, and a majority of economists expect it to activate its Transmission Protection Instrument (TPI) this or next year, which will result in yet more buying.

ECB bond flows are going in the opposite direction in German and Italy

Source: Refinitiv, ING

As in any jurisdiction, a reduction of its almost €5tr bond portfolio would add to the policy tightening delivered through rate hikes. The problem in the eurozone is that a shrinking bond portfolio would deliver sharply different degrees of tightening from one member state to the next. This is the very reason why the ECB is currently a net buyer of Italian bonds and a net seller of German ones. An overall reduction of its bonds portfolio is possible but likely at differentiated speeds in our view. The ECB should tread carefully if it wants to avoid yet more widening in sovereign spreads.

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