

It's Oh So Quiet

Expecting noise from the European Central Bank next week on any proposed reduction in asset purchases or interest rates? Don't get your hopes up. We preview what we can expect next week. The latest US job numbers are just out; why aren't they better? And if Sustainable Finance Disclosure Regulation's your thing, we've got you covered there too

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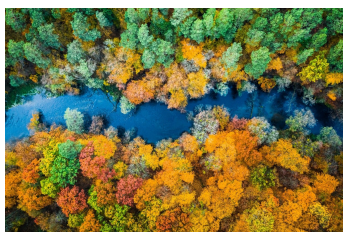


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ECB preview: Avoiding taper talk

Higher inflation, an accelerated vaccination roll-out and a strong economic rebound on the back of post-lockdown reopenings will put not only the ECB's asset purchase front-loading to the test next week. Avoiding the T-word contributed to a pause in the climb in EUR rates - we think this will resume after the meeting.



When the ECB meets again next week the economic outlook will have brightened further, inflation will continue to surge, and it will be hard to once again avoid any taper talk. The Thursday meeting could be packed with insightful information but probably not with tangible action.

Here is where the excitement should be:

New staff projections

First of all, the ECB will present a fresh round of staff projections. Remember that back in March, the staff projections predicted GDP growth to come in at 4% this year and at 4.1% in 2022. Inflation was expected to come in at 1.5% this year and 1.2% next year. While confidence indicators point to strong activity, no hard data is yet available for the second quarter. As actual 1Q GDP was weaker than ECB staff had expected in March, we expect the growth projections to remain broadly unchanged for 2021 and 2022. The inflation projections, however, could be revised upwards. Not

only has actual inflation come in higher than the ECB had penciled in so far, but the combination of supply chain disruptions, elevated commodity prices and the reopening inflation will in our view keep inflation closer to 3% than to 2% in the second half of the year.

Assessing financing conditions

Another interesting element will be the first official quarterly assessment of financing conditions in the eurozone. Remember that last year, favourable financing conditions had all of a sudden become a new quasi target for the ECB. Other than 'holistic', 'multi-faceted' and 'upstream' or 'downstream' no clear definitions were given. Maybe only that financing conditions in December were regarded by some as the benchmark. As at least bond yields have increased by around 40bp since then, the ECB's official assessment will be interesting. Official comments that rising yields were a natural development at turning points in a recovery already point to a possible communication line, preventing the ECB from being caught in its own logic from a few months ago.

(Avoiding the) taper talk

The final discussion next week will be on tapering, or at least on how to avoid this discussion. Why? Even if economic developments would in our view clearly justify at least having a first tapering discussion, the sheer mention of such a discussion could push up bond yields further and consequently undermine the economic recovery before it has actually started. The fact that several more dovish statements have been made by ECB officials recently underlines this view. Last week, ECB Executive Board member Isabel Schnabel, who currently for us gives the most informative speeches and interviews for those searching for the ECB's reaction function, set the scene by warning against "a premature withdrawal of either fiscal or monetary support". However, the ECB will not be able to avoid the tapering discussion for long.

How ECB tapering could eventually look

Tapering, in our view, will be a very special operation twist, not extending the PEPP beyond March 2022 but increasing the 'old' APP to the extent that the ECB will still purchase between 40bn to 50bn euro per month after March 2022. This operation twist results from the fact that the PEPP was mainly aimed at bringing the inflation path back to its pre-crisis level, while APP can be used to bring the inflation path back to target.

Changes to the ECB communication next week

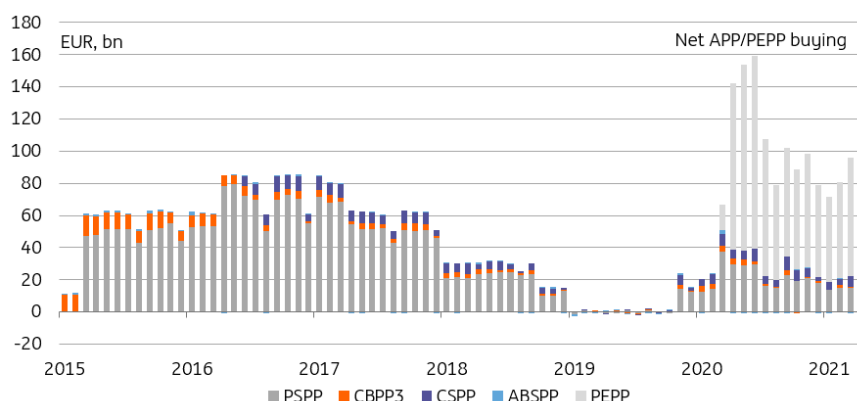
All in all, next week's ECB meeting could fall into the category "exciting but uneventful". We have seen worse...

As the ECB will try everything it can to avoid any explicit taper talk at next week's meeting, all eyes will be on the wording of the current front-loading of its asset purchases. This front-loading was implemented in March when bond yields had started to increase on the back of higher US yields but not on the back of improved eurozone fundamentals. The key sentence in March was "the Governing Council expects purchases under the PEPP over the current quarter to continue to be conducted at a significantly higher pace than during the first months of the year." We would

expect the ECB to drop the “significantly higher pace” and replace it with something like “the Governing Council expects purchases under the PEPP to ensure current favourable financing conditions”. Any additional changes to the communication would be a surprise and would signal either a growing willingness for, or opposition to, taper talk after the summer.

PEPP purchases, just a bump on the road to higher EUR rates

Bond and wider interest rate markets will receive mixed messages at this meeting that they will find hard to process. By and large, it is true that maintaining PEPP purchases at their current rate for another quarter (liquidity and seasonality of purchases allowing) should be the overriding influence but, this has to be weighed against the fact that Lagarde and in particular Schnabel have done a good job steering markets towards this outcome last week.



Source: ECB, ING

The countdown to another leg higher in rates has started last week

Moreover, an upbeat tone from Lagarde next week and heavy flow of positive economic releases over the coming months should dampen the impact of purchases. In fact, we think the reaction to the March PEPP boost surprise is a good template for how EUR rates will trade in the coming months. At the time, the ECB managed to engineer a pause in the bond market sell-off that lasted a few weeks. The rise in EUR rates resumed in April.

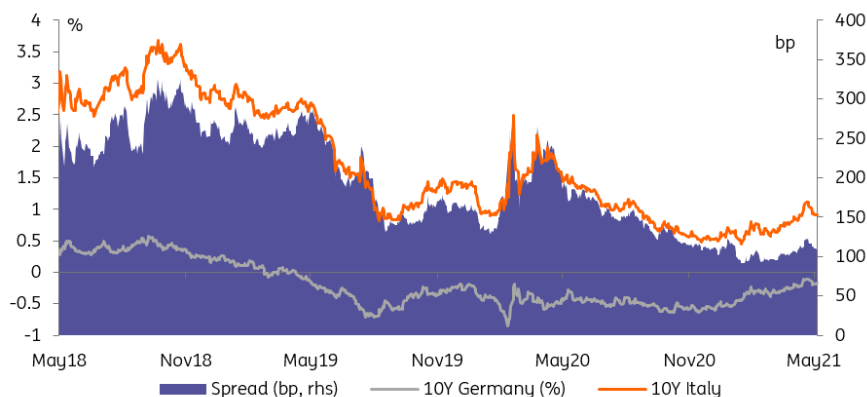
This time around, we'd argue that the countdown to another leg higher in rates has started last week, with the expectations-setting exercise mentioned above. This leaves little room for EUR rates, for instance Bund yields, to drop further, and should set the stage for the climb in rates to resume once the curtain has been drawn on the June 10th press conference.

A greenlight for carry trades in higher yielding bond markets

We wouldn't dismiss the relevance of faster PEPP purchases in Q3 altogether however. It is true that their impact on Bund yields and swap rates should prove temporary at best but they will send a signal to the broader fixed income markets: the ECB will work to suppress volatility well into the

European recovery, and thus provide an extra incentive for investors to chase returns in higher yielding investments. The effect has already been felt in significantly tighter Italian spreads since their spike in May, but [we think they are on course to cross 100bp even as Bund yield rises resume](#).

Faster PEPP purchases won't stop higher yields, but they will stabilise sovereign spreads



Source: Refinitiv, ING

Our expectation of higher rates in the coming months also requires qualification. It is true that the rate markets are facing a degree of normalisation this year as economies reopen, but not a regime change in terms of long-term growth and inflation. This implies that most of the rise in yields should be front-loaded to this year, with much tamer increases in 2022. If the ECB decides to double the pace of APP purchases to €40bn/month next year, we estimate this will be enough to Hoover up the roughly €320bn of sovereign net issuance we're forecasting, and upward of €100bn of EU net debt sales, with some change to spare (for agencies and regional government for instance).

Most of the rise in yields should be front-loaded to this year, with much tamer increases in 2022

Limited scope for much higher rates next year is an additional argument in favour of tame spread developments in higher beta fixed income markets. In addition, our colleagues in credit strategy [continue to see strong fundamentals to their markets](#), and the broader EUR sovereign complex still trades with a distinct appetite for carry trades.

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Bouvet: Shh... don't mention eurozone interest rates

Market forces are set to regain a foothold in the rates world, despite what the European Central Bank does or doesn't say at its next meeting on Thursday. ING's Antoine Bouvet looks at what's happening in the markets, why it matters and what's likely to happen next



Shh.. don't mention eurozone interest rates

The big question for the European Central Bank is for how much longer can they keep supporting the eurozone economy at the levels they're doing right now. But don't expect that to be addressed at next week's meeting. That said, ING's Senior Rates Strategist, Antoine Bouvet, says market forces will soon regain a foothold and rates, such as the German 10-year, are likely to rise by 30 to 40 basis points by the end of 2021; that's not much in the grand scheme of things. Antoine does expect increasing demand for higher-yielding fixed-income bonds. But again, that demand will be much lower than we'd normally expect at this stage in the economic cycle.

[Watch video](#)

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Shortages to send eurozone goods prices higher, but probably not for long

Goods inflation is set to rise more as shortages and supply chain disruptions will be priced through to the consumer. We find that shortages do lead to price rises, but that there is no lasting effect once shortages end, suggesting the surge in prices will be temporary



Supply chain problems and the surprisingly quick recovery of demand for goods after the first lockdown have caused shortages for all sorts of inputs. A perfect storm has hit the market for lumber, plastics and semiconductors, which is unfortunate but also illustrative of how tight markets are anyway. With demand returning quickly and supply having been scaled down in the aftermath of the first wave, isolated events can have significant ripple effects. Think of the Texas freeze which impacted plastic production, the fire at a large computer chip production facility in Japan and the beetle infestation which has devastated Canadian forests. Despite all of the supply-side pressures, this has not yet resulted in surging goods inflation. However, in May, goods inflation increased from 0.4% to 0.7% and we expect this to be the start of higher trending goods inflation, as businesses grappling with shortages have indicated they will pass higher costs onto the consumer.

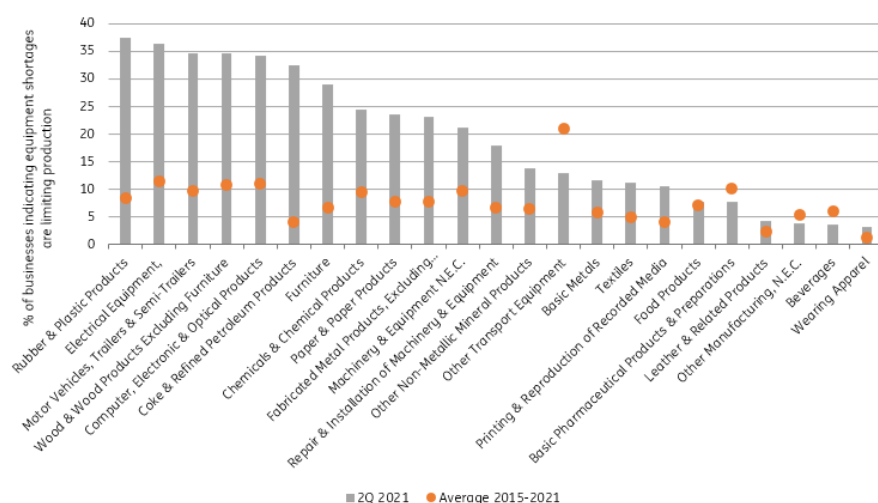
Shortages have popped up in several sectors, causing hiccups in industrial production

Across eurozone industry, multiple sectors are now reporting significant shortages in equipment. The European Commission's Economic Sentiment Indicator provides quarterly information on which factors are limiting production and 'equipment' has spiked as a factor in 2Q 2021. In fact, for total eurozone industry, it is now at its highest level since the start of the indicator in 1985, with 22.8% of businesses reporting equipment shortages as a key factor limiting production.

Shortages are rising across sectors, but the sectors affected most by this are logical given the pressing problems in computer chips, plastics and lumber. Rubber and plastics producers top the list, with electrical equipment producers a close second. Automotive, wood and computer and electronics producers round out the top five, showing a clear link to the problems in finding chips, plastics and lumber at the moment.

The impact on production has varied for now, with the main problems accumulating in the auto sector so far due to semiconductor shortages. This has brought production down -14.3% from its November peak. Other sectors are seeing less impact in terms of outright production declines. Furniture production is also down 6% from its recent peak, while smaller declines are reported among computer and electronics producers.

Shortages have become a key issue in several industrial sectors



Source: Eurostat, ING Research

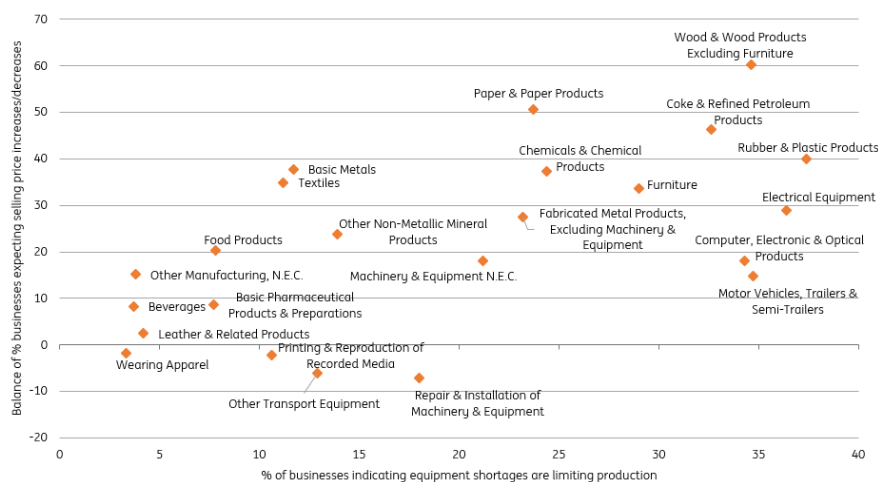
Producer prices are rising and businesses seem keen to pass these onto the consumer

The impact on producer prices has started to show. In April, producer prices increased by 7.6% year-on-year, the strongest increase since 2008, much of which is because of energy price base effects. For some of the sectors most affected by shortages, the lack of availability of inputs has not yet translated into excessive increases in producer prices up till now. This could be because the data lags a bit; producer prices for May have not yet been reported. It could also be because the shortages represent a small amount of total inputs in the production process, think of computer chips in car production. In wood production, we're starting to see elevated producer prices at 6.3%

YoY in April, but the spike in lumber prices continued in May so this is not yet the peak. The sectors for which we have seen large increases in producer prices have been base metals and the manufacture of coke and refined petroleum products, at 18.3 and 53.1% YoY. So for many of the sectors experiencing shortages, margins have not yet come under huge pressure, which has limited the pressure to raise prices so far.

Even though producer prices have had differing responses to shortages, businesses do seem ready to start increasing prices. Selling price expectations among businesses have shot up dramatically in recent months, which has been led by sectors depending on lumber as its main input, but also the oil and chemicals sector, rubber and plastics and basic metals sector have seen a rapid rise in expected selling prices. While other sectors have seen a more muted response, almost all goods-producing sectors currently face a much higher percentage of businesses expecting to increase prices than was the case on average in the 2016-2019 period. This shows that businesses do intend to increase prices on the back of the disruptions facing the supply chain.

Selling price expectations are the highest for industries experiencing shortages



Source: European Commission, ING Research calculations

Historically, equipment shortages have had only temporary impact on consumer prices

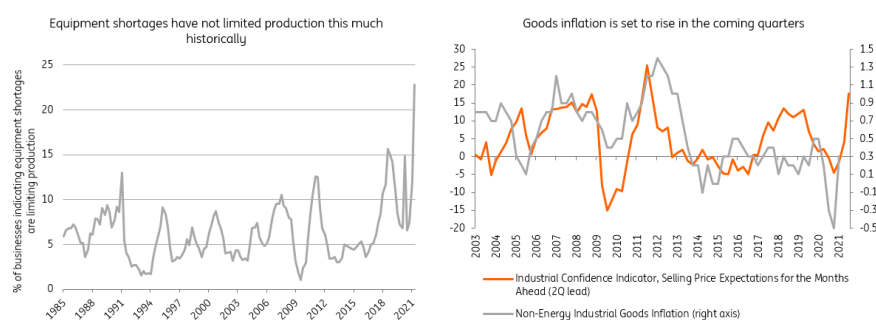
The question is how this is going to influence consumer price inflation and importantly, whether the impact is temporary or more long-lasting. When looking at past behaviour of businesses experiencing equipment shortages, we find that the impact on selling price expectations is usually coincident with the shortage. This means that once shortages fade, selling price expectations normalise again. [1]

What firms are currently facing is not a normal event though as chart 3 shows. We're currently at the highest level of reported shortages limiting production since the start of the time series. When we look at the impact for another period with significant shortages like 2011 when supply chains were significantly disrupted by an earthquake and tsunami in Japan, and flooding in Thailand, we find a slightly longer-lasting effect of higher expected selling prices into the next quarter. Given the extent of the current issue, that could be expected in this period as well.

Now ultimately, we see that this relation between shortages and selling price expectations does translate into consumer prices, but the effect is more watered down and uncertain. Chart 4 shows that the relationship between the two is stronger with a lag of two quarters, which would result in an acceleration of non-energy industrial goods prices for the consumer over the summer.

[1] We have found this using a panel regression of industry-level data of firms' selling price expectations, with equipment shortages and output as explanatory variables (data from the European Commission Industrial Confidence Indicator). The $t=0$ variables for both explanatory variables are highly significant, but higher order lags of the shortages variable are not significant.

Shortages are at historic highs, expect goods inflation to trend higher over the summer months



Source: European Commission, Eurostat, ING Research

Expect surging goods prices from here on, but we do expect it to remain mostly temporary

Goods prices have only risen cautiously so far, but this is just the start. With supply chain issues, shortages of inputs and strong demand, they are going to increase from here and add to inflation that is already above the European Central Bank's target. This means that when energy base effects start to fade, the ECB will not be out of the woods and we expect inflation to remain above 2% for a large part of 2021.

Still, we do expect most disruptions, and the shortages, to ease over the course of this year and early next, with semiconductors being the major exception, as tight markets are likely to remain. This means that we expect goods inflation to rise over the coming months, but the effect of shortages should fade over the course of 2022 because we find that the impact of shortages on inflation is usually only temporary.

For the ECB this means that, bar any second round effects, the spell of above-target inflation is likely to end sometime early next year. Still, with a strong economic rebound and above-target inflation, a discussion around tapering will be unavoidable in the coming months.

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Supply strains hold back the US jobs market

US jobs growth disappointed again in May, but this is not a demand issue. A host of reasons are keeping the supply of workers constrained, which means firms are having to pay-up if they want to recruit staff. Tensions will eventually ease, but in the near term it heightens the risk of more elevated inflation readings



A job fair in Florida

559,000 The number of US jobs added in May

Jobs miss again as firms struggle to find workers

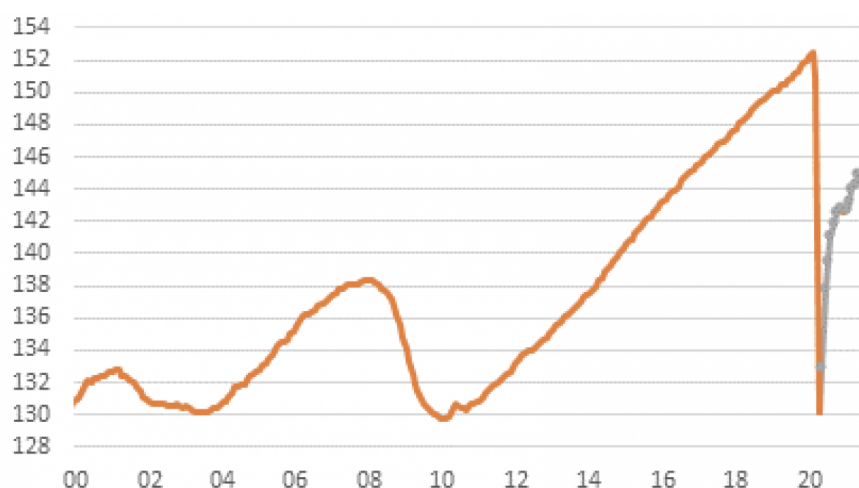
So, US payrolls growth has disappointed again in May with a net 559,000 jobs created versus expectations of 675,000. The range of expectations was wide at 335,000 to 1 million, but we had suspected it would come in on the softer side due to a lack of labour supply rather than any drop-off in the demand for workers.

There was a net 27,000 upward revision to the past couple of months of data while the details show private payrolls rose 492,000 versus expectations of 610,000. For the second consecutive month we see a drop in construction employment, which seems odd given the strength in activity in the sector. Meanwhile retail fell 6,000, financial services fell 1,000 and Federal government employment fell 11,000. Leisure and hospitality was the big growth driver with employment up 292,000 as the service sector continues to re-open and expand.

While the lost jobs continue to be clawed back in aggregate there are still 7.63mn fewer people in work than before the pandemic started. Federal Reserve officials will likely use this to justify their dovish message on eventual interest rate rises. That said, we don't think this means the Fed is right to say there is no need to raise interest rates until 2024.

US employment levels (millions)

In millions. Dots mark from May 2020 onwards



Source: Macrobond, ING

Where are the workers?

The softness in job creation is supply related, not demand related and with wage rates picking up more than expected (0.5% month-on-month versus 0.2% consensus), there is growing evidence that the labour market will add to medium-term inflation pressures.

The slowdown in both the manufacturing and service sector ISM employment components was pinned on companies struggling to find suitable workers and this message was reinforced by data from the National Federation of Independent Businesses overnight. It reported the fourth consecutive new record high for the proportion of small businesses that have vacancies that they couldn't fill. The reading of 48% is 26 points above the average for the survey that goes all the way back to 1975. The report added that 93% of companies looking to hire reported "few or no 'qualified' applicants".

The lack of supply of workers was also acknowledged in this week's Federal Reserve Beige Book where "a growing number of firms offered signing bonuses and increased starting wages to attract and retain workers".

NFIB survey - proportion of firms with vacancies they can't fill (1975-2021)



Source: Macrobond, ING

Another 3-4 months before jobs take off again

The problem was highlighted by the labour participation rate dropping back to 61.6% in May. The obvious reasons are ongoing child-care issues surrounding home schooling, which is forcing many parents to stay at home rather than go out to work. Secondly, there is also still some concern from some workers about returning given the pandemic isn't over. Thirdly, some older workers who lost their jobs may simply have decided to retire early. Finally, there is the debate over the impact from extended and uprated unemployment benefits. They may have weakened the financial incentive of going out to work, particularly for low paid roles, especially when you factor in associated costs of commuting and any childcare.

Around half of all US states have announced they are ending them either this month or next, but for the majority of recipients they will continue until September. With the summer vacation season also kicking in this is not going to help the labour supply issue either with parents still required to stay home for childcare.

Consequently we may not see labour supply strains ease for another three or four months, which will likely keep employment growth relatively subdued in the near term. This won't mean demand disappears, merely that those companies that want to expand and grow are going to have to pay-up to attract staff.

A full recovery is coming

We are set to see the US recover all of the lost economic output through the pandemic in the current quarter, but returning all the lost jobs is going to take many more months. As the structural rigidities in the jobs market ease we expect to see employment take-off and still forecast a December announcement of a QE taper and look for the first Federal Reserve rate hike to come in early 2023. The prospect of consumer price inflation getting close to 5% next week and core inflation hitting the highest level since 1993 means the risks are skewed towards earlier rather than later action.

Author

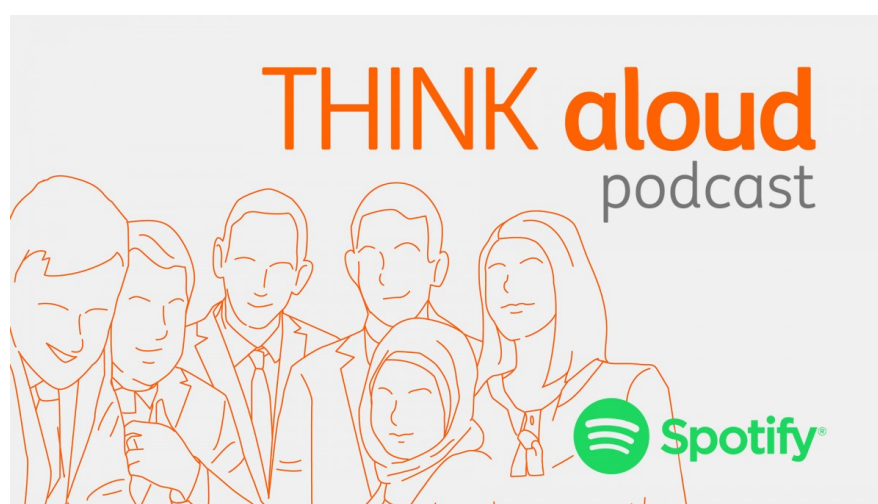
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Listen: Why the Fed may be wrong about inflation

US inflation is rising at the fastest pace in more than a decade. Should we be worried? In this podcast, ING's James Knightley discusses whether recent price rises are likely to be transitory as the Federal Reserve believes, or a more sustained risk to the recovery



US consumer prices rose in April at the fastest pace in 13 years while the core PCE deflator, a measure of inflation favoured by the Federal Reserve, stands at the highest level since 1992. Members of the Federal Reserve say temporary factors are at work and high inflation readings won't be sustained. But others aren't convinced. Larry Summers, former US Treasury Secretary under Bill Clinton and a top economic adviser to President Obama, has accused the central bank of "dangerous complacency" over inflation which could unsettle financial markets. [In this podcast](#), Senior Editor Rebecca Byrne asks Chief International Economist James Knightley where he stands on the issue and what the Fed is likely to do next.

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Selling credit - Is the Fed setting an example?

The Federal Reserve will begin selling off its corporate holdings under its Secondary Market Corporate Credit Facility (SMCCF). At first glance, this seems insignificant as the Fed is only holding the small amount of US\$13.8bn. However, this is an extra addition into the cocktail of our slight bearish outlook for the second half of the year



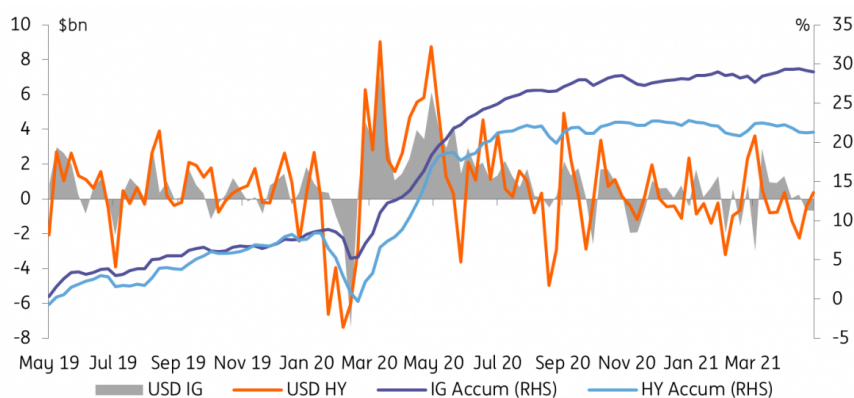
Source: Shutterstock

The Fed has announced that it will not just taper off its corporate holdings, but actively sell holdings under its Secondary Market Corporate Credit Facility (SMCCF). This did come as a surprise, however in the grand scheme of things, the amount is relatively small at just US\$13.8bn. Of this, just US\$5.2bn is in corporate bonds and US\$8.6bn is in ETFs. This includes both investment grade and high yield ETFs. For comparison, the European Central Bank's holdings of corporate bonds extend to a substantial €275bn. Therefore, the selling of US\$13.8bn by the Fed should not have any detrimental effect on spreads or funding levels.

Furthermore, this is fully outweighed by mutual fund (& ETF) inflows. Over the past 12 months, USD investment grade inflows have amounted to a substantial US\$44bn. On a year-to-date basis, USD investment grade inflows have accumulated to US\$5.2bn. Bear in mind, fund flows so far this year have been positive but relatively low. This comes after the substantial inflows seen in 2020 and 2019. Looking at this year alone, the technical picture, in this sense, is now flat.

All of that said, the Fed's move does add weight to our slight bearish outlook. It is a signal that while it's not all out tapering, it is the start of a different phase.

USD Fund Flows

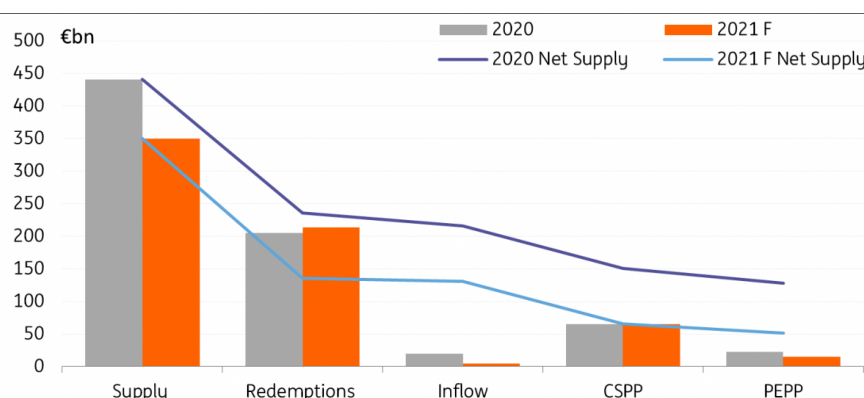


Source: ING, EPFR

On Thursday, USD spreads did push about 1bp wider in places but remained unchanged for the most part. If anything, the high yield market may be affected marginally more but all in all, we do not expect any significant pressure. In saying that, we do still remain somewhat bearish on spreads for the second half of this year. As inflationary fears increase, matched with continued tapering talks coming to the forefront and a rise in rates, we do expect to see softness in credit spreads, and a widening from these current tight levels. And we expect USD spreads to underperform against EUR spreads. In both USD and EUR, the technical picture in credit remains strong, however the technicals in EUR are certainly more supportive, namely because of the ECB. The lack of corporate bond holdings by the Fed may act as an additional minor catalyst for USD underperformance and could provide another reason for a little softness in spreads in the second half of this year.

Strong Technical Picture in EUR credit

Forecast net supply after demand (CSPP, PEPP & Inflows) comes to just €50bn

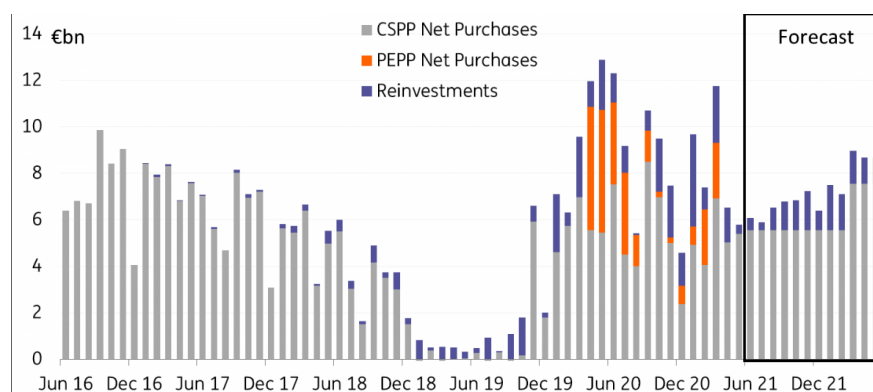


Source: ING, Dealogic, ECB, EPFR

The ECB is a notable driving factor in the strong technical picture in EUR credit. The central

bank has been buying €5.5bn of corporate bonds per month, on average, under its Corporate Sector Purchase Programme. It also makes a significant amount of reinvestments each month. In fact, looking long term, when the ECB does decide to end its purchases under the CSPP, the reinvestments will be so significant, we do not expect to see any taper tantrum. We do not expect the ECB to follow the Fed's lead in selling its holdings. However, if the Fed's move is successful, the ECB may want to consider something similar to ensure its holdings are sustainable. In our report: [To green or not to green: What it means for Credit if ECB becomes greener](#), we outlined the ECB's options to make its holdings more sustainable. One of these is to sell carbon intensive holdings. While this is less likely, it remains an option nonetheless.

ECB corporate purchases



Source: ING, ECB

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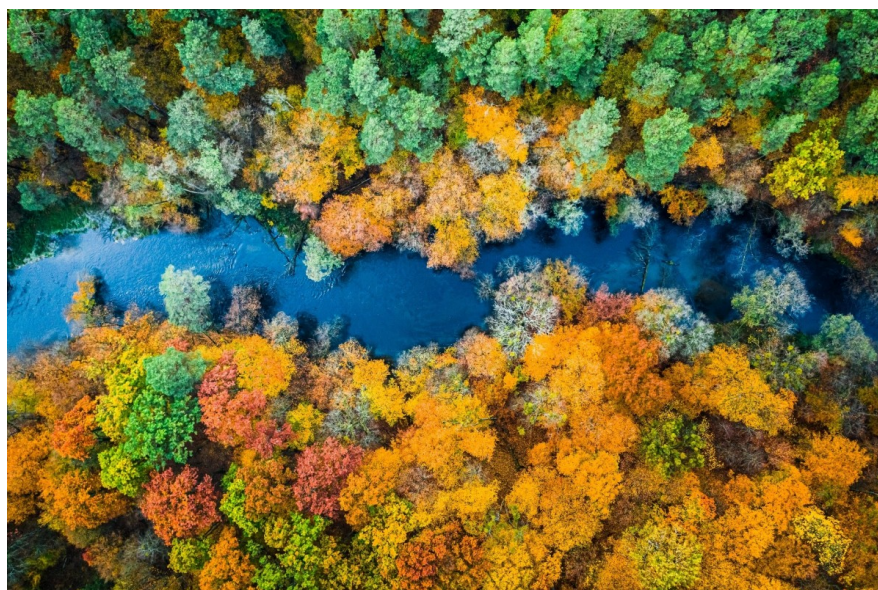
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Sustainable disclosures: A three-layer transparency path towards darker green bond markets

Since 10 March 2021 the EU sustainable finance disclosure regulation (SFDR) requires portfolio managers to “show colour” as to what extent their investment funds and portfolios consider sustainability aspects. The SFDR has three important funnel stages to achieve this goal, which we discuss in detail in this report



Source: Shutterstock

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