

De Bon Recuperation: The ECB Moves Gradually, Keeps Its Options Open

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The mounting economic challenges of the pandemic and the war have kept central bankers busy, forcing rapid changes in policy earlier this year. Since little has changed in the euro area's macro outlook over the intermeeting month and with Madame Lagarde still lumbering from the effects of COVID, there was no shock and awe or policy shift to speak of following the major pivot since the start of the year. In fact, the meeting had the look of a "time out" for markets and for the President to reflect, settle down, and evaluate the steps taken to date and how incoming data have progressed before proceeding more deliberately in the months ahead.

Our Take on the Meeting

As expected, the ECB largely confirmed its policy normalisation journey in the coming months, including the tapering of asset purchases over the course of the second quarter. That said, recent data suggest a somewhat accelerated pace of tapering, with the Governing Council now viewing asset purchases as likely to conclude in the third quarter of this year. Overall, the market viewed this latest policy announcement as somewhat more dovish than anticipated, which is reflected in three key takeaways that the ECB emphasized in the policy statement and the press conference.

First, the ECB has stressed two key uncertainties - namely, the economic impact of higher energy prices due to the war and the risk of a sudden stop in energy flows from Russia to the region. President Lagarde emphasised that the Governing Council remained "attentive to current uncertainties" and noted that an abrupt energy boycott would have a significant negative economic impact in Europe.

The second message is that these uncertainties underpin a more gradual approach. Both the policy statement and President Lagarde stressed flexibility and optionality in the face of such uncertainty, which manifest in a patient approach. Judging from the combined messaging of remaining on track with the removal of extraordinary stimulus while adopting a cautious approach, we think the debate on the Governing Council has likely shifted away from when rate rises should begin to at what point they stop. This will hinge crucially on the evolution of macro data, including whether the currently benign inflation expectations and wage data start showing any signs of overheating, or whether downside risks were to crystallise.

Third, whilst stopping short of announcing a new policy tool, President Lagarde went further than we had expected in her comments regarding the role of policy in addressing fragmentation risk. Importantly, her comments confirmed to us that "flexibility" includes efforts to ensure the transmission mechanism of monetary policy beyond alleviating pandemic-related stresses. This was a key lesson for the Governing Council coming out of the recent crisis.

Market Reaction

Overall, the European bond market reaction was heavily influenced by a steep selloff in U.S. Treasuries that happened late on a low-volume, pre-holiday European trading day. However, we can still interpret the meeting's impact from market movements during the interval between the announcement and press conference. The selloff in the U.S. market began shortly after the presser began and price action in European bond markets became quite muted.

Nonetheless, the direction of travel indicated some relief at the lack of any further acceleration of the policy normalization path - even if just for now. Reflecting this less-hawkish-than-feared tone was a small drop in short-term rates while longer-term rates and inflation expectations inched higher, again, in response to the more dovish-than-expected overall policy tone.

Peripheral spreads remained calm post announcement and through the press conference, no doubt relieved at the unchanged track of asset purchases but also the ongoing theme that there will be tools to avoid fragmentation risk and ensure the transmission of policy across all Eurozone countries. The ECB's not-so-veiled intention to limit any serious downside risks in peripheral debt was also at play.

While the steady approach was a relief for the bond market, the more patient and dovish tone of the meeting was not as well-received in the currency market. The euro's decline over the past year has broken into the double digits and left the euro near the bottom of its multi-decade range.

FIGURE 1: The Decline of the Euro in the Past Year Has Left the Currency at Multi-Decade Lows



Source: PGIM Fixed Income, Bloomberg.

Against this backdrop, the euro weakened as the policy path, in contrast to the last few meetings, did not shift further to the hawkish side, and in fact may have received some further downward impetus from President Lagarde's outright acknowledgment that the euro's depreciation was not discussed at the meeting.

FIGURE 2: The Euro Weakened Further as its Recent Depreciation and High Inflation Outturns Failed to Warrant Direct Attention at Today's Meeting



Source: PGIM Fixed Income, Bloomberg.

Conclusion

To us, the bottom line is that the ECB is on course to end asset purchases and will raise rates out of negative territory before the year is out. That said, we would caution against taking too strong a signal from the end of the conventional Asset Purchase Programme and negative rates. These policies did little to re-anchor inflation to the ECB's target before the pandemic, nor were they particularly effective in the pandemic crisis itself. Rather, it was a bespoke policy tool - the pandemic emergency purchase programme (PEPP) - that was a game-changer for markets in 2020. It's not surprising that ECB staff are now working on a tool specific for addressing market shocks that are outside of individual government's control, such as those caused by the conflict in Ukraine. Such a tool would enable the Governing Council to proceed with confidence on its normalisation path, but ultimately rate rises will be capped due to a deteriorating macro environment going into 2023.

Today's market reaction suggests that the firm underpinnings of the bond market that existed during the low inflation era, as well as the stability achieved with the PEPP during the pandemic era, are waning. While peripheral spreads appear to have found a value point assuming a "slow go" ECB reaction function, should the ECB need to top market expectations for 200bps of rate hikes over the two years, we are likely to see a return to spread widening and fragmentation risks, with Italy and Greece looking most vulnerable. Conversely, today's price action on the currency side suggests the cautious ECB approach to withdrawing accommodation will continue to weigh on the euro as the interest rate differential relative to the U.S. looks set to widen.

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