Bond Blog

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Russia's Invasion: a "Watershed for Europe," but Not the ECB

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Yesterday's policy decision by the European Central Bank (ECB) surprised many observers. Russia's invasion of Ukraine has created acute economic uncertainty and presents material risk to the eurozone's economy. Despite these risks, however, ECB President Lagarde announced a faster reduction in asset purchases over the second quarter than previously planned. Depending on what the data says after that, it may end asset purchases altogether in the third quarter. Might this be a decision that the ECB comes to regret? And what are the investment implications?

Russia's Invasion Has Lowered Growth and Raised Inflation Expectations

The eurozone's economic momentum is strong as it recovers from the pandemic. As a result, the ECB is placing greater emphasis on the short-term inflation caused by Russia's invasion than on medium-term growth - and the medium-term inflation outlook.

The ECB's economic base case assumes relatively benign downside risks from the conflict in Ukraine, compared to its previous projection: it lowered its growth outlook for this year and 2023, but left it unchanged for 2024. The bank's view on supply chain disruptions also appears sanguine, considering the supply chain dislocations going into this crisis and the scope for non-linear, amplified economic effects.

On inflation, the ECB raised its projection at the end of its horizon (to 1.9% in 2024) compared to December, still below its 2% target. Its latest policy response incorporates a relatively backward-looking view of inflation, stirring memories of the bank's ill-timed policy tightening in 2011. That decision was later reversed, but it contributed to below-target inflation and sclerotic growth that plagued the region for a decade.

Normalisation in the Face of Headwinds Comes at a Cost

In our view, the ECB's decision to reduce its asset purchases more quickly is an attempt to increase the bank's "optionality". This stance has opened an escape route to faster normalisation if the medium-term inflation outlook accelerates beyond its 2% target.

But continuing to normalise policy as set out in December and February, despite the pivotal events of recent weeks, comes at a cost: it tightens financial conditions across the region, which will put further downward pressure on medium-term growth. It also puts a greater onus on fiscal policy to support the euro area through this crisis and increases fragmentation risks for so-called peripheral countries, such as Italy.

Finally, what if downside risks were to crystallise? In that case, yesterday's further hawkish pivot could lead to a policy reversal, denting the ECB's credibility. It could even undermine the bank's ability to provide support, as it already finds itself close to the zero lower bound for interest rates, with a sizable balance sheet.

After yesterday's announcement, our base case is that asset purchases will end in the third quarter of 2022 if the economy evolves broadly as expected, with rate rises possible from early 2023. As growth slows into 2023, we see rate rises capped to just above zero, with the risk that the ECB finds itself, once again, stuck with below-target inflation and weak growth.

How Did Investors React and What Are the Implications for Investors?

Eurozone inflation is high, but many observers expected that downside risks to growth would keep the ECB on hold. Instead, yesterday's re-calibration of the ECB's asset purchase programme sent a further hawkish signal. It left investors confused not only by the uncertainty around Russia's invasion, but also by the conduct of monetary policy. The re-pricing of euro rates, credit and equities is therefore likely to continue.

Yesterday's ECB decision exacerbated some of the pre-existing dislocations in European markets. On the rates front, investors reverted to pricing in rate hikes at the front end of the euro yield curve. Rates markets are now pricing in about 66 basis points (bps) of ECB rate hikes over the next 12 months, having dropped to about 30 bps when the conflict escalated in early March. This volatility is clearly reflected by the large move in German two-year government bond yields, especially when compared with higher but more stable US two-year yields (Figure 1).

FIGURE 1: ECB Rate Hike Expectations Have Risen Again

Source: Bloomberg.

Yesterday's hawkish tilt also raised the rest of the euro yield curve, and it may continue to do so as higher inflation starts to come through. But this rise in yields is likely to be limited, especially relative to US yields, given the severe risks to growth and financial stability in the euro area. If those risks were to crystallise, the ECB might well grow more cautious and, eventually, favour growth over inflation. Indeed, this would be consistent with its own growth and inflation forecasts, as well as downside risks to growth that it highlighted.

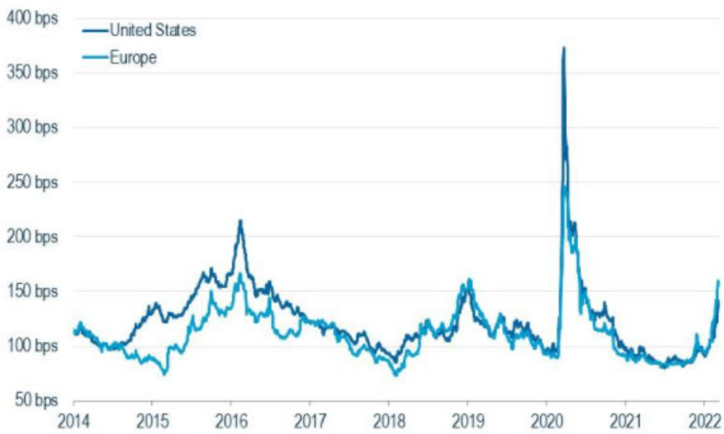
Policy normalisation and downside risks to growth are challenging for so-called peripheral eurozone members. Unsurprisingly, therefore, Spanish and Italian spreads widened in the wake of the ECB meeting (Figure 2). If the crisis in Ukraine puts further pressure on peripheral spreads, this will give another reason for the ECB to pivot to a more dovish stance and peripheral bonds could perform well over the medium term.

FIGURE 2: Peripheral Spreads Widened as a Result of the ECB's Further Hawkish Tilt

Source: Bloomberg.

In the credit space, eurozone corporate spreads widened in the wake of yesterday's meeting, for investment-grade as well as high-yield issuers, and the gap with US spreads grew. If that repricing continues, we feel strongly that it will meet with monetary and fiscal policy support. Governments' fiscal priorities, focused on energy security, energy transition and defence are more aligned than ever, and low interest rates can ensure cohesion and accommodative financial conditions. Investment-grade credit looks particularly interesting: the gap with US investment-grade spreads is the widest since 2014 and investment-grade bonds would be part of the ECB's first line of defence in a downturn.

FIGURE 3: The Gap Between Euro and U.S. Investment-Grade Spreads is at its Widest Since 2015



Source: Bloomberg.

Conclusion

The current environment presents an unusual set of challenges. Russia's invasion of Ukraine casts the shadow of stagflation, as commodity prices and inflation reach levels not seen for decades. Euro area growth is particularly sensitive to this shock, given its reliance on Russian energy.

After yesterday's announcement, our base case is that the ECB will end its asset purchases in the third quarter of 2022 if the economy evolves as expected, with rate rises possible from early 2023. But especially if downside risks were to crystallise, the bank could find itself with even less leeway than before to fight below-target inflation and weak growth.

Yesterday's decision did not send a clear signal that monetary policy will look through inflation to support growth. It therefore adds risks premia to rates and spreads. It also adds uncertainty to a market environment that is already anxious about the conflict in Ukraine and calls for patience, before investors can make the most of the opportunities that are starting to emerge.

Important Information

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