

MARKET COMMENTARY

Worsening inflation situation to push ECB towards an early end of QE

Author: Martin Wolburg

April 14, 2022

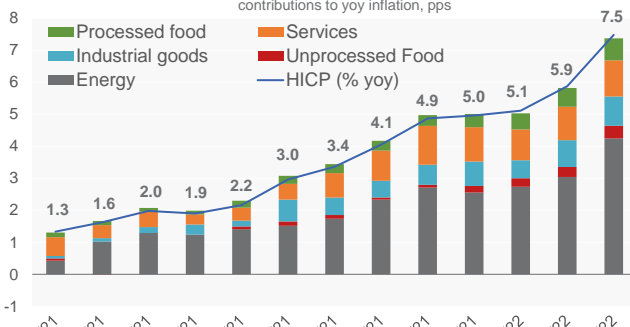
- At today's meeting the Governing Council (GC) took no policy decisions, as expected. But the overall tone was more hawkish than at the previous meeting.
- The GC acknowledged the negative fallout of the war on activity but stated that *"inflation will remain high over the coming months"* and that *"initial signs of above-target revisions"* in inflation expectations *"warrant close monitoring."*
- It became very clear that the June update of the macro projections will very likely reflect this and underline the need for rate hikes. Already today the GC was *"reinforced"* in its expectation that QE would end in Q3.
- At the pivotal meeting on June 9 we expect the ECB to announce an end of QE by July. Further down the road we look for 25 bps rate hikes in September and December of this year.

No policy decisions today but a more hawkish tone: As expected, the GC took no policy decisions at today's meeting. In contrast to the March 10 meeting, it not only acknowledged uncertainty surrounding the war but also the negative effect on the economy while at the same time expressing more concerns about inflation. Overall, the GC adopted a more hawkish tone with increased confidence that QE will end in Q3 and fuelling key rate hike expectations.

A delicate macro mix triggers policy action: Today's meeting took place at a time of on the one hand sky-rocketing inflation readings and on the other hand deteriorating forward-looking components in key indicators suggesting a deceleration of activity. The GC is aware of the fact that *"the conflict and the associated uncertainty are weighing heavily on the confidence of businesses and consumers"* but the wording also suggests that euro area output expansion is still seen to continue. In contrast, *"Inflation has increased significantly and will remain high over the coming months, mainly because of the sharp rise in energy costs. Inflation pressures have intensified across many sectors."* This is a delicate growth-inflation mix which the ECB never faced before. On top, the GC now sees the risk of an *"even stronger"* fallout of the war on activity while at the same time the *"upside risks surrounding the inflation outlook have also intensified..."*. Indeed, the ECB's proprietary measures of underlying inflation (see right-hand chart below) signal inflation pressure well above 2%. Inflation expectations and wage rise complement the upside risks to inflation. The only inflation downside risk is due to weaker demand in the medium term.

EA inflation breakdown at a glance

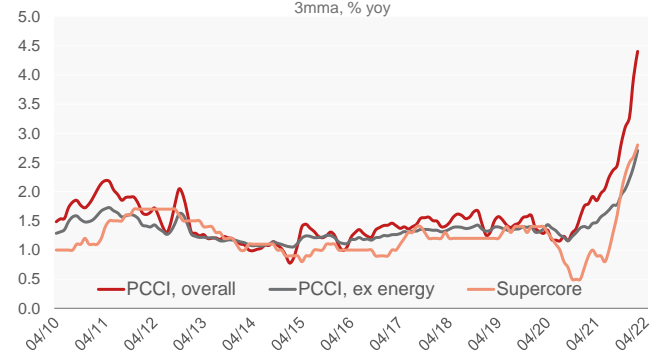
contributions to yoy inflation, pps



Source: Datastream, GIAM calculations

ECB's underlying inflation measures

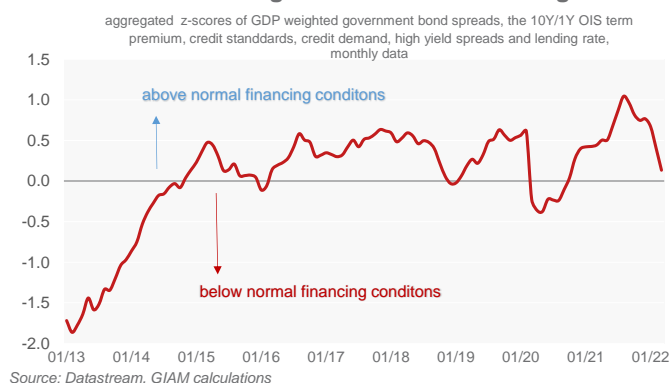
3mma, % yoy



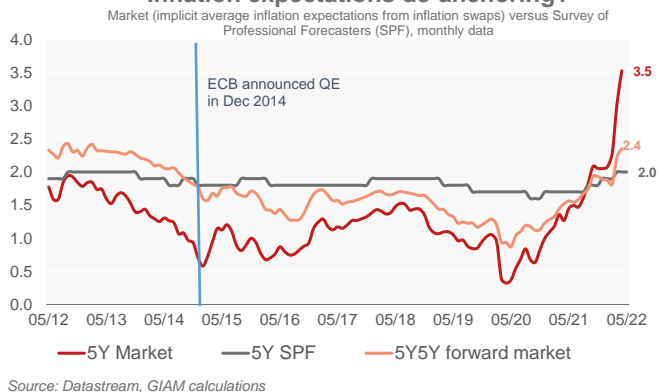
Source: Datastream, ECB

Risks of de-anchoring inflation expectations now acknowledged: Over the past weeks inflation expectations have continued to trend upwards. To put it into perspective, it is worth recalling that before the GFC (in July 2008) 5Y5Y expectations averaged even 2.7%, above the current 2.4% average of April. However, 5Y market expectations were at 2.7% vs 3.5% now and the Survey of Professional Forecaster (SPF) reading was 1.9%. The update of the SPF will be out tomorrow (Apr. 15), and we see a good chance that the 2.0% reading may be exceeded for the first time. The upshot is that inflation expectations might be on the verge of de-anchoring. Against this backdrop it did not surprise us that the GC stated: “*While various measures of longer-term inflation expectations derived from financial markets and from expert surveys largely stand at around two per cent, initial signs of above-target revisions in those measures warrant close monitoring.*” It thereby clearly stepped up its language versus the previous meeting. In the press conference President Lagarde commented that the ECB was therefore “*particularly attentive to wages*”. While wage growth was still muted (negotiated wages up by 1.6% yoy as of late) she warned that the longer the period of high inflation lasts the higher the risk of second-round effects.

Financing conditions deteriorating



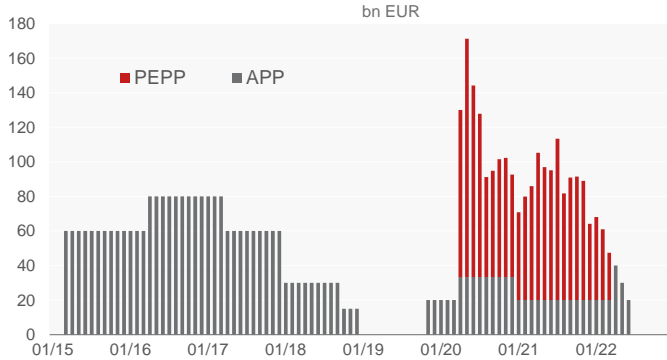
Inflation expectations de-anchoring?



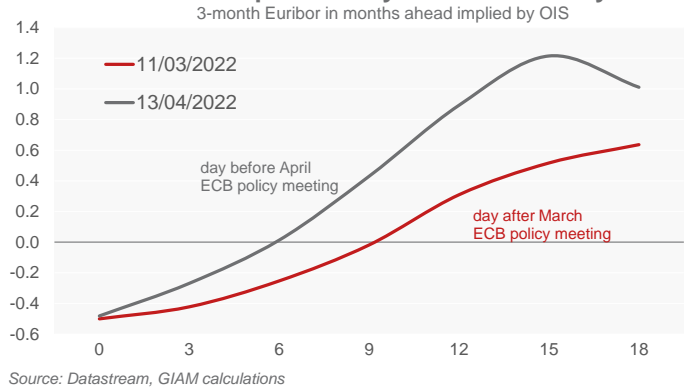
Faster policy normalization but with a seatbelt: President Lagarde left no doubt that the ECB has no other choice than adjust its monetary policy to the worsened inflation environment. Yet, it also became clear the policymakers are not only aware of the downside risks to activity but also of the risk of increasing fragmentation, something the GC wants to avoid. So far government bond spread widening remained contained. But the GC stated not only as usually that it stands ready to adjust all its instruments but added the possibility of “*incorporating flexibility if warranted*”. In the Q&A session Lagarde emphasized the need for flexibility, that the ECB constantly tries to improve its toolbox and that this could happen quite fast if needed. That said, she denied that the ECB was creating a new instrument. We think that she wanted at this stage send a signal to markets that the widening of government bond spreads will be observed. Indirectly these comments should support speculations that the ECB might deviate from capital key buying in the case of reinvestments more lastingly. However, in our view such an instrument could also raise legal issues and would need to properly discriminate between pure fragmentation and other factors without eliminating the disciplining effect of the market. Still the overall message is that the ECB will embark on policy normalization with a seatbelt.

End of QE in July and first rate hike in September our base case: At today’s meeting no policy decisions were taken, as expected. Lagarde emphasized – as in the previous meeting – optionality and gradualism. Still the GC was “*reinforced*” in its expectation that QE would end in the third quarter. In the press conference Lagarde even talked of a “*very high probability to end QE*”. In our view, at the June 9 meeting the ECB macro projections will take account for the considerably worsened inflation outlook and an end of QE by July is likely to be announced. That said, the GC will likely want to wait until September before embarking on a first 25 bps rate hike, followed by another one in December. Our key reason for this somewhat reluctant stance is that we see a good chance that the combination of very high inflation and fallout from the war will bring activity temporarily close to a halt. But with these factors losing importance and wage growth likely increasing we look for first action by September only. That said, if for instance inflation expectations were to de-anchor, the ECB might be forced into even earlier action. According to rumours, some ECB policymakers also see a July rate hike still feasible.

ECB's QE outlook after the end of the PEPP



Markets expect steady normalisation cycle



This document is based on information and opinions which Generali Insurance Asset Management S.p.A. Società di gestione del risparmio has obtained from sources within and outside of the Generali Group. While such information is believed to be reliable for the purposes used herein, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. The information, opinions estimates and forecasts expressed in this document are as of the date of this publication and represent only the judgment of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio and may be subject to any change without notification. It shall not be considered as an explicit or implicit recommendation of investment strategy or as investment advice. Before subscribing an offer of investment services, each potential client shall be given every document provided by the regulations in force from time to time, documents to be carefully read by the client before making any investment choice. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio may have taken or, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein provided. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio relieves itself from any responsibility concerning mistakes or omissions and shall not be considered responsible in case of possible damages or losses related to the improper use of the information herein provided. It is recommended to look over the regulation, available on our website www.generali-investments.com. Generali Investments is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro Italiche. Generali Investments is a commercial brand of Generali Investments Partners S.p.A. Società di gestione del risparmio, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Generali Investments Luxembourg S.A. and Generali Investments Holding S.p.A..