

Focal Point

Russian invasion exacerbates central banks' policy dilemma

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Our Focal Point series explores topical issues on macro, markets and investment

- The fallout from the Russian war in Ukraine exacerbates global price pressures further. It comes on top of already elevated pre-war inflation on the back of high energy prices, supply bottlenecks and a post-Covid recovery.
- Moreover, huge uncertainties surrounding the war and the sanction-retaliation spiral add to central banks (CBs) headaches and create stagflationary challenges. Monetary policy responses will be heterogeneous.
- With second-round effects from high inflation unfolding the Fed and the BoE are most advanced in lifting rates. Amid QT we look for a total of seven and respectively five hikes this year. Still, policy rates will remain below neutral.
- The euro area and Japan are laggards in the business cycle. However, we expect the ECB to start hiking rates in December after a period of almost stalling growth, as it will need to address second-round effects from the labour market on inflation. The BoJ is struggling to keep its policy constant. Markets could force her to give in rather sooner than later. bts are rising that it will manage to prevail.
- In this uncertain stagflationary environment government bonds face headwinds and we see yields rising further. We are also cautious on equities near term. The euro is set to gain lasting ground against the greenback only once the ECB embarks on its normalization cycle.

About one month ago the Russian invasion in Ukraine shocked the world. Economically, the most import immediate reaction is rising energy and commodity prices. The oil price temporarily reached 122 €/b Brent and the gas price peaked at 252 €/mWh. This has immensely complicated the already hard task of CBs to stem inflationary pressures, without compromising the recovery. Already before the war inflation sky-rocketed towards 8% in the US and 6% in the euro area. The spike in commodity prices adds to the part of inflation of which CBs have less control on, and at the same time hits demand via lower purchasing power and falling confidence.

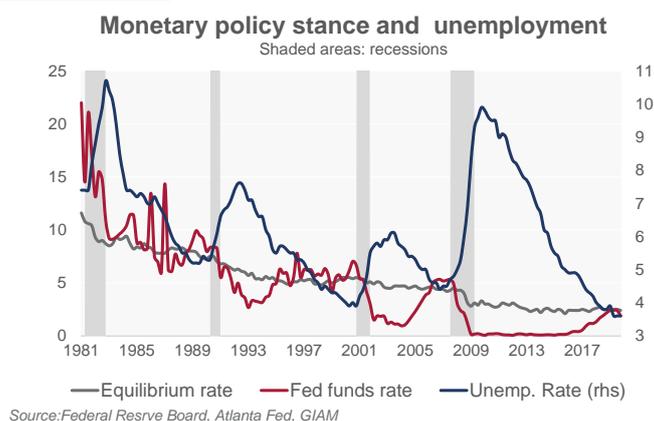
It is by no way clear how the conflict will evolve. In this [fog of war](#) our baseline scenario is one of prolonged military fights and persistent sanctions with oil and gas prices settling at elevated levels for longer. The likely persisting high degree of isolation of Russia from global energy and raw material markets has in our view the potential to not only increase price pressure but to also induce more volatility. This will make it even harder for CBs to keep inflation close to target.

Inflation concerns are currently most pronounced in the US and the UK where CBs already started to respond by policy tightening. In contrast, the ECB still has more leeway but will

need to act also in late 2022. Only central banks like the BoJ where inflation is set to recover merely close to target will leave rates constant. A special case is China. The PBoC is seen to cut rates due to new pandemic fallout on activity and other headwinds to growth. 2022 will be a year of strongly diverging speed of policy normalisation.

Growth headwinds will test Fed's hawkishness

After the rate lift-off in March, the Fed has doubled down on its determination to quell inflation. The dots published at the March meeting show the intention to raise rates seven times this year. Moreover, large (50 bps) increases remain a likely option. Despite the global tensions, the Fed deems the economy strong enough to withstand a quick removal of accommodation and to sustain a long period of tightening. Indeed, according to the March projections by the Fed Board the policy rate is set to remain some 40 bps above the equilibrium value until 2024, allowing inflation to go back to just above 2% in 2023 but without the unemployment rate moving from a low of 3.5%. In the Fed's view, the firm re-anchoring of inflation expectations would neutralise the negative impact of policy tightening on activity, leading to a relatively painless disinflation. This would be a stark depart from what has happened over the last 40 years or so: apart from 1994, each time the Fed raised the policy rate above the estimated equilibrium a recession followed. The lesson of 2018 is also relevant. After having increased rates by 200 bps in two years until December 2018, signs of market turbulence and weakening growth forced the Fed to cut by a cumulated 75 bps in the second half of 2019.



Yet, markets seem to have taken seriously the possibility of heavily frontloaded Fed action, as they expect the policy rate to peak close to 3% by September 2023. However, futures show that this will be followed by an abrupt turn pulling back the rate to 2% by the end of 2024, to respond to faltering activity. This is consistent with the possibility that some part of the yield curve will invert soon as the 5Y/30Y already has and relates to the doubts on how much tightening the US economy can endure.

On top of the negative impact of high inflation and political

uncertainty on sentiment, we point to three potentially headwinds looming for summer. First, with the end of the income support measures in 2021 and the limited political scope for further action, fiscal policy will provide a negative contribution to growth this year. Secondly, the household saving rate has fallen rapidly and in January was, at 6.4%, roughly one percentage point below the 2016-2019 mean. Dissaving can proceed further, but the impulse to consumption is likely to be short lived and limited by the fact that wealth accumulation in the form of liquid assets was concentrated among the richest households. Finally, some further headwind can come from the expected cooling of the housing market. The sharp increase in mortgage rates since the beginning of the year put a lid on mortgage applications. Reduced demand for housing will also dampen the surge in house prices (still running at a faster pace than in the period preceding the 2007 bust). This in turn will moderate the increase in the housing component of CPI, which accounts for around 40% of the core rate.

Summing up, in our baseline scenario of persistent but not permanent disruption from the war, the strength and durability of core inflation clearly calls for a frontloaded increase in rates. But we expect it to be slower and more stretched out than what markets see (or fear). We expect the Fed funds rate to be increased by some further 150 bps in 2022, with the policy rate peaking at around 2.6% in the first half of 2023. Risks are tilted to a stronger frontloading over the next months, with a high probability of 50 bps increases over the coming meetings, especially if economic activity and the labour market prove to be relatively little affected by the war. But these aggressive moves would add to growth woes and likely entail other unwelcome bouts of market volatility.

The outlook for the balance sheet reduction appears much less controversial. Chair Powell hinted that the mechanics will be like what seen in 2017 but will proceed at a faster pace. This means that the monthly maximum caps for reinvestment will be set at around US\$ 60 bn for Treasury and US\$ 40 bn for MBS. Given evidence of pockets of liquidity stress and the likely persistence of market turmoil related to the war in Ukraine, the Fed will likely opt for a gradual approach, with a lower rate of runoff throughout the summer. The reduction in asset holding of around US\$ 700 bn in 2022 is equal to an additional rate hike. We expect the process to end in H1 2025, with holdings cut by around 15% of GDP (US\$ 3 tn). Afterwards, the Fed will likely keep its balance sheet at just above 20% of GDP, reflecting a higher desired level of reserve buffers. During the process, the stock of MBS could shrink faster to speed up the normalization of the housing market. In any case, once the size of the balance sheet is back to its desired value, maturing MBS will be gradually replaced by Treasuries.

A more severe disruption causing an escalation in financial

market turbulence posing strong risks for growth would force the Fed to stop or significantly slow down its monetary tightening, implying a much flatter path for the Fed funds rate and a much slower reduction of the balance sheet. On the contrary, a quick cooling of tension would allow the Fed to concentrate more on the home-grown components of inflation and to make good on its promise to deliver the fast-paced tightening that it has committed to.

BoE more cautious on policy dilemma

The BoE raised Bank Rate by 25 bps to 0.75% on March 17, the third consecutive hike. Thus, the BoE has frontloaded its hikes at a much faster pace than the Fed. However, one dissenting vote in the Monetary Policy Committee (MPC) at the last meeting and a more dovish wording showed the BoE increasingly worried about the war's growth fallout (higher energy/commodity prices, disruptions to supply chains and lower global growth). This deteriorates the BoE's policy dilemma to which the MPC responded with a more cautious policy guidance. Instead of saying that "*some further modest tightening in monetary policy was likely to be needed*" it now scaled back its view to this "*may be appropriate in the coming months*".

UK inflation will again outpace the BoE assumptions of its February Inflation Report which forecast price increases to peak in April 2022 at 7.25% yoy but to stay rather high until Q1 2023 at 5.2% yoy. The BoE upgraded its expectation already to 8% yoy in Q2 2022. Moreover, a likely second rise in the energy price cap in October could push inflation to new highs. We expect inflation to average 7.4% in 2022 (3.5% in 2023). As the latest labour market indicators remained strong and average weekly earnings growth has risen to 4.1% yoy (the BoE uses a 3-months rolling average now up to January) there are also still ongoing risks of a wage-price spiral.

However, back in February the BoE ran its model under the assumption of a rise in Bank Rate to 1.5% (by then the market expectation) and oil prices as implied by future markets. The model already predicted growth to fall substantially below potential and inflation to undershoot the target of 2% over the medium term (see [here](#) for more details). Now, the BoE expects the developments since the February Report "*likely to accentuate both the peak in inflation and the adverse impact on activity [...]*". The main reason is the even higher squeeze in household incomes. This likely implies for the BoE a more cautious stance than in the February report. Consequently, we cut out one rate hike in our forecast (August) and see the BoE to stop the cycle now at 1.25% in November. By contrast, markets still price in a much steeper pace, expecting Bank Rate at 2% by the end of this year and another 1.5 hikes in 2023. In our view, such a path would likely result in a recession.

BoE Model projections February 2022

Central projection	Q1 2022	Q1 2023	Q1 2024	Q1 2025
CPI	5.70	5.20	2.10	1.60
GDP	7.80	1.80	1.10	0.90
Excess supply (-)/ excess demand (+)	+0.5	-0.25	-0.50	-1.00
Alternative projection	Q1 2022	Q1 2023	Q1 2024	Q1 2025
CPI	5.70	5.10	1.20	1.20
Annual projections	2022	2023	2024	
GDP growth	3.75	1.25	1.00	
Real post-tax labour income	-2.00	-0.50	0.75	
Unemployment rate (in Q4)	4.00	4.50	5.00	

Source: Bank of England Inflation Report Nov. 2022, GIAM

ECB will be forced into action by second-round effects

The euro area's low-inflation decade has come to a quite sudden end, too. Headline inflation exceeds the 2% norm since the second half of 2021 and jumped to unprecedented 5.9% yoy as of February – and more is yet in the pipeline. January PPI was at 30.6% yoy and import prices were up by 11.9% yoy. Output price indicators from business surveys reached new highs in March. What is more, inflation is broadening with only 15% of the (Jan. 22 weighted) HCPI categories showing inflation rates below 1.5% while almost 2/3 displayed rates above 2.5%. The ECB's proprietary measures of underlying inflation (supercore, PCCI) have also risen strongly to new highs suggesting that the huge inflation pressure will not ebb soon as well.

The ECB's decision making is complicated by increased activity risks from the fallout from the war in Ukraine. Additional bottlenecks, spiking pump station prices, possible gas shortages and a blow to confidence are likely to bring growth to a halt. In March consumer confidence dropped sharply and forward-looking components in key business surveys deteriorated. On top, headwinds from renewed lockdowns in China risk disturbing global production chains further. We expect activity to grind to a halt in Q2/Q3 and even see the risk of a technical recession. With an expected 2022 annual growth rate of 2.2% we are way below the ECB staff projection (3.7%). At the June meeting the ECB staff will likely need to revise its central scenario projections sharply down.

That said, inflation rates will stay at or above 6% yoy at least until mid-year in our view, keeping financial markets inflation expectations elevated. Over the past month they advanced to levels still broadly consistent with the 2% target (e.g. 5Y5Y inflation linked swaps) or even beyond (e.g. 10Y inflation linked swaps). While the ECB would normally look through a supply shock Governing Council (GC) member [Panetta](#) several times made the point that in case of an ugly inflation, namely the "*de-anchoring of inflation expectations*" monetary policy would need to act in any case.

A key role in assessing this is the outlook for underlying inflation which in turn is strongly impacted by wage developments. According to Vice-President [de Guindos](#) the ECB is “attentive to any developments that could indicate a wage-price spiral”. Thanks to crisis-related government support measures the labour market is in good shape with the unemployment rate at 6.8% in January. This puts unions in a good position for negotiating higher wages in response to reduced purchasing power and would be consistent with past experience. Just before the GFC started to unfold, in 2008 the euro area unemployment rate was at 7.6%, inflation at 3.3% yoy and negotiated wages grew by 3.5% yoy. Currently (Q4/2021) negotiated wages grow by only 1.6% yoy. Accelerated wage growth will contribute to a further rise of inflation expectations. Finally, the ECB will be forced into action amid data showing that growth stalled over summer.

The update of the macro projections should lift headline and core inflation above the 2% threshold by 2024 and finally also convince the doves to make clear that a first rate hike will need to come. Still, we expect the ECB to proceed only carefully. A major factor will be that the likely stop of QE after Q2 and aggressive Fed tightening already contribute to monetary tightening. Following a 25 bps rate increase in December we look for a step-by-step normalisation of only 50 bps each year thereafter. Expiring large TLTROs will likely only be rolled over under less favourable conditions. The ECB committed itself to reinvest PEPP purchases until the end of 2024 and we expect no unwinding of APP purchases earlier either. Later, QT will also become an important tightening tool for the ECB. All in all, we see the neutral policy rate of around 1.5% not in reach before 2025.

While the ECB normalisation cycle will be measured it would also take much to prevent the ECB from starting it. Only in case of a severe recession with labour market slack emerging and disinflationary factors gaining the upper hand this could be the case in our view. We would then also expect QE purchases to persist or to be resumed. Reasons could be an escalation of the war or a significant worsening of the pandemic, e.g. due to severe mutations. Conversely, if the positive scenario were to materialize the GC would likely start its hiking cycle already by September.



BoJ struggling to keep its expansionary stance

Markets have speculated already several times on an early exit of Japan’s strongly expansionary monetary policy. However, so far BoJ Governor Kuroda forcefully rejected these speculations. In his view, the price increases from the fallout of the war will not affect Japan’s inflation on a sustained basis and thus it would be too early to tighten monetary policy. But market pressures are rising and the BoJ may need to give in, considering the following mechanism:

Long-term JGB yields are highly correlated with their US counterparts. Given the tightening stance of the Fed, US 10y Treasury yields have risen strongly of late and are forecast to rise by about 20 bps within the next twelve months. This would also push up 10-year JGB yields, which have most recently violated again the upper limit of 0.25% of the BoJ’s yield curve control policy band. The BoJ responded by offering (again) to purchase unlimited amounts of JGBs at 0.25% to defend the upper bound. Currently, a 10y Treasury yield rise by 10 bps pushes up 10y JGBs by an estimated 2.8 bps. Consequently, the forecast Treasury yield rise would surpass the band on a lasting basis, which would force the BoJ to maintain its offer unlimitedly in quantity but also without any time constraint. In principle, this offer is compatible with the BoJ’s policy goals and thus will not force it to end the policy soon.

However, this policy comes with side effects mainly in the form of a rising yield differential, rendering it even more attractive to buy US assets and thereby depreciate the yen, which has already slid by 6% vs. USD year-to date. This movement could help exports but also additionally increase import prices on top of the already elevated energy inflation. To some extent, higher inflation could be welcomed but households would see their real income suffer, which could become politically untenable. The government already commented on the current “kind of inflation” as unwelcome. We expect core CPI inflation to rise to around 2% in April, and the BoJ recently confirmed this view. The BoJ still has the option to intervene in the FX market, but such a policy could fast deplete currency reserves.

In sum, previously we had expected the current BoJ policy to be modified at the latest after Kuroda’s term will end in April next year. However, given the recent strong market moves, we believe that the BoJ will be forced to widen its band by e.g. 10 bps rather sooner than later. Given the above correlation, this could help taking out the sting of upside pressures.

PBoC to support expansionary fiscal stance

China will step out of the global line of tightening monetary policy as a fresh Covid outbreak led to widespread lockdowns under China’s zero-tolerance policy with a likely

marked negative impact on production and consumption. At the NPC meeting China's 2022 growth target surprised on the upside with around 5.5%, pointing to more government support. Generally, the main focus shifted to fiscal policy. The growth target is backed by a widening of the broad deficit by about 3 pps of GDP, stemming from PBoC and SoE's profit transfers as well as from past fiscal savings. By comparison, the narrow (official) deficit will decrease to 2.8% of GDP. Rising energy and commodity prices will push up PPI and CPI inflation, with the latter expected to rise to around 2.5% yoy, from currently 0.9% yoy. However, we still see room for monetary policy to support the economy. We expect three 10 bps cuts in the 1-year Medium-term Lending Facility (MLF) rate and one 50 bps cut in the reserve requirement ratio (RRR). Yet, the growth outlook remains very uncertain. We currently see growth at 3.7% this year, followed by a rebound to 6.3% in 2023.

Financial market implications

The war also rattled financial markets. Surging inflation concerns and overall hawkish central banks have triggered a sharp sell-off in international bond markets which has likely not run its course yet. While the leeway for long-dated inflation expectations to climb even further appears limited real yields have scope to rise from still depressed levels. Having said that, the rise in yields is forecast to lose momentum as self-correcting mechanism will kick in.

Likewise, equity markets were hit strongly right after the Russian invasion. The market shakeout has brought valuations down from lofty levels. Persistently high risks of a further escalation of fights and sanctions will keep volatility high. In an environment of strong headwinds to growth and hawkish central banks we recommend a small underweight on equities near term. But we still look for positive total returns on a 12-months horizon (5% and 7% for the MSCI EMU and S&P500, respectively).

Divergent monetary policies alongside high geopolitical risks will keep the USD bid near term. Yet, EUR/USD has already undershot on fair value metrics and past episodes point to fading USD support after actual Fed lift-offs. We expect EUR/USD to gradually recover over H2 once uncertainty recedes, the euro area economy recovers from stagnation and the ECB clears the path towards an end of negative rates.

IMPRINT

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