

MARKET COMMENTARY

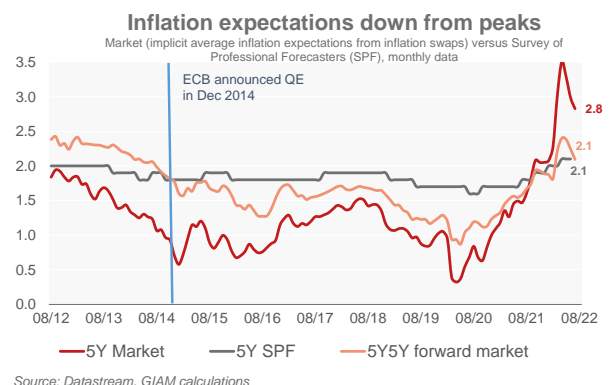
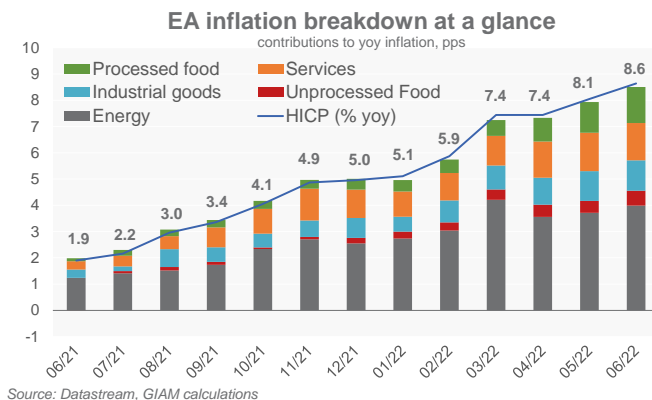
No forward guidance after today's 50 bps surprise. TPI no panacea but to facilitate further hikes.

Author: Martin Wolburg

July 21, 2022

- At today's meeting the Governing Council (GC) lifted its key rates by 50 bps, more than the 25 bps pre-announced at the June meeting. The key reasons for this stronger than initially foreseen rate hikes were the reassessment of the inflation risks and the launch of the announced anti-fragmentation tool, the Transmission Protection Instrument (TPI).
- The rate decision was taken by "total consensus". The GC stated that at "upcoming meetings, further normalisation of interest rates will be appropriate. No indication about the size of the September hike was given. Instead, the "future policy rate path will continue to be data-dependent" and that a "meeting-by-meeting approach to interest rate decisions" will be taken. This keeps flexibility and stops damaging communication flexibility.
- The ECB's anti-fragmentation mechanism is a two-step procedure: First, PEPP reinvestment purchases are used to counter pandemic-related risks. Second, in case they are not sufficient the TPI will come into play. Its purchases are not restricted but eligibility requires compliance with the EU fiscal framework, absence of severe macro imbalances, fiscal sustainability and sound and sustainable macro policies. However, in the end its application is at full discretion of the GC.
- We doubt that the TPI will be a panacea against current market stress. But with it now in place the GC will no longer feel constrained by fragmentation as Lagarde made clear during the press conference.
- Against this backdrop we see the risk of another 50 bps hike in September and a more than currently pencilled in year-end key rate of 0.75%. In any case, we deem current market expectations of about 1.25% as too high given our below consensus activity expectations for the second half of the year.

A 50 bps surprise as TPI is now available: At today's meeting the GC did not follow its announcement from June and lifted its key rates by 50 bps thereby bringing the deposit rate to 0.00% and the repo rate to 0.50%. Key reasons were the reassessment of the inflation risks and the launch of TPI. It was the first rate hike since May 2011 and the ECB made clear that further rate hikes are ahead. The GC stated that at "upcoming meetings, further normalisation of interest rates will be appropriate". No indication about the size of the September hike was given. Instead, the "future policy rate path will continue to be data-dependent".



High inflation amid ongoing growth remains ECB base case: Just weeks ago the GC stated that it intends to raise key rates by 25 bps in July and in between the lines implied a 50 bps hike in September. One important reason given for the deviation of this path was (apart from the TPI) according to President Lagarde the realization of upside risks to inflation (headline inflation soared to 8.6% yoy in June), high pipeline pressure on inflation, the strength of underlying inflation measures and weakening of the EUR against the USD. Looking ahead, the GC continues to see the activity risks tilted to the downside. In contrast, the “risks to the inflation outlook continue to be on the upside and have intensified, particularly in the short term”. However, GC is aware that “if demand were to weaken over the medium term, it would lower pressures on prices.” That said, in the Q&A Lagarde pointed out that under the ECB’s baseline scenario there was no recession, neither this nor next year.

The TPI shall give the GC more policy leeway: As the second reason for a bold rate hike today Lagarde mentioned the TPI which “will ensure that the monetary policy stance is transmitted smoothly across all euro area countries”. Following widening peripheral bond spreads the GC had after an ad hoc meeting announced an anti-fragmentation tool on [June 15](#). Today it revealed the details. PEPP reinvestment flexibility will continue to be the first line of defence. It amounts to roughly € 20 bn per months according to calculations. If not sufficient the Eurosystem will make secondary market purchases. The [key elements](#) are:

- They will comprise securities with a remaining maturity of between one and ten years. Purchases of private sector securities could also be considered.
- There are 4 eligibility criteria that “will be an input into the Governing Council’s decision-making and will be dynamically adjusted to the unfolding risks and conditions to be addressed”. These are compliance with the EU fiscal framework, absence of severe macroeconomic imbalances, fiscal sustainability and sound and sustainable macroeconomic policies.
- Activation is done by the GC based on a comprehensive assessment of the situation. In the press conference Lagarde openly stated that there “is an element of discretion and judgement” and also implied that it could be activated quickly.
- The Eurosystem accepts the same (pari passu) treatment as private or other creditors.
- Purchases under the TPI would be conducted such that they cause no persistent impact on the overall Eurosystem balance sheet and hence on the monetary policy stance but no details about sterilization were given.

The ECB’s Financing Conditions Dashboard

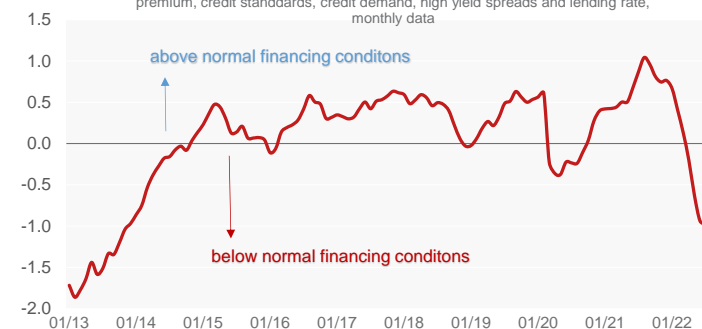
z-scores of respective variables with values > 0 indicating better than average financial conditions, < 0 the reverse; own calculations, latest data on lending rate estimated, BLS data monthly interpolated

	2021	Q1 2022	Q2 2022	May-22	Jun-22	Jul-22
Gov. bond spread (GDP weighted)	1.45	0.22	-1.26	-1.01	-2.62	-1.83
Term premium (10Y-1Y OIS)	1.01	0.14	-0.46	-0.46	-0.46	-0.46
BLS credit standards	-0.52	-0.01	-0.66	-0.91	-0.59	-0.26
BLS credit demand	-0.30	0.01	-0.45	-0.42	-0.62	-0.82
High Yield spread	1.02	0.13	-0.90	-1.06	-1.45	-2.59
Lending rate	1.39	0.20	0.21	0.11	0.11	0.11
unweighted mean	0.67	0.12	-0.59	-0.63	-0.94	-0.98
~ ex Lending rate	0.53	0.10	-0.75	-0.77	-1.15	-1.19

last update: 21/07/2022, lending rate: June/July assumed constant at May level
Source: Datastream, GIAM calculations

Financing conditions sharply down

aggregated z-scores of GDP weighted government bond spreads, the 10Y/1Y OIS term premium, credit standards, credit demand, high yield spreads and lending rate, monthly data



Source: Datastream, GIAM calculations

TPI no panacea: The presented details of the new anti-fragmentation tool make clear that it is not a mechanical spread-containing mechanism. It probably deliberately left the question open whether for the detection of fragmentation it looks at the spread level or the speed of spread widening. The ECB gets around the problem of deriving a fair, fundamentally justified spread by relying on the compliance of a specific country with the overall EU framework. Only in this specific case the TPI applies, otherwise – and Lagarde was very clear about this in the Q&A – the OMT would come into play. While theoretically appealing it will probably be only of limited effectiveness for countries in which at least one on the above mentioned four eligibility criteria is not met. The pressure in this country to adjust policy then clearly increases. Still, short-term there might hardly be any protection from fragmentation. However, according to what has been released about the TPI it also became clear that the GC will in the end also carefully weigh the risks and these criteria are only an input. Hence, in case of systemic

stress the ECB might in the end nevertheless act via the TPI. The future will show how the GC handles the tool giving markets the possibility to infer a reaction function. At least short term this creates huge uncertainty. All in all, we doubt that the TPI will be a panacea to current bond market stress.

Further rate hikes ahead but recession risks to tame normalization: With the TPI now available, the GC seems to be willing to move ahead more decisively with rate hikes. According to Lagarde the TPI was approved with unanimity and all members of the GC rallied to the consensus of 50 bps. Looking ahead, she also made clear that the previous forward-guidance for September was no longer available. Uncertainty regarding future policy action increases: On the one hand, the TPI enables the ECB to proceed somewhat fast on its normalisation path than otherwise. On the other hand, the decision will become much more data driven from now on and in the Q&A session Lagarde admitted that the neutral rate was not yet known. We expect a cooling of activity ahead and even see a high risk of a recession while inflation likely peaks in September/October. We think that in this environment the ECB will become less vigilant on normalising rates. On balance, we see mounting upside risks to our year-end 2022 key rate forecast of 0.75%. In any case, we deem current market expectation of about 1.25% too high.

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 Italiane. 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..