

# MARKET COMMENTARY

No surrender: The Russian invasion does not stop the ECB's will to tighten policy

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- At today's meeting the Governing Council (GC) surprised again on the hawkish side. The unwinding of QE will be accelerated, and asset purchases will end by June unless the inflation outlook deteriorates. Pandemic-related asset purchases will end by March, as expected.
- But at the same time the GC emphasized uncertainty and data-dependency regarding future policy action. It basically eliminated the time-link between the end of net asset purchases and the first rate hike while maintaining the sequence of policy steps.
- The updated staff projections back the case for policy normalization. Unless downside risks to the medium inflation outlook materialise, we see the way paved for the start of the normalization cycle in 2022. The ECB's proprietary baseline case seeing growth at 3.7% in 2022 would be consistent with two rate hikes this year.
- We are more cautious regarding the fallout from the war and see the euro area growing by only 2.2% in 2022, well below the ECB's expectation. We therefore continue to see only one hike in December but acknowledge that the risk shifted again towards two hikes this year.

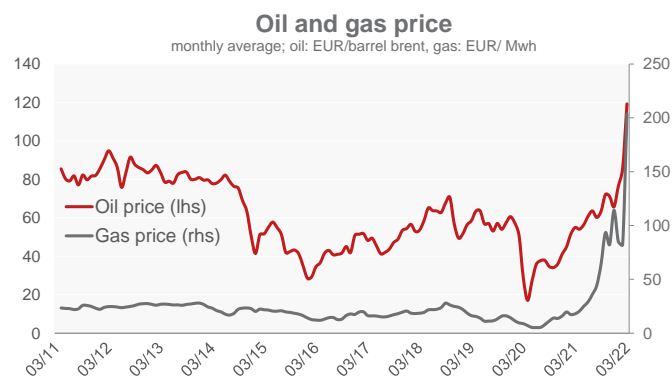
**Hawkish policy decisions:** As expected, at today's meeting the Governing Council (GC) announced an end of the PEPP but at the same time made clear that policy normalisation will not be derailed. More specifically, the GC decided:

- To terminate the PEPP at the end of March but emphasized that "*renewed market fragmentation related to the pandemic, PEPP reinvestments can be adjusted flexibly across time, asset classes and jurisdictions at any time.*"
- To adjust monthly APP purchases to € 40 bn in April, € 30 bn in May and € 20 bn in June and stating that thereafter the "*calibration of net purchases for the third quarter will be data-dependent and reflect its evolving assessment of the outlook*". If the inflation outlook does not weaken after the end of QE, the GC will conclude net asset purchases in Q3.
- However, this does not mean that a key rate hike thereafter is imminent as the GC also stated that "*Any adjustments to the key ECB interest rates will take place some time after the end of the Governing Council's net purchases under the APP and will be gradual*".
- The special conditions for the TLTROs will likely end in June and repo facilities with other central banks are extended to January 2023 to offset potential financial market stress related to the Russian invasion.

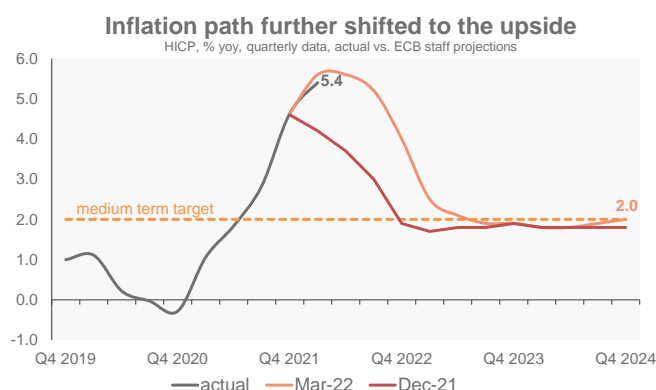
**Inflation up but still discussion about persistence:** The sharp update of the inflation outlook in the ECB staff projections hardly came as a surprise. Annual inflation is now seen to average 5.1% this year and 2.1% and 1.9% in the years 2023/24. Also, the path of underlying inflation was lifted to the upside (2021: 2.6%, 2022: 1.8%, 2024: 1.9%). Thereby both key metrics for the ECB policy decision are close to the 2% target over the forecast horizon. As a result the "*Governing Council sees it as increasingly likely that inflation will stabilise at its two per cent target over the medium term*". Still it points out that "*it is uncertain how persistent the rise in these indicators will be, given the role of temporary pandemic-related factors and the indirect effects of higher energy prices.*"

**Substantial risks:** The baseline scenario is one of a prolonged inflation spike (see graph below). But against the Russian invasion into Ukraine the risks to the outlook have risen considerably. In an adverse scenario for instance, headline inflation is

forecast to average only 1.6% by 2024. In the press conference President Lagarde made clear that the risks to inflation are definitely on the upside in the near term but over the medium term this is less clear. Regarding activity sentiment effects from the Russian invasion are a key wildcard and the balance of risks is clearly seen on the downside. We are more pessimistic regarding the macro scenario. We see inflation surpassing the 6% yoy level in the coming months and look for a more severe fallout from the war via sentiment effects, bottlenecks and a blow to purchasing power.

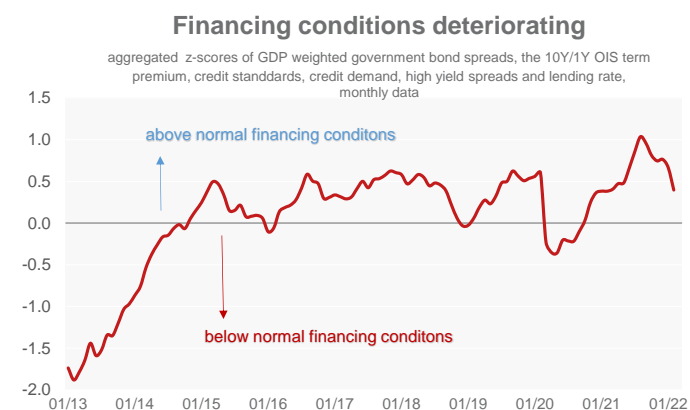


Source: Datastream, GIAM calculations

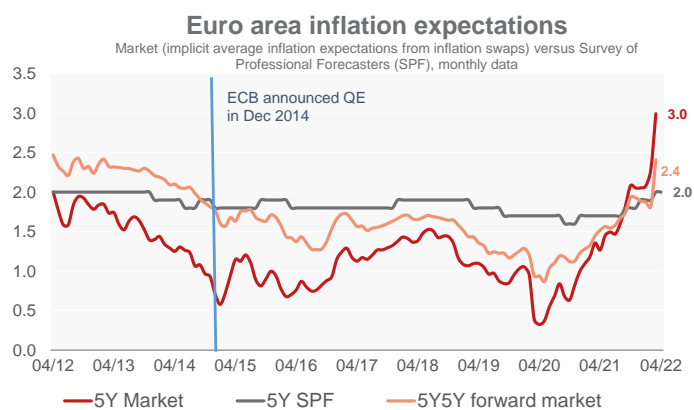


Source: Datastream, ECB, GIAM calculations

**Inflation expectations up, financing conditions down:** The GC's view about inflation expectations looks somewhat optimistic. It states that "longer-term inflation expectations across a range of measures have re-anchored at our inflation target. The Governing Council sees it as increasingly likely that inflation will stabilise at its two per cent target over the medium term." However, market-based measures for inflation expectations clearly passed the 2% threshold and also long-term measures are above this level. In case the ECB's inflation projection materializes they will for sure again come down but currently we rather see the risk that they become de-anchored and this might also have been on the GC's mind when they discussed today. In contrast, financing conditions weakened somewhat indicating some kind of endogenous policy tightening.



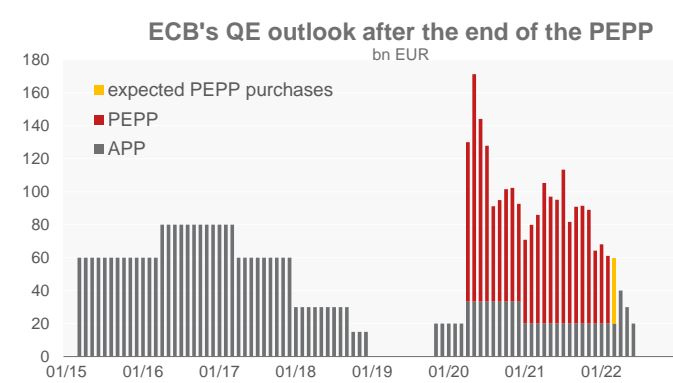
Source: Datastream, GIAM calculations



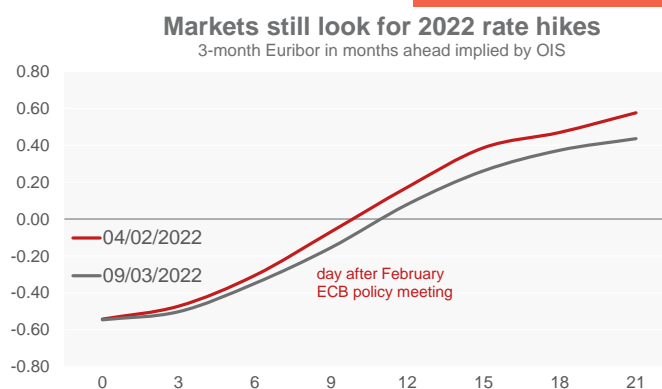
Source: Datastream, GIAM calculations

**Policy normalization will continue but optionality increases:** In the current situation uncertainty is extremely high and the GC rightly is "very attentive" to it. Not surprisingly, there was a "very intense discussion" and according to President Lagarde there was a wide range of options on the table ranging from ignoring the special situation to moving ahead with the current policy stance. The compromise taken makes sense in our view. On the one hand, the GC was clear on ending QE while on the other hand the time-link between the end of QE and the first rate hike was cut. It is now stated that "adjustments to the key ECB interest rates will take place some time after the end" of QE and no longer "shortly after". In order to make clear that the next move in rates will be up the GC cancelled to downside bias in rates. By making the timing of the first rate hike fully data dependent the ECB seeks to maintain "maximum optionality under maximum uncertainty" as Lagarde called it. She also insisted that today's decision was no acceleration of the normalization path but that progress will be made step by step in an agile way. She explicitly stated that QE could end at any month in the third quarter and that the new term 'some time after' can be "the week after or months after".

**A December 2022 rate hike remains our base case:** We think that the GC made a wise decision by keeping maximum flexibility. However, it restrained to give hints about the decision in case of a growth and inflation trade-off emerging. Will the ECB in a stagflationary situation fully sacrifice growth and hike rate nevertheless? And if not, will it fully look through? Today we got no new information about this. Policy uncertainty will therefore remain high. The only thing clear to us is that the further evolution of the war in Ukraine and its fallout will significantly impact its decisions. Unlike to the GC we are rather pessimistic on activity and see the euro area on the verge of a recession in the summer half of 2022 with growth averaging only 2.2% this year. The ECB expects 2022 output growth of 3.7% in its base case. Hiking rates in such a situation after having already ended QE would do more harm than good in our view. We do not expect the ECB to have turned on a hawkish autopilot. We stick to our view that a first rate hike by 25 bps likely takes place in December. That said, given the surprisingly hawkish decision at today's meeting the risk is that the ECB already starts hiking in September and continues to do so in December.



Source: Datastream, ECB, GIAM calculations



Source: Datastream, GIAM calculations

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