MARKET COMMENTARY

A step-by-step ECB policy normalization has started

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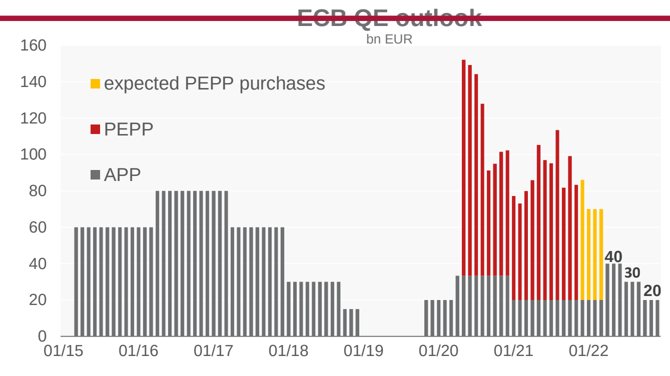
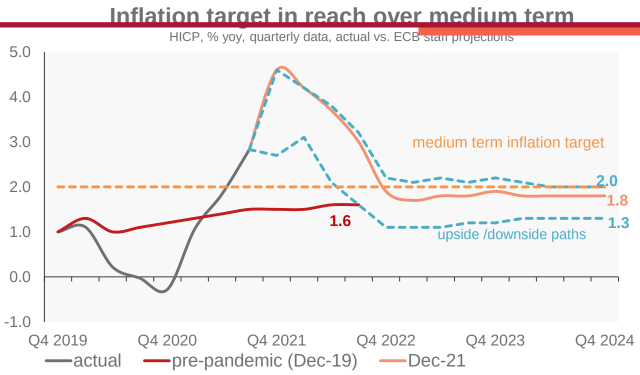
- **As expected, at today's meeting the Governing Council (GC) decided to further reduce PEPP purchases in Q1 and to end them after March 2022. To cushion the policy transition APP purchases will temporarily rise in Q2/22 and Q3/22 (to € 40/30 bn/month) while the period of (flexible) PEPP reinvestment is extended to at least year-end 2024.**
- **Notwithstanding Omicron, the updated macro projections remain constructive on activity. They show a much higher inflation path (with now even 3.2% in 2022) but still below target price dynamics in 2023/24. However, President Lagarde emphasized that uncertainty remains high.**
- **The GC adopted the decision with "*very, very large majority*" and again made clear that a 2022 rate hike is "*very unlikely*" and in the Q&A session President Lagarde stressed the flexibility regarding monetary policy.**
- **Next year will be a year of transition out of the pandemic: as a next step, the ECB will likely adjust TLTRO conditions. The ECB will prepare investors for rate hikes and try not to cause havoc in the process. We continue to see the first rate hike in 2024 but acknowledge that the risks of a 2023 hike increased.**

GC announced exit from emergency QE: At today's meeting the Governing Council (GC) announced long awaited steps towards policy normalization. As expected, it started adjusting QE purchases. More specifically,

- Monthly PEPP purchases will be further reduced in Q1/2022 and terminated after March 2022.
- However, the effect on markets will be eased by a temporary increase of APP purchases to € 40 bn per month in Q2/2022 and an afterwards adjustment to € 30 bn in Q3. In Q4/2022 APP purchases will again be back to € 20 bn/month. In 2022, it will hence buy € 330 bn under the APP.
- The reinvestment horizon of PEPP purchases is extended at least to the end of 2024 (from end of 2023 before) and the GC emphasized that "*reinvestments can be adjusted flexibly across time, asset classes and jurisdictions at any time*" and explicitly mentioned that this also includes Greek bonds.
- Moreover, net purchases under the PEPP could also be resumed if needed.



Source: Datastream, ECB, GIAM calculations



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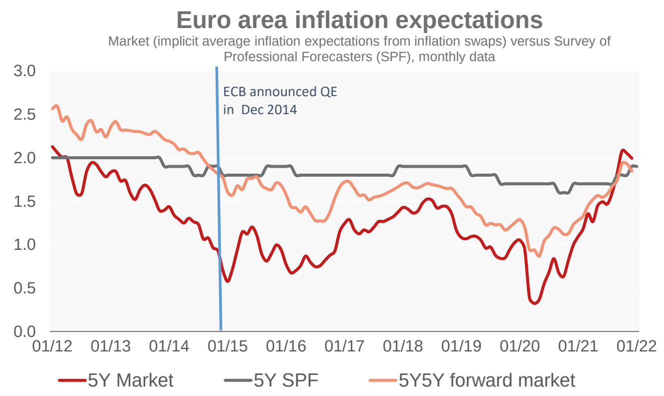
Inflation more persistent than thought: Over the past weeks GC members had in their speeches emphasized the upside risks to inflation. As expected, the ECB did not give up its transitory inflation view and stuck to the trinity of base effects, energy price spikes and bottlenecks temporarily boosting inflation. However, in its projections the inflation path was substantially shifted to the upside. Headline inflation is seen to average 3.2% in 2022 (after only 1.7% in September) but to fall to 1.8% in 2023/24. President Lagarde pointed out in the Q&A session that about two third of this upward revision was due to energy prices and the rest due to extended bottlenecks. That said, the recovery is set to continue notwithstanding the arrival of Omicron. In this environment the outlook for underlying inflation was also shifted upwards but in 2024 it is still seen not to reach the target and to average 1.8%.

Inflation uncertainty increased: Against this backdrop it is no surprise that the inflation uncertainty has increased. At the end of the forecast horizon in 2024 there is now a difference of 0.7 pp between the upside (implying the reaching of the target) and the downside path (suggesting a relapse in a lowflation environment). The GC seems to be pretty much aware of the issue. A key factor to watch is wage negotiations. According to Mrs Lagarde the projections already comprise some impact from higher wages and hence second-round effects on inflation. Still, the ECB is "extremely attentive to wage accounts on a weekly basis". Energy prices as well as the question if and when the consumption pattern will normalize remain also risks. Inflation expectations are now broadly in line with the 2% threshold, but a further significant rise would probably cause headache among the GC members.



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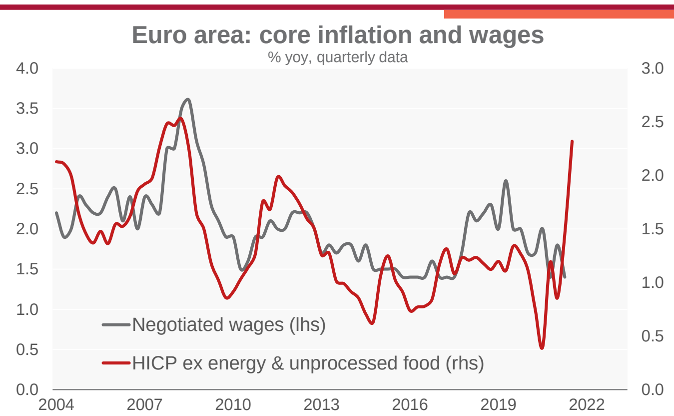
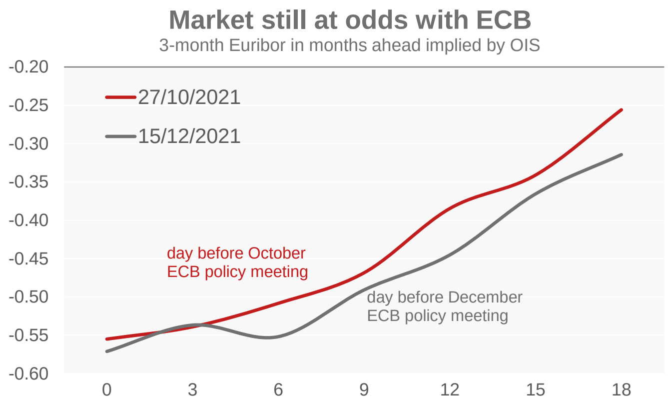


Source: Datastream, GIAM calculations

First key rate hike still distant Markets embarked on the expectation of a starting rate hike cycle of major central banks. Today the BoE lifted its key rate by 15 bps and the Fed confirmed rate hiking expectations yesterday (we now look for three hikes in 2022). However, President Lagarde tried to avoid the impression that the ECB was about to follow other central banks soon. When asked about the Fed in the Q&A session she unsurprisingly hinted at the special situation in each of the economies and at its forward guidance. The ECB's threshold for lifting rates is high. The new strategy demands inflation to reach its target "*well ahead of the end of its projection horizon and durably for the rest of the projection horizon"* and moreover the GC "*judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term*". This condition will most likely not be met in 2022 and President Lagarde found it "*very unlikely*" that the ECB would raise rates in 2022.

… but GC wants to be prepared for a 2023 hike: One of the key objectives of the ECB is to smoothen monetary policy changes and to avoid market gyrations. Hence, the GC will also keep in mind that Fed action also tightens financing conditions in the euro area. Therefore, we expect weekly PEPP purchases to be brought down gradually to € 12 bn in Q1/2022 (from € 16 bn in Q4/2021). In this scenario about € 200 bn of the € 1.85 tr envelope would then remain. The next step is probably the adjustment of the TLTRO conditions and the announcement of bridging tenders to avoid a policy cliff in 2023. And with overall QE purchases being reduced to € 20 bn per month in Q4/2022, the ECB will then be prepared to lift rates. The extension of the reinvestment period for PEPP purchases towards at least year-end 2024 will help to cap unorderly market movements as well. The announcement to resume net purchases under the PEPP if needed also goes in this direction. President Lagarde even suggested that the PEPP envelope could again be extended. All in all, the risks have clearly shifted more towards an anticipation of the first rate hike from 2024 to already 2023. The outcome of the early 2022 wage negotiations and the persistence of the bottleneck issue will be key. The fact that today's decisions were met by a "*very, very large*" majority suggests that the GC is increasingly aware of the upside risks to inflation and agrees with the need to normalize policy step-by-step.



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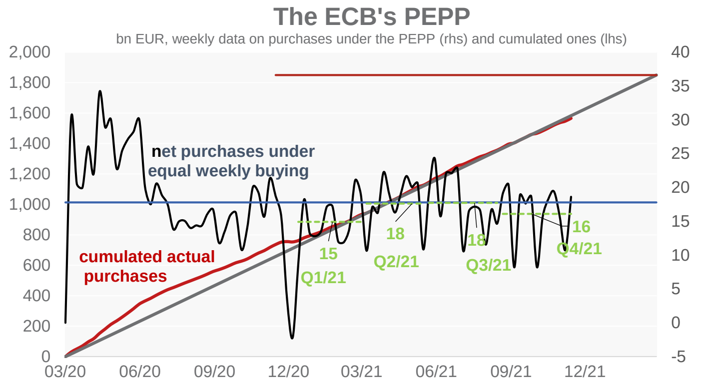

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