

GIAM Macro & Market Research - Market Commentary

June 10, 2021

ECB holds a steady hand, no tapering yet

- At today's meeting the Governing Council maintained its policy stance. Net PEPP purchases will *"continue to be conducted at a significantly higher pace than during the first months of the year."*
- The growth and inflation outlook improved and – unlike the previous meetings – risks were now assessed as *"broadly balanced"*.
- While financing conditions were viewed as *"broadly stable"* the Governing Council sees risks stemming from higher yields.
- Exchange rate movements remain on the ECB's radar screen.
- All in all, the ECB adopted a steady hand approach. Tapering was postponed and the current speed of purchases could be maintained until the PEPP regularly ends in March 2022.

Tapering postponed: At today's policy meeting the Governing Council decided to leave the policy stance unchanged. Most importantly, its stated that net PEPP purchases over the coming quarter will *"continue to be conducted at a significantly higher pace than during the first months of the year"*. This decision was taken based on a joint assessment of financing conditions and the inflation outlook

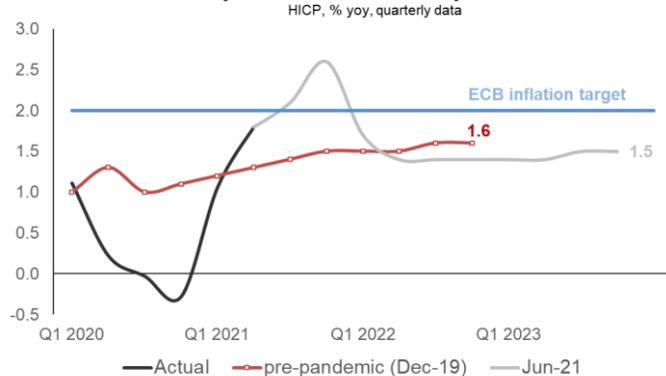
Macro outlook improved and risks now balanced: With the pandemic expected to gradually lose its sting the ECB projects a more positive macroeconomic outlook. Compared to the March projections the cumulative GDP growth for 2021/22 was increased by 1.3 pp and the one for inflation by 0.7 pp while. The expectations for 2023 were left unchanged. Also, the risks surrounding the outlook are now viewed as balanced, after having been on the negative side before. Positive risks from a reduction in savings and global demand might be broadly offset by a potential worsening of the pandemic situation.

Key ECB Macro Forecasts

ECB staff mid-point projection, % yoy

		2021	2022	2023
GDP	Jun-21	4.6	4.7	2.1
	Mar-21	4.0	4.1	2.1
Inflation	Jun-21	1.9	1.5	1.4
	Mar-21	1.5	1.2	1.4
Core inflation	Jun-21	1.1	1.3	1.4
	Mar-21	1.0	1.1	1.3

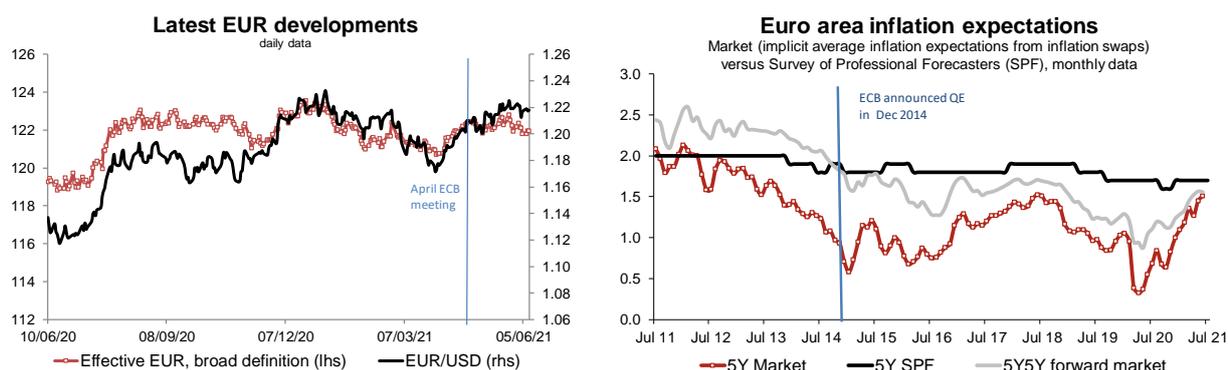
ECB: Pre-pandemic inflation path still distant



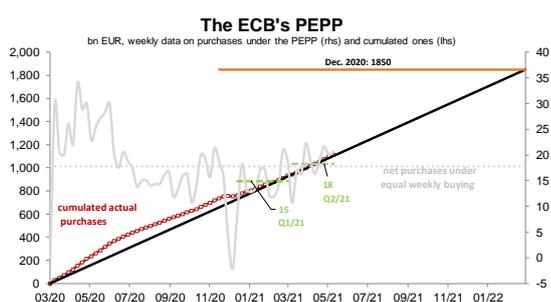
All in all, the projections suggest that there is light at the end of the tunnel. According to the ECB projections the pre-crisis level of activity will be reached in H2/2021. And what is more, the updated projections also see underlying inflation improving gradually in the medium term. That said, President Lagarde tried to tune down monetary policy implications. In the Q&A session she emphasized that

underlying price pressures will remain subdued overall on the back of still subdued wage growth, exchange rate developments and the overall slack in the economy. We think it is also important to keep in mind that following a temporary spike in headline inflation this year (oil prices, base effects, the end of the German 2020 temporary VAT cut and other technical factors), headline inflation will moderate again and its projected rate at the end of 2023 still be below the pre-pandemic projection, a threshold the ECB used to justify its pandemic emergency measures.

Exchange rate remains on the radar screen: Given its importance for inflation the Governing Council stated, in line with the previous meeting, that it will “*continue to monitor developments in the exchange rate with regard to their possible implications for the medium-term inflation outlook*” and that its stands ready to adjust all instruments.



Financing conditions “broadly stable” but watch risk of rising rates: Financing conditions remained according to the Governing Council “*broadly stable*”. Also, our proprietary dashboard of the ECB financing conditions assesses them all in all as slightly supportive (see table below). However, the risk clearly is that an (US led) increase in global bond yields raises government bond yields via a higher term premium. The risk of increasing interest rates was also mentioned by the Governing Council in the introductory section. It warned that tightening financial conditions would be premature and a risk for the recovery and inflation. Such a risk adds to the case for a very accommodative policy stance.



The ECB's Financial Conditions Dashboard
z-scores of respective variables with values > 0 indicating better than average financial conditions, < 0 the reverse; own calculations with latest date on lending rate estimated

	2020	Q4 2020	Jan-21	Feb-21	Mar-21	Apr-21	May-21
Gov. bond spread (GDP weighted)	0.82	1.38	1.52	1.58	1.55	1.49	1.20
Term premium (10Y-1Y OIS)	1.55	1.63	1.54	1.17	1.00	0.91	0.77
BLS credit standards	-1.76	-2.55	-2.45	-2.46	-1.97	-1.48	-0.99
BLS credit demand	-0.71	-0.65	-0.84	-1.00	-1.01	-1.03	-1.05
High Yield spread	-0.89	-0.06	0.68	0.93	0.96	1.15	1.12
Lending rate	1.28	1.37	1.40	1.44	1.35	1.36	1.37
unweighted mean	0.05	0.19	0.31	0.28	0.31	0.40	0.40

Tapering not needed if current pace of purchases is maintained: When, back in March, the ECB announced a significant increase in PEPP purchases, many market participants (ourselves included) thought of a volume that would imply the need to reduce purchases later in order to be able to conduct purchases until March 2022. However, the last quarter average of € 18 bn per week could be maintained until the scheduled end of the programme. Hence, if there was no need to speed up PEPP purchases significantly the tapering discussion could turn out to be a fata morgana. Tapering looks an even more distant prospect also in light of the risk of US-induced higher rates. At today’s press conference President Lagarde answered that a discussion about the evolution of PEPP was too early, premature, not necessary and that it was not dealt with by Governing Council.

While she acknowledged that there were partly diverging views she emphasized that the text of introductory statement was approved by unanimity. The Governing Council holds the view that a steady hand is the best option. This means that it will look through the various temporary factors, like the spike in inflation or summer market illiquidity. The ECB will likely just keep on buying under its PEPP at the current pace until the program ends. This would postpone the monetary policy cliff to March. We think that the Governing Council will at its September meeting start to think a redesign of the APP (monthly purchases, flexibility) that would make post-PEPP life easier for both, the ECB and markets.

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