Market Commentary

ECB defends transitory inflation view, no near-term hike ahead

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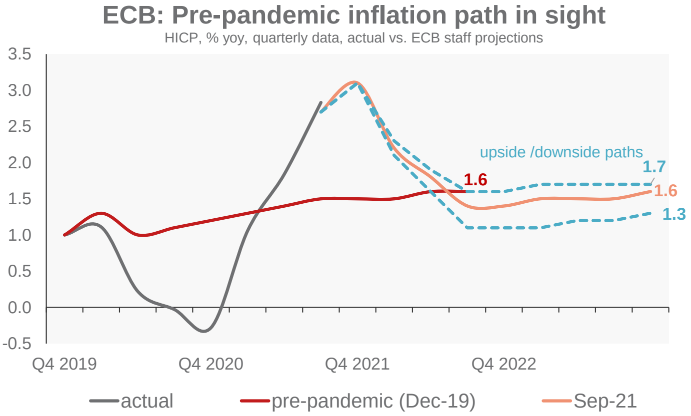
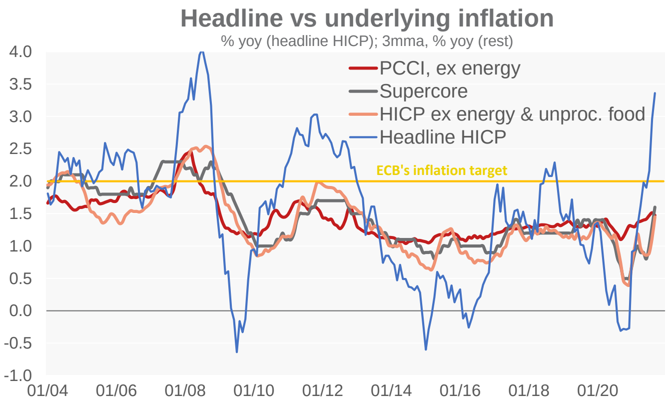
- At today's meeting, as expected the Governing Council (GC) did not change its policy stance. The key message is that the ECB continues to stick to its view of only transitorily higher inflation. But it acknowledges that its abating is taking longer than previously thought.
- President Lagarde made very clear that markets have gone too far with rate hike expectations. The conditions for higher policy rates were not met at present and "*certainly not in the near future*".
- Markets slightly increased their rate bets defying Lagarde's comments on market pricing. The ECB's patience on inflation stands in clear contrast to other central banks.
- Looking ahead, the December 16 meeting will be pivotal. With new macro projections PEPP purchases for Q1/2022 will need to be recalibrated and the GC will have to decide about the post-PEPP QE. We look for € 40 bn/month (broadly in line with consensus) but see the risk that a deteriorating growth-inflation mix triggers a less benign stance.

At today's monetary policy meeting the Governing Council members were confronted with increased skepticism about the transitory nature of the current inflation spike and hence concerns that the ECB could fall behind the curve. With headline inflation likely coming close to 4 % yoy in October, further inflation pressure in the pipeline and inflation expectations exceeding the 2% threshold from the 1-year up to the 30-year bucket, markets have started to question the ECB's ability to keep inflation contained.

As expected, the ECB left its policy tools unchanged today. Instead, President Lagarde tried to soothe market concerns about a too reluctant ECB by defending the transitory inflation view while acknowledging increased inflation risks.



Source: Refinitiv, ECB



Source: Refinitiv, ECB

The view of transitory inflation remains intact: The ECB's positive view on the post-pandemic recovery has not changed. However, the recent spike in inflation caused an in-depth discussion within the GC. President Lagarde took today's press conference as an opportunity to defend and communicate the view that the current inflation spike is only transitory. She reiterated several times that a combination of base effects (e.g. temporary German 2020 VAT cut), energy price increases (also mainly due to one-off factors) and post-pandemic shortages is currently at work. These factors are expected to abate next year but she "*granted that it will take a little longer than expected*." She sounded quite confident about this and also reported that the ECB was conducting surveys on firms' attempts to re-establish production chains.

Lagarde relatively relaxed on inflation risks: The risks to the growth outlook were again assessed as "*broadly balanced*". Quite interestingly, the wording on inflation risks remained unchanged. Only in the Q&A session Lagarde said that the ECB "*very attentive to wage evolution*". We find this remarkable because in a latest speech she said that the ECB was "*continue to monitor the risk to the inflation outlook carefully*" and we had thought that such wording would have also been used today. She also expressed no concerns about the rise in inflation expectations but characterized them as "*very much anchored*".

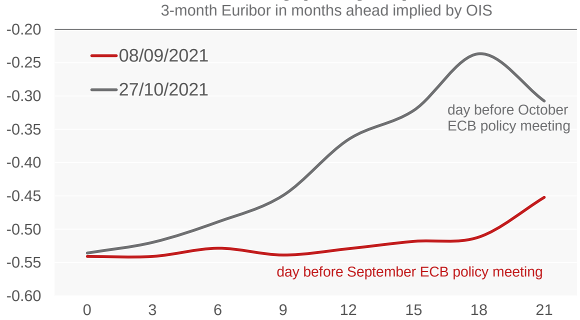
Change of forward guidance unlikely for the time being: According to the ECB's new strategy a potential increase of the policy rates is crucially tied to reaching the 2% target – in terms of headline as well as underlying inflation - well ahead of the end of the projection horizon that currently ends in 2023. At the December 16 meeting the updated projections will for the first time also cover 2024. We doubt that the criteria for higher policy rates will be met, even with the inflation path adjusted to the upside. However, the risk that the ECB might be forced into earlier action increased. While at the last press conference President Lagarde stated that the ECB was "*pretty far away from hiking*" she today only mentioned that the conditions for higher policy rates were not satisfied at present and "*certainly not in the near future*".

ECB no longer in a monetary policy comfort zone: Over the past decade the ECB operated in a low inflation environment giving it the leeway to implement exceptional policy measures to support activity. This favourable environment has (at least temporarily) come to an end. Markets were not impressed by today's ECB decisions and the press conference and continued to price an early rate hike. The ECB patience on inflation stands in clear contrast to other central banks and it will increasingly need to justify its deviation.

All eyes at the pivotal December meeting: Today the GC was not pushed into action. This will be different at the forthcoming December 16 meeting. It will then have to decide how to trim PEPP purchases in Q1/2022 and how to avoid a policy cliff after the PEPP expires. At today's meeting President Lagarde was surprisingly clear about the end of the PEPP. For the time being we stick to our view that the APP (of currently € 20 bn/month) will most likely be beefed-up (at least temporarily) to engineer a smooth exit from the crisis measures. However, we also sense that given the high hurdles for lifting rates under the new strategy, with markets becoming more and more concerned about a too relaxed ECB policy stance, the GC could unwind other emergency measures (e.g. TLTRO financing conditions) quicker and more decisively. In case of a more significant deterioration of the growth-inflation mix we see the risk that the GC agrees on less benign post-PEPP QE purchases in order to keep inflation expectations in check.

ECB monetary policy expectations

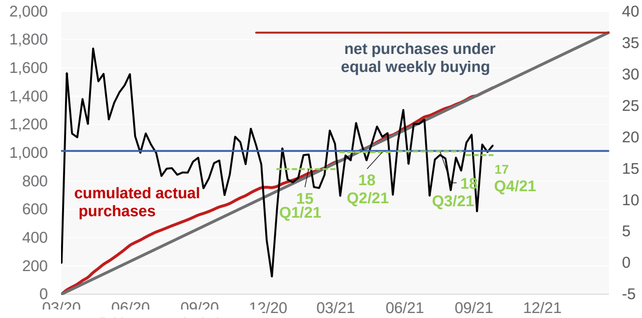
3-month Euribor in months ahead implied by OIS



Source: Refinitiv, own calculations

The ECB's PEPP

bn EUR, weekly data on purchases under the PEPP (rhs) and cumulated ones (lhs)



Source: Refinitiv, own calculations