GIAM Macro & Market Research - Market Commentary

July 22, 2021

ECB sends a dovish message as new strategy increases threshold for raising rates

- **At today's meeting the Governing Council the ECB put its new strategy into practice for the first time.**
- **Accordingly, the forward guidance was strengthened. Raising rates now requires reaching the inflation target "*well ahead*" of the end of the forecast horizon and "*durably for the rest of the projection horizon*" while underlying inflation has to be consistent with medium term inflation at 2%. The transitory moderate overshooting is allowed.**
- **As expected, no change to the quarterly PEPP purchases nor any other instruments was announced.**
- **We do not expect that the conditions for lifting rates will be reached soon. This leaves the ECB plenty to leeway to support financing conditions and thereby indirectly also government bonds.**
- **Looking further ahead, a beefing up of the APP after the termination of the PEPP in March 2022 seems highly likely to us.**

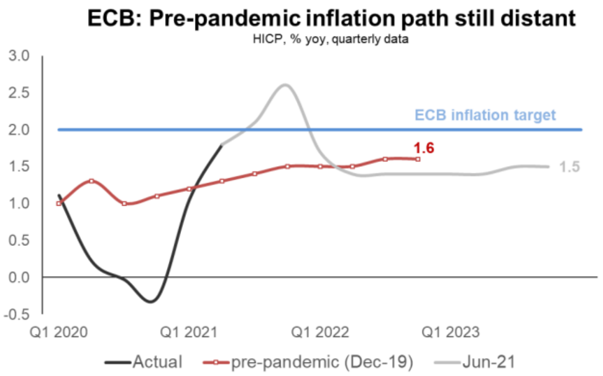
Today's policy meeting was the first after the presentation of the ECB's new strategy earlier this month. As expected, the Governing Council continued to deliver a dovish message.

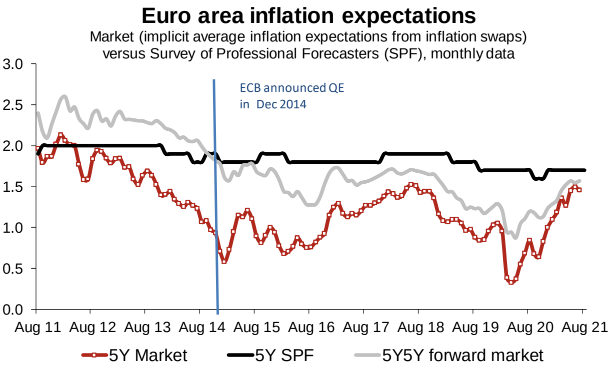
Forward guidance strengthened, hurdles for rate increases lifted: The key change is about the forward guidance. So far the Governing Council (GC) was only requiring inflation to converge to the target within the projection horizon before raising rates. Now, these requirements were strengthened in various ways:

- First, the inflation target is now symmetrically around 2% and no longer below but close to 2%.
- Second, it wants to see "*inflation reaching two per cent well ahead of the end of its projection horizon and durably for the rest of the projection horizon*". In the Q&A session President Lagarde referred to the mid-point for the projection horizon as the relevant benchmark. Durably means that it shall not fall below 2%. That said, she also made clear that this was no mechanical exercise with the GC making its own judgement.
- Third, the ECB wants to be reassured by the actual development of underlying inflation, meaning that the "*realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term*".
- Fourth, this "*may also imply a transitory period in which inflation is moderately above target*". Hence, the ECB has lifted the threshold for raising policy rates significantly.

Unanimity only on the strategy, not the forward guidance: The Governing Council agreed on its new strategy by unanimity. There was also agreement on the need to adjust the forward guidance. However, its operationalization was only supported by an "*overwhelming majority*". In the Q&A session Lagarde tried to play these internal divergences down by characterizing them as "*minor*" and concerning only the "*choice of words*".

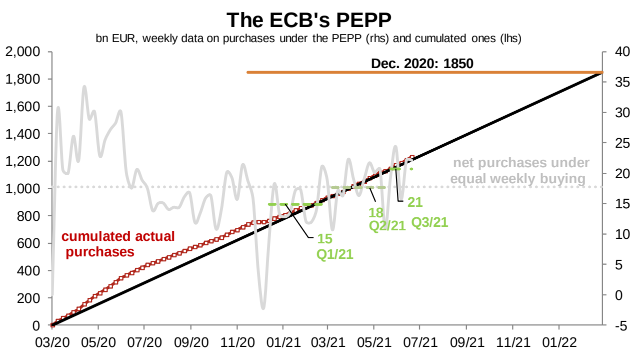
ECB gives itself the license for 'low for even longer': In the press conference President Lagarde made clear that the revised forward guidance aims at two goals: To strengthen the effectiveness of monetary policy with a strong commitment and to avoid policy mistakes. Thereby she obviously had in mind the 2008 and 2011 hiking cycles, which proved premature. Overall, the desire to maintain a steady hand was also reflected in the unchanged stance of all other policy instruments. Looking ahead, the latest ECB staff projections do not even foresee a return to the pre-pandemic inflation path by 2023. We doubt that the 2024 projections (due in December) will fulfil the ECB's new criteria for raising rates. Thereby, the ECB gives itself the licence for rates at the current historically low level for even longer. A first rate hike before 2024 looks highly unrealistic from this perspective.





ECB will continue to steer financing conditions thereby supporting fiscal policy : With inflation in an unsatisfactory limbo over the coming years, the ECB will devote full attention to financing conditions. Under the new strategy, they became part of the second pillar in designed to assess the situation. This is good news for government bond holders and the finance ministers as the term premium and the sovereign spreads are among the indicators considered (see table below). Asked about fiscal dominance in the Q&A session Mrs Lagarde for sure rejected its relevance to ECB's decisions. But with the new strategy being implemented we see leeway for some kind of light fiscal support through the backdoor of financing conditions.

September meeting to provide guidance on the PEPP: Today's meeting exclusively focused on the forward guidance. The PEPP was not discussed and according to Mrs Lagarde it would have been premature to do so. We think that the discussion about it and the other instruments will start at the September meeting. The ECB's base case remains one of a recovering economy with Covid-19 not sending renewed shockwaves to the economy. The economic risks are assessed as balanced. We share this scenario and expect the ECB to start thinking about the time after the termination of the PEPP more loudly. It remains to be seen whether the GC judges that the "*coronavirus phase is over*" or not as the condition for terminating the PEPP. Given the dovish twist regarding the forward guidance we could imagine that the GC lays the ground for continued pandemic-related accommodation, not least as support is also needed from a fiscal policy perspective. In the end we expect the ECB not to announce fewer PEPP purchases but to run it at around the current speed until it expires in March 2022. We look for a beefing-up of the APP purchases by a pandemic-related component, immediately afterwards, thereby still enabling flexible across asset classes and countries in the case of government bonds to ensure ongoing favourable financing conditions.



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 with latest data on lending rate estimated

	2020	Q1 2021	Apr-21	May-21	Jun-21	Jul-21
Gov. bond spread (GDP weighted)	0.82	1.55	1.49	1.20	1.30	1.38
Term premium (10Y-1Y OIS)	1.55	1.24	0.91	0.77	0.86	1.11
BLS credit standards	-1.76	-2.01	-1.36	-0.99	-0.68	-0.37
BLS credit demand	-0.71	-0.95	-1.03	-1.05	-0.47	0.11
High Yield spread	-0.89	0.85	1.15	1.12	1.26	1.12
Lending rate	1.28	1.39	1.36	1.37	1.40	1.40
unweighted mean	0.05	0.35	0.42	0.40	0.61	0.79

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