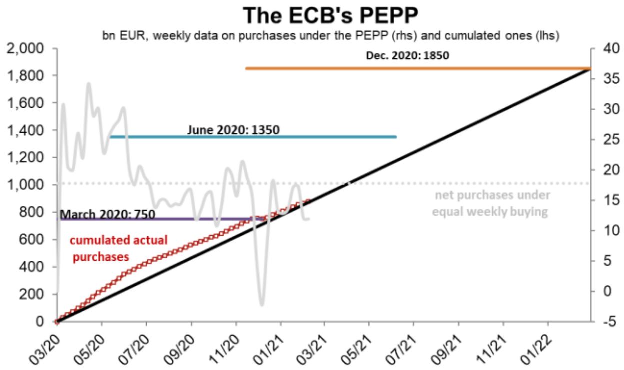
GIAM Macro & Market Research - Market Commentary

March 11, 2021

Dovish surprise - ECB announces higher pace of PEPP purchases over next quarter

- **At today's meeting the Governing Council became surprisingly clear by unanimously deciding on a higher pace of PEPP purchases over the next quarter to prevent a tightening of financial conditions.**
- **As expected, the inflation outlook was lifted but the Governing Council will look through the 2021 spike emphasizing the need to raise inflation in the medium term. The growth outlook remained broadly stable.**
- **EUR strength remains on the radar screen, but the wording was scaled down.**
- **Looking ahead, the Governing Council will look at a holistic and multifaceted set of indicators to adjust the policy stance. President Lagarde stated that this will regularly take place every three months with the update of the macro projections.**
- **Today's message is clearly ensuring for markets in the short-term but implies less purchases after the next three months, unless the PEPP would again be extended.**

A surprisingly clear dovish statement: The Governing Council sent a surprisingly clear dovish message to markets at today's meeting. It was very explicit in stating that it "*expects purchases under the PEPP over the next quarter to be conducted at a significantly higher pace than during the first months of this year* " and that it "*will purchase flexibly according to market conditions and with a view to preventing a tightening of financing conditions that is inconsistent with countering the downward impact of the pandemic on the projected path of inflation"*. Since the start of the year the ECB undertook weekly purchases worth € 12 bn and exhausted € 879 bn out of the total amount of € 1850 bn. Equal buying until the end of current PEPP in March 2022 alone would imply stepping up weekly purchases to about € 17.5 bn (broadly consistent with hypothetical constant weekly buying since the start of the programme). However, the ECB made clear that, as it intends to fight a possible deterioration of financing condition near term, the actual volume will likely be even higher. In the Q&A session President Lagarde refrained from giving any precise number, and stated that the ECB was not doing weekly micro-management and that the decision will be implemented right after today's meeting.

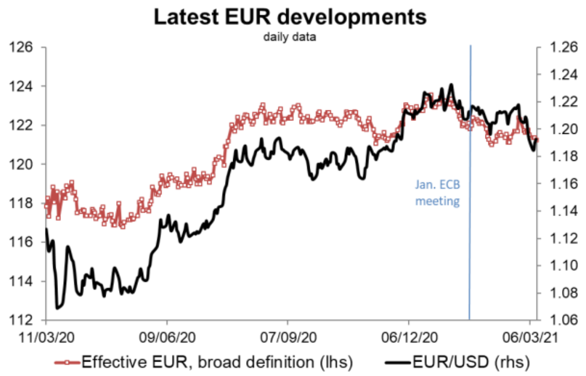


ECB to look through inflation spike, exchange rate stays in focus: The regular update of the staff macro projections was broadly in line with expectations. Mainly on the back of higher energy prices and special factors (we discussed them in greater detail in a recent [Focal Point]) the ECB revised its 2021/22 inflation outlook up. At the same time, it reiterated that underlying price pressures remain subdued. Mrs Lagarde mentioned in the Q&A session the slack in the economy, limited wage pressure and the EUR appreciation as key depressing factors for inflation. Quite noteworthy, according to her, the 1.4% inflation rate envisaged for 2023 will still be below pre-pandemic path and far below target. The EUR appreciation has lost momentum since the January 2021 meeting. Still it stays on the ECB's radar screen. That said, the accompanying wording has been attenuated from monitor exchange rates "*very carefully*" and be "*very attentive*" to them in January to "*continue to monitor*" now.

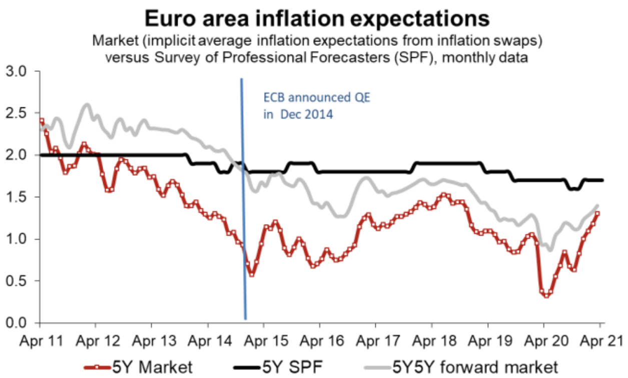
Key ECB Macro Forecasts

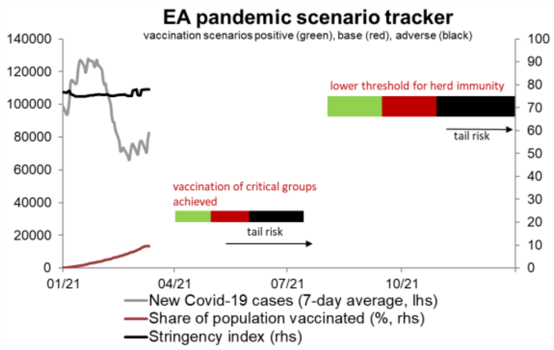
ECB staff mid-point projection, % yoy

	2021	2022	2023
GDP			
Mar-21	4.0	4.1	2.1
Dec-20	3.9	4.2	2.1
Inflation			
Mar-21	1.5	1.2	1.4
Dec-20	1.0	1.1	1.4
Core inflation			
Mar-21	1.0	1.1	1.3
Dec-20	0.8	1.0	1.2



Constructive view on growth, with risks more balanced: The updated ECB projections foresee *a "firm rebound in economic activity in the course of 2021*". The growth outlook was left broadly unchanged. The ECB also finds that the "*overall, the risks surrounding the euro area growth outlook over the medium term have become more balanced, although downside risks remain in the near term*." It is important to keep in mind that the ratification of the $ 1.9 tr US stimulus has not been incorporated in the macro projection yet and that it will tilt them to the upside.





ECB's definition of financial conditions goes beyond sovereign yield targets: The Governing Council also gave some indicators on the definition of financing conditions. It refers to "*a holistic and multifaceted set of indicators*"**.** In the Q&A session Mrs Lagarde explained that '*holistic*' refers to the whole channel of transmission from upstream stage (sovereigns etc.) to the downstream stage (where monetary policy acts with a lag). The Governing Council was very explicit in stating that "*banks use risk-free interest rates and sovereign bond yields as key references for determining credit* *conditions. If sizeable and persistent, increases in these market interest rates, when left unchecked, could translate into a premature tightening of financing conditions for all sectors of the economy*." This makes it very likely that the recent increase in yields triggered today's decision. But '*multifaceted*' means that the ECB does not operate mechanically but focuses on all indicators not necessarily influenced by upstream factors, e.g. fiscal support measures. In any case, the message to the market is clear: The Governing Council wants to maintain flexibility and financial conditions go far beyond the 10-year yield levels. In this context Mrs Lagarde also made clear that the Governing Council – while clearly having an eye on sovereign yields - was not conducting yield curve control.

ECB to move to quarterly regular policy updates, next due in June: Looking ahead, the ECB envisages policy updates only every three months. Asked in press conference why the ECB had not increased PEPP purchases earlier, Mrs Lagarde made two important points: First, she related the policy commitment to the December inflation outlook. Obviously, it will play an even more important role for future decision so that the update of the growth and inflation projections is seen as critical. Second, she stated that the Governing Council needs to be involved. Hence, she probably wants to ensure a clear majority. Today this was more than achieved as she even referred to a "*total consensus*" probably meaning unanimity. While today's message is clearly ensuring for markets in the short-term it is important to keep in mind that elevated purchases over the next three months imply significantly less purchases per week thereafter, unless the PEPP would again be extended. But given the ECB's (and our) macro outlook this is not imminent.

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