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EMEA Strategy Bulletin

ECB remains accommodative, Ms Lagarde says “the lady is not for tapering”

Jeffrey Sacks, Head – EMEA Investment Strategy | +44 207 508 7325 | Jeffrey.ian.sacks@citi.com
Maya Issa – Senior Vice President, Global Investment Strategy | maya.issa@citi.com

ECB Summary

- **Unchanged interest rates:** The European Central Bank (ECB) kept its deposit rate at -0.5%, the refinancing rate at 0.0%, and the minimum lending facility at +0.25%.
- **Slowing of bond buying** within the Pandemic Emergency Purchase Programme (PEPP) versus the level of purchases in the last two quarters. No changes to the programme’s €1.85 trillion size. The Asset Purchase Programme (APP), reinvestment policy, and long-term refinancing operations are unchanged. The December meeting will give more detail on the last phase of PEPP and the ongoing APP.
- **Inflation expected to moderately exceed the ECB’s 2% target for a transitory period.** Inflation forecast has risen for 2021 to 2.2%
- **GDP growth ‘clearly rebounding,’** with the speed dependent on the path of COVID. The real GDP growth forecast for 2021 is rising to 5.0%.
- **Positive fixed income reaction.** After the announcement, equities and the euro were steady, and bonds – particularly periphery bonds – rallied strongly.

Ahead of the ECB Meeting:

Earlier this year in the fledgling stages of the vaccine rollout, the ECB announced an acceleration in its bond purchase programme. More recently, its strategic review concluded that it might be prepared to tolerate inflation above its 2% target for a short period. Headline inflation rose 3% in August – **figure 1** – and expectations had been rising that the ECB might start to tighten policy slightly earlier. This speculation was further supported by recent Federal Reserve and Bank of England comments, leading to good support for the euro, with bonds under price pressure.

Questions for the ECB ahead of the meeting were mainly about its view on whether the inflation upturn was transitory, whether any PEPP changes would also be reflected in the APP, and whether the ECB feels that rate rises will only come when tapering is complete. Only the first of those was made clear today, with Ms Lagarde saying that the December ECB meeting would elaborate on the other issues.

Continued dovish policy and forward guidance despite improving growth:

Growth

The growth rebound phase is advanced. The 2.2% GDP growth in 2Q21 is expected to be followed by a strong third quarter. Overall European output is expected to reach pre-COVID levels by the end of this year. The key to this is that 70% of adults have now been vaccinated, while the Delta variant has not led to widespread shutdowns. This is leading to greater mobility and spending in services. The labour market is firm, which is feeding through to decent income growth. The manufacturing sector remains firm despite materials and equipment shortages. These factors should support 5.0% real GDP growth this year, higher than the ECB's forecast three months ago.

The GDP growth forecasts for 2022 and 2023 are unchanged at 4.6% and 2.1% respectively. The risks are "broadly balanced." The main upside surprise could be COVID ending sooner than expected. Downside risks include: the Delta variant impacting on global trade, 2 million more people unemployed than before the pandemic while many employed remain in job retention schemes, and cautious albeit firm consumption. Along with these risks, Ms Lagarde mentioned the higher debt levels of consumers and businesses. For these reasons, the economy still needs favourable financing conditions to help avert strain. This is particularly relevant for consumers, but less so for companies which are mostly comfortably well-funded. In addition, Ms Lagarde continued to stress the need for ongoing fiscal policy support driven by the EU Recovery Fund and at national levels.

Inflation

Inflation is expected to rise further this year to 2.2% – **figure 1**. This is driven by year-on-year base effects after reopening, the oil price rise over the past 12 months, the reversal of some temporary measures like Germany's VAT reduction, cost pressures due to supply bottlenecks, shortages' impact on the prices of both durable and non-durable prices, and a strong rebound in summer sales compared to 2020

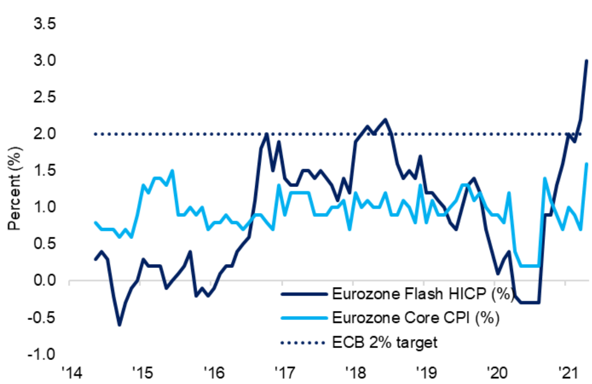
The inflation forecasts for 2022 and 2023 of 1.7% and 1.5% are lower than for 2021 but also higher than previously forecast by the ECB. So, underlying pressures are rising but only gradually. A key indicator moving forward will be "second round impacts", with price pressures potentially impacting on wage pressures, which could lead to more durable inflation pressures.

Policy change

The PEPP is only a measure for the COVID emergency and is flexible in terms of how quickly the €1.85 trillion is used before the programme ends in March 2022. So, the slight reduction in bond purchases over the next 3 months is entirely consistent with the better and improving COVID backdrop. With no change in the total envelope size nor length of programme, and no mention of any changes to the APP, Ms Lagarde said that "the lady is not for tapering". (This has echoes of former UK PM Margaret Thatcher who once famously said 'the lady is not for turning'). The first interest rate hikes are 'far away.' The stretched ECB balance sheet – **figure 2** – is not going to significantly contract any time soon.

During the Q&A session after her formal remarks, Ms Lagarde made it clear that the December ECB meeting would focus in a comprehensive way on the looming PEPP programme ending in March 2022, what the implications of that might be for the APP in place since December 2019, what might replace the end of the TLTRO (Targeted Longer-Term Refinancing Operations) programme, and the timing of the first rate rises after the eventual end of tapering.

Figure 1: Eurozone inflation vs ECB target



Source: Bloomberg as of 9 September 2021.

Figure 2: ECB balance sheet size

Source: Bloomberg as of 9 September 2021.

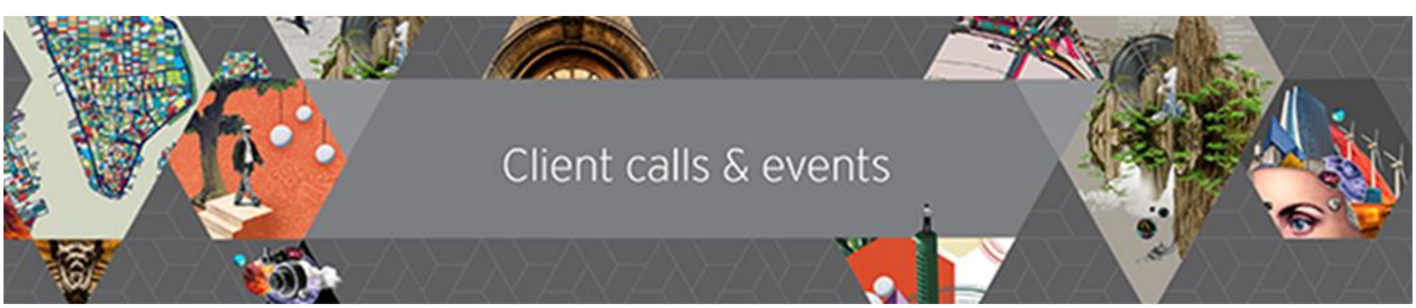
Market reaction

Equities: The announcement is supportive for equities, with greater confidence in the growth outlook, without offering fresh reasons to buy. The Euro Stoxx 600 index, which is already up 18.5% so far this year, is unchanged on the day, with little change since the midday announcement. Further upside will be driven mainly by the probable ongoing surge in earnings, valuations still below the global average, and many investors still lowly-weighted. The Private Bank's Global Investment Committee remains overweight.

Encouragingly, despite the yield curve flattening across EU sovereign bond markets, the Euro Stoxx Bank index modestly rallied following the ECB announcement, perhaps suggesting that the earnings tailwinds that could come from additional accommodation outweigh the net interest income headwinds of a flatter yield curve.

Fixed income: This asset class rose because Ms Lagarde was dovish. In the run-up to the meeting, there had been growing expectations of hawkishness. The critical driver was no immediate changes to the APP programme. The 10-year German Bund fell 2.7bp to 0.36%. The biggest area of strength today has been periphery 10-year bonds: Italy fell 7.8bp to 0.67%, Portugal fell 4.8bp to 0.21%, Spain fell 5.3bp to 0.31%, Greece fell 9.3bp to 0.74%. While these periphery bonds could move down further, an important read-through into European equities and currency is that periphery-related risks are low and still falling.

Euro: unchanged at US$1.1831. This demonstrates that the ECB messaging struck a balance between explaining why growth and inflation are firm and justifying less bond buying over the next 3 months, alongside its ongoing need to maintain favourable financing conditions with some ongoing COVID uncertainty and lessening inflation pressures. The key currency driver in the coming few weeks will be the German election on 26 September, where the risk is rising of a left-leaning coalition which could pressure the euro. See our latest EMEA Bulletin for more information.



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