AXA Investment Managers

Diving in the alphabet soup

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Key points

- Although the market's reaction was positive, the European Central Bank (ECB)'s press conference leaned to the hawkish side on substance. Yet, Lagarde's openness to use an "anti-fragmentation" weapon is reassuring. We need to go back to 2012 to explore the possible avenues for the ECB on this matter.
- Core inflation surprised to the downside in the US in March. It's too early to call for the inflation rollover though.

The market moderated its expectations for the ECB rate lift-off after Christine Lagarde's press conference last week. True, instead of an acceleration in the termination of Quantitative Easing (QE) which some investors were fearing, the Governing Council chose to stick to the timeline sketched out last month. Still, we found the overall message rather hawkish: the central bank is visibly getting even more nervous about the risks of inflation persistence, and although Christine Lagarde expressed several times a willingness to be very cautious in the face of the uncertainty created by the war in Ukraine, overall it seems the ECB's baseline is that the fallout should be manageable. The Governing Council also seems unimpressed by the tightening in financial conditions.

Yet, the bond market has welcomed Christine Lagarde's readiness to "design and deploy" anti-fragmentation weapons if and when necessary. She was remarkably guarded about the form that such programmes could take though. It's understandable given the technical and political difficulties already faced by the ECB in the past when designing tools to specifically address monetary policy transmission impairment, while it was preparing to normalize its stance. We go back in time to 2010/2012 and the debates around the Securities Market Program (SMP) and Outright Monetary Transactions (OMT). The latter - although never used – has been seen for 10 years as the "go to" anti-fragmentation weapon. It is cumbersome though, even if alternatives are not necessarily appealing. We note however that there is an imbalance between what the ECB is being asked to do – create more Ptolemaic circles around its core missions to deal with every shortcoming of monetary union – and the contribution from national governments. In 2012, the solution to the sovereign crisis did not come from the ECB only, but also from the governments' capacity to put together new frameworks, such as the European Stability Mechanism (ESM). We continue to think that without an extension of Next Generation EU, the ECB may be forced into "half solutions", such as mobilizing the reinvestment from the QE programmes to support the most fragile signatures.

Meanwhile, the US dataflow has come up with a rare feat last week: core inflation rose less than expected last week. It's too early to call the "inflation rollover" in the US though: the contribution from one single component (used cars) was essential. Yet, we continue to believe in a subsequent deceleration in consumer prices in the US which will allow the Federal Reserve (Fed) to stop before reaching the levels seen in the "dot plot".

Financial engineering like it's 2012

Dear reader, where were you in 2012? If you were in the financial industry, odds are you were poring over the pretty indigestible alphabet soup of SMP, OMT or Precautionary Conditioned Credit Line (PCCL) to navigate your way through the nasty Euro area sovereign crisis. With the ECB's 2014 conversion to the mother of all anti-fragmentation weapons – plain vanilla, open-ended Quantitative Easing – it seemed our world had become simpler. Unfortunately, fast-forward 10 years and the very likely removal of the Asset Purchase Programme at some point in the third quarter, in the midst of yet another shock to the Euro area economy, lays bare again the fact that **the economic framework of the monetary union remains incomplete**.

APP (Asset Purchase Programme) and even more so PEPP (Pandemic Emergency Purchasing Programme) provided a single answer to two connected but distinct central banking problems: (i) ensuring that the *stance* of monetary policy could still be made more accommodative when policy rates had reached their effective lower bound and (ii) ensuring smooth *transmission* of the monetary impulse across the entire monetary union, by taking sovereign spreads to a minimum. Now that the ECB believes that the time has come for the stance to gradually normalize, policy rates will soon become again the main instrument of monetary policy. Yet, the calibration of the right level of monetary conditions consistent with the macroeconomic outlook for the Euro area as a whole can be thwarted if some member states face specific market pressure. Transmission is becoming a headache again. Before we get into the analysis of last week's press conference by Christine Lagarde, we need a historical refresh and another dive into the alphabet soup.

It is not the first time the ECB needs to think about transmission and stance separately. The Securities Market Programme (SMP) was launched in May 2010 precisely to deal with transmission issues pertaining to widening spreads – the first symptoms of the sovereign crisis were emerging – while the central bank was at the same time preparing to normalize its stance as the economy was apparently exiting from the Great Financial Crisis with limited scars. The latter illusion dissipated quickly, but to materialize the fact that SMP would be solely about targeting monetary policy *transmission* without altering the stance, purchasing bonds of fragile member states would be offset by conducting liquidity draining operations. Still, SMP was not a resounding success to address fragmentation, and given our current predicament, it might be useful to remind ourselves why.

SMP – as many other ECB contraptions – was the result of an uneasy compromise. The central bank would purchase bonds from member states at risk of losing market access without explicit macroeconomic conditionality but given the risk it entailed for the ECB's balance sheet, those purchases would be deemed "senior" (they would receive preferential treatment in case of restructuring). These choices ended up making the system both politically and financially unconvincing.

The launch of the programme triggered the resignation of the President of the Bundesbank Axel Weber and the lack of conditionality made SMP very unpopular in the "core" countries. Moreover, while conditionality was not explicit in the tool's design, in reality negotiations took place between the ECB and the recipients of the support. Without a clear framework for such institutional dialogue, the ECB managed to be at the same time powerless – e.g. when then Prime Minister Berlusconi ultimately reneged on the reforms he had pledged against ECB support – and seen as overstepping its mandate: the letter sent by Jean-Claude Trichet to the Italian Prime Minister in August 2011 has become a staple of the populist, anti-European rhetoric in the country.

Meanwhile, the "seniority" issue proved to be a major point of concern for market players, as they saw themselves at a growing risk of being the main victims of sovereign restructuring : if the share of the public debt held by the ECB could not be part of any haircut, then "ordinary" bondholders would have to accept an even higher sacrifice to make a country's public finance sustainable again.

The Outright Monetary Transactions (OMT) framework designed in the summer of 2012 reversed the logic: the ECB would renounce its seniority status, which would make its interventions more likely to reassure the market, but a member state would need to request support and negotiate explicit macroeconomic conditionality not just with the ECB, but also with the European Commission and, preferably, the International Monetary Fund (IMF). More financial support for countries facing market closure but coming with a larger political cost for the member state, while providing more "political cover" for the ECB.

Your humble servant confesses that at the time OMT was unveiled – in September 2012 – he was expecting such requests to come from Italy and Spain and the scheme to be effectively switched on. Madrid and Rome managed to eschew the domestic political cost of actually asking for help, as the threat of OMT was enough to reduce market pressure in the periphery. To some extent, we think the current rhetoric of the ECB is informed by the 2012 precedent: by stating that they could "*act promptly if need be"* with a new programme, the central bank is probably hoping that even the most adventurous investors will refrain from launching an all-out attack on any of the sovereigns, without having to actually deploy the weapon.

Indeed, last week Christine Lagarde pledged to deploy an "anti-fragmentation" tool which would be used if and when necessary to avoid "*unwarranted and exogenous causes"* which would *"impair the transmission of monetary policy"*. While affirming the principle of an action against fragmentation is in itself a reassuring message, the ECB President was very reluctant to get into any detailed discussion of such a tool. **The ECB's reluctance to unveil anything precise is perfectly understandable, since we don't think that we have made that much conceptual progress since the SMP versus OMT days.**

The biggest issues yet in our view remain conditionality and the ECB's control of the scheme's trigger. Even if it was not used, OMT remained in the ECB's arsenal as the "go to" weapon in case of a return of fragmentation issues and over time, discussions on OMT's "potential" conditionality evolved. A new targeted bond-buying program could be organized around a "light-touch" approach rather than the "full fat" Memorandum of Understanding which had to be negotiated by the peripherals "under programme" at the time of the sovereign crisis. A simple way to structure OMT would be to make it dependent on the same set of conditions as what the member states have already submitted to in order to access the Next Generation funds. This approach – proposed by the economists from Bank of America – would reduce the burden to a minimum, but we would still be left with a key drawback of the OMT set-up: it needs to be requested by the member state. Since this always entails a political cost to the government (recognizing that the sovereign is in a dire financial position rarely helps with electors), odds are that support would be triggered too late, i.e. once market access has been seriously compromised and spreads have significantly risen.

To address transmission issues swiftly, the ECB needs to be in control, and with OMT it is not. This would get us back to SMP-like options. Arguably, one of the features of SMP – sterilization – could be appealing in the current circumstances when the central bank wants to avoid flooding the market with more liquidity now that it wants to normalization of financial conditions at the aggregate level. It's no panacea though and could have some thorny political ramifications: if the ECB buys bonds from selected countries while draining liquidity at the same time, it will remove net stimulus outside of these selected countries. More fundamentally, the absence of conditionality – or a type of light conditionality that would be imposed by the ECB unilaterally (such as tying bond buying to fulfilling the Next Generation milestones) – could possibly be acceptable in the current political configuration in which populists have been ejected from governments and there is a remarkable level of convergence on the design of fiscal policy across member states, but it can hardly be a permanent equilibrium. True, since the first round, polls in France have suggested that E. Macron's lead has improved, ahead of the final round (Politico's poll of polls put him at 54% as of 16 April) possibly due to the fact that the far-right candidate's platform is now facing more scrutiny. Yet, it is still uncomfortably tight relative to 2017, and there will be elections next year in Italy. Given the political risks, unconditional support by the ECB might be a hard sell to large swathes of the Governing Council.

In our view, **there is an imbalance between what the ECB is being asked to do – create more Ptolemaic circles around its core missions to deal with every shortcoming of monetary union – and the contribution from national governments.** Ultimately, the sovereign crisis did not end solely because the ECB promised to buy bonds. It was also the product of a profound change in the EU's fiscal set up, exemplified by the creation of the European Stability Mechanism, to which OMT was explicitly plugged. In 2020-2021, the Euro area did not survive the pandemic shock only because the ECB was creative and forthright in its support, but also because the taboo of debt mutualization was broken with the Next Generation framework. At the risk of being repetitive, with the advent of another shock to the Euro area, we need an enhanced NGEU ambition, in content and scope. Yet, just like in the complicated 2010-2012 years, the central bank and governments are stuck in a timid dance, waiting for the other to "crack" and make the first move.

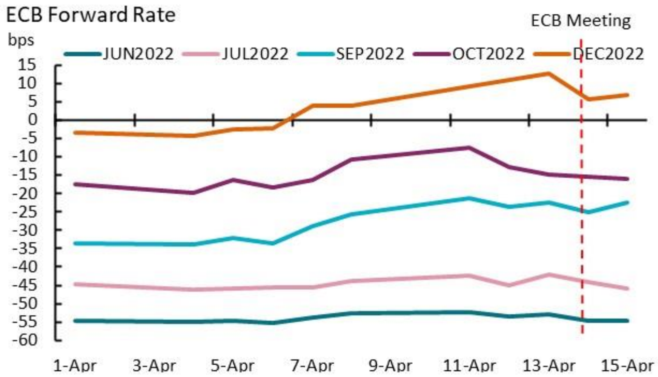
In the meantime, the ECB could fall back on "half solutions". The Governing Council had already made it clear that it could use the reinvestments of the PEPP to fight fragmentation, skewing the rollover of the debt held towards the signatures under stress. By tying the pledge on "fragmentation fighting" to "quantitative easing" in general in the last paragraph of the latest monetary policy statement, and not just on PEPP, we think the ECB sends the signal the APP reinvestments could be used as well. This would certainly increase the central bank's central power, but we suspect that if this is "all" the market gets if spreads widen again, the impact may not be significant. **Investors have got used to endless creativity from a central bank which has constantly pushed its own boundaries, materialized in "big programmes" mobilizing new money. It's an addiction which is difficult to wean oneself off.**

The ECB is running on faith

For us, the explicit albeit vague inclusion of the need to deal with fragmentation was the "pièce de resistance" of last week's Governing Council meeting. Yet, there were some interesting takeaways on the overall policy stance as well. **Although we were not expecting any revolutionary statements from the ECB, the market was taking last week's press conference with some trepidation, pricing in some acceleration in the central bank's normalisation trajectory** as sketched out last month, in the face of further upside surprises on inflation prints. The Governing Council however chose to maintain a steady pace, and merely holding to the timeline was enough to trigger some moderate de-pricing of rate hikes in the market (see Exhibit 1).

While the market took it on the dovish side, one could argue – and your humble servant certainly would – that implying that the ongoing sharp deterioration in consumer and business confidence, and significant tightening in financing conditions are not material enough threats to the inflation outlook stabilising at the ECB inflation target, is a pretty "strong view". Judging by their communication, the bar to move the ECB's trajectory is very high. We think the termination of APP is likely to be announced in June, effective in July.

Exhibit 1 – ECB press conference calmed the market down



Source: Bloomberg, Estimated OIS Forward Rate and AXA IM Research, April 2022

The ECB is "running on faith" on four key items. First, while admitting that the risks to growth are skewed to the downside, the introductory statement pointed to slow but *positive* growth ahead. For our part, we have pencilled in a GDP contraction in Q2. We do not think that the reopening of the economy, the fiscal measures deployed to cushion the current shock, nor the use of accumulated savings will be strong enough to avoid a more pronounced slowdown than envisaged by the ECB to the short-term growth path. As we have already discussed in Macrocast, we are particularly wary of confidence effect – we will take a hard look at the April batch of confidence data to be released in the next couple of weeks – while renewed supply chain disruptions due to the war and the resurgence of COVID-19 in Asia could affect activity beyond the fallout of the Ukraine war.

Second, the ECB seems to be convinced the ongoing price shock is going to affect the inflation regime in a lasting manner, through inflation expectations. It's plausible but not certain. Yet, the central bank is very "asymmetric" in its views there. Increased nervousness on the inflation outlook transpires from the introductory statement and press conference*: "While various measures of longer-term inflation expectations derived from financial markets and from expert surveys largely stand at around two per cent, initial signs of above-target revisions in those measures* *warrant close monitoring."* We find it interesting that when asked about wage dynamics in the Euro area, Christine Lagarde was very quick to downplay the current lack of any tangible sign of acceleration to focus on what *may* happen in the near future. Finally, during the press conference, president Lagarde let it slip that inflation may converge to 2% from the upside rather than from the downside as currently projected. That would be a key element in any hawkish rhetoric.

Third, the ECB seems comfortable with the ongoing tightening in financing conditions. 10-year Bund yields have increased by more than 70bps since the low in early March and "*bank lending rates for firms and households have started to reflect the increase in market interest rates*" as Christine Lagarde noted. Furthermore, the latest Bank Lending survey reported a significant tightening of lending standards for firms expected for Q2. Yet again, in her qualitative comments, the President of the ECB did not come across as swayed by these latest developments. She even insistent on the fact that the tightening in financial conditions was not yet affecting the volume of loan origination.

So, overall, while the market reacted to the press conference “nicely”, in our view the gradual hawkish turn of the ECB is continuing. We note that Reuters, quoting internal ECB sources, reported just after the press conference that policymakers see a July hike as possible. For our part, we continue to think that the deterioration in the dataflow will ultimately force the ECB to wait until December (still our baseline), but we acknowledge September as a distinct possibility for the lift-off.

Has US inflation started to roll over?

Meanwhile, **last week the US dataflow came up with an event unseen for months: inflation excluding food and energy surprised on the downside,** gaining 0.3% on the month in March, against a market expectation of 0.5% and down from 0.5% in February. Headline inflation rose in line with expectations, and fast (1.2% on the month) but the print for core drew quite a lot of attention, as it could signal that, finally, “inflation is starting to kill inflation”, i.e. that higher prices, by depleting purchasing power, start forcing “endogenous” price dynamics down. On a year-on-year basis, indeed, the beginning of a plateau could appear (see Exhibit 2).

Exhibit 2 – Is headline inflation starting to kill core inflation?

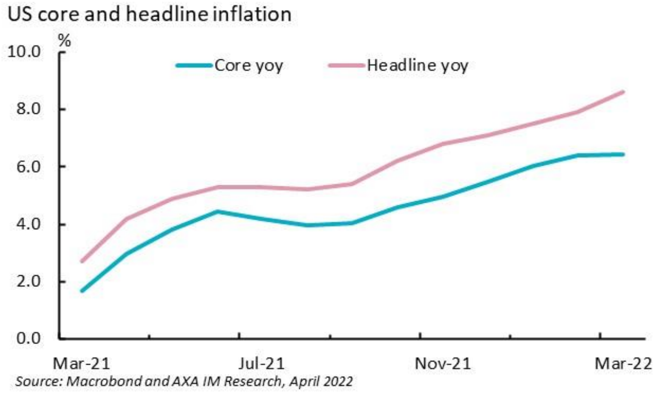
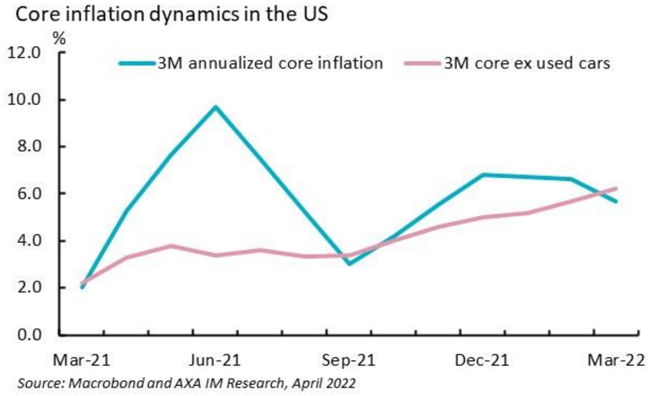
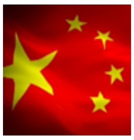


Exhibit 3 – Still a very idiosyncratic move



Now, as much as your humble servant believes that some self-stabilizing factors will be at play in the second half of this year to dampen inflation (see Macrocast from last week) we think we need to remain cautious at this stage. Indeed, the recent deceleration in core inflation is essentially attributable to one component: used cars. When looking at 3-month annualized changes in core inflation excluding used cars, the acceleration continues (see Exhibit 3). The benefit of the March print though is that it may force observers to take a “second look” at the dominant persistent inflation narrative and become more granular again. Yes, a lot of the current inflation acceleration in the US is endogenous, but not all of it, and a number of idiosyncratic developments – and the price of cars is one – have magnified the move. We think we will need several months before we see a more widespread deceleration pattern, but in the meantime, the most dovish members of the Federal Open Market Committee (FOMC), without arguing against the need to normalize monetary policy, may be able to persuade their peers to be a bit more cautious with the quantum of tightening.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• CPI inflation (Mar) rose to 8.5%, 40-yr high, should be around peak, but will recede more slowly in advent of war • Retail sales (Mar) +0.5%mom in nominal terms, but as in Feb fell in real terms, signalling consumer pressure • Empire State survey (Apr) rebounded • Improved U Mich sentiment (Apr) 5-10y inflation expectation unchanged • Inventories (Feb) strong build continued	• Several Fed FOMC members speeches expected – Bullard, Evans, Daly, Powell • Conference Board (Mar) • Philadelphia Fed manufacturing index (April)
	• ECB GC meeting revealed increased hawkish bias. President Lagarde committed to a new anti-fragmentation tool but stayed clear from specifying any detail • German ZEW survey deteriorated further in April, with expectations dipping lower than during COVID-19 crisis	• TV debate between the two final candidates of the French Presidential election (Wed.) • Confidence surveys for April: INSEE business climate (Thurs.), EC flash consumer (Thurs.), flash PMIs (Fri.) • Details of euro area final March inflation print (Thurs.)
	• GDP (Feb) up 0.1%mom below expectations of a 0.3% rise • CPI (Mar) set new 30y high of 7.0% with price rises in oil and some service sectors • Unemployment (Feb) fell to 3.8% driven by a rise in inactivity	• Retail sales (Mar) expected soft after Feb figures showed weakness • Flash PMIs (April) expected to rise as recovery continues • BoE Governor Bailey speaking at Peterson Institute and IMF conference (Thurs and Fri)
	• Reuters Tankan Mfg and Svcs indices (Apr) rose respectively to 11 (from 8) and 8 (from-1) • Machinery orders data (Feb) surprised on the downside (-9.8%mom from -1.5% expected) • Corporate goods price (Mar) came at 9.5%yoy	• Trade figures (March) should surprise on the downside following China lockdown • Assessing any upside surprise on March CPI • Svcs Flash PMIs is expected to rise while Mfg should suffer from Ch lockdown and Ukraine
	• Inflation surprises on the upside driven by food and energy price increases • Ongoing Omicron wave continues to place stress on the economy	• State Council signals a RRR and/or interest rate cut could be announced next week
	• CB: Korea hiked +25 bps to 1.5%, Turkey on hold again at 14% • March CPI (yoy%) accelerated in India (7%) and Romania (10.2%) • Singapore Q1 GDP slowed 0.4%qoq 3.4%yoy • Weaker IP in Mexico and India, but stronger in Turkey in Feb	• CB: Indonesia (3.5%) expected to stay on hold • March CPI (yoy%) to accelerate in South Africa. Release of April first 2-week inflation in Mexico to monitor • Korean 20-days exports in April to be released

Upcoming events		
	US :	Mon: NAHB Housing Market indx (Apr); Tue: Building permits & housing starts (Mar); Wed: MBA Mortgage Applications (15 Apr), Existing home sales (Mar), Fed's Beige Book; Thu: Philly Fed Indx (Apr), Jobless claims (16 Apr), Leading indx (Mar); Fri: Mfg, services & composite PMI (Apr,p)
	Euro Area:	Mon: Sp Trade balance (Feb); Wed: It Trade balance (Feb), Ge PPI (Mar), Ez Industrial production (Feb), Ez Trade balance (Feb); Thu: Fr Business & Mfg confidence (Apr), Ez CPI (Mar), Ez consumer confidence (Apr); Fri: ECB Current Account (Feb), Ez Mfg, services & composite PMI (Apr,p), Ez Govt Debt/GDP ratio (2021), It Current Account balance (Feb)
	UK:	Fri: GfK consumer confidence (Apr), Retail sales (Mar), Mfg, services & composite PMI (Apr,p)
	Japan:	Tue: Industrial production (Feb); Wed: Trade balance (Mar), Imports & Exports (Mar); Fri: Natl CPI (Mar), Mfg, services & composite PMI (Apr,p)
	China:	Mon: GDP (1Q), Industrial production (Mar), Retail sales (Mar), Property investment & sales (Mar), Surveyed jobless rate (Mar); Wed: 1y & 5y Loan Prime Rate (20 Apr); Fri: Bloomberg economic survey

AXA Investment Managers SA

Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
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