Market Commentary

ECB's shy monetary policy turn has started

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- At today's meeting the ECB's Governing Council (GC) decided on a "*moderately lower pace*" of PEPP purchases compared to the two previous quarters based on an improved inflation outlook amid favorable financing conditions. Quite important, the decision was taken unanimously.
- Today's decision suggests to us that weekly PEPP buying will come down from the € 18 bn per week current average but will stay above the Q1 average of € 15 bn. Given that bond supply decreases in Q4 anyway, we see today's decision merely as a signal that the monetary policy turn has begun but that it will be conducted very cautiously.
- Lower PEPP purchases shall not affect credit markets as the amounts currently purchased are limited to € 1 to 2 bn per month. This is much less than under the CSPP (about € 5 bn) that will continue beyond the end of PEPP. Equities should behave decently well, withstanding the recalibration of the PEPP.
- Looking ahead, the decision about the end of the PEPP and how to cushion it comes into focus. President Lagarde announced that key future policy decisions will be announced at the December meeting. Macro projections will then also cover 2024 and the regular end of the PEPP is just three months ahead.

At today's meeting the Governing Council (GC) acknowledged the improved prospects for the euro area economy and announced a *'moderately lower pace'* of purchases under its Pandemic Emergency Purchase Program (PEPP) than in the previous two quarters of the year. All other policy tools were left unchanged. It thereby gave the long-awaited signal towards a less accommodative future policy stance. That said, President Lagarde made clear that the ECB will proceed very carefully, that monetary policy support will not end abruptly, and that December will be the next key policy meeting.

Key ECB Macro Forecasts

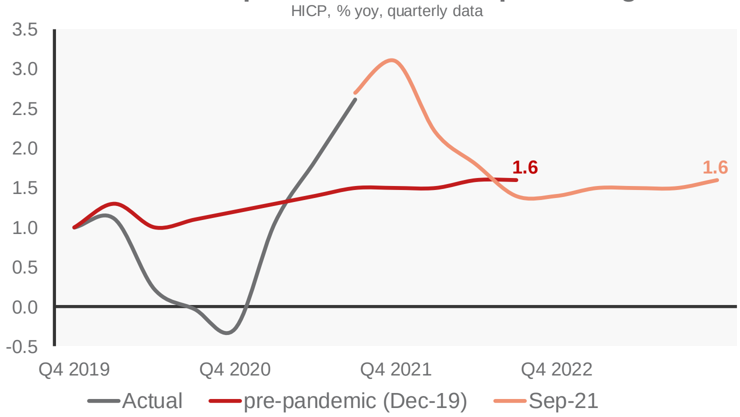
ECB staff mid-point projection, % yoy

	2021	2022	2023
GDP			
Sep-21	5.0	4.6	2.1
Jun-21	4.6	4.7	2.1
Inflation			
Sep-21	2.2	1.7	1.5
Jun-21	1.9	1.5	1.4
Core inflation			
Sep-21	1.3	1.4	1.5
Jun-21	1.1	1.3	1.4

Source: ECB

ECB: Pre-pandemic inflation path in sight

HICP, % yoy, quarterly data

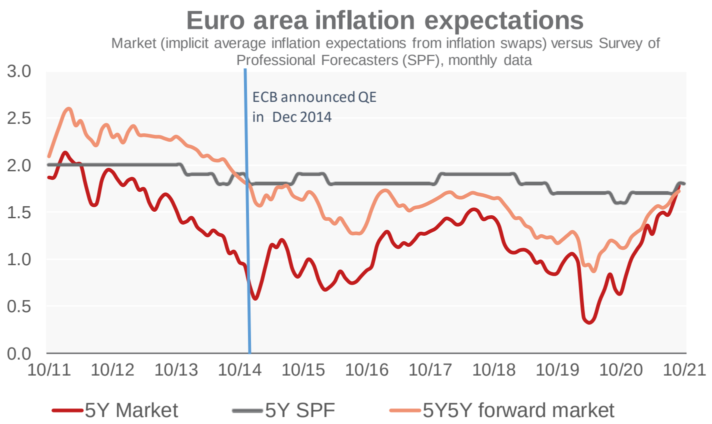


Source: Refinitiv, ECB

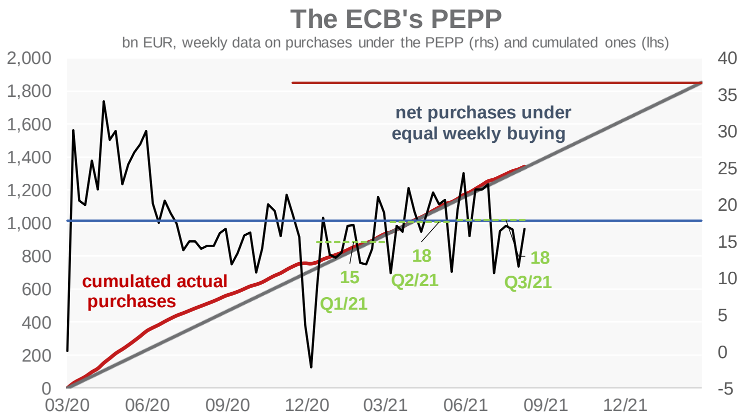
Outlook improved and pre-pandemic inflation path now in sight: The key reason behind the ECB's turn is the improved economic outlook. The pandemic lost some of its sting as large parts of the lockdown measures were unwound and in its updated staff projections the growth path was lifted upwards. The current spike in inflation is still viewed as temporary but the inflation path is lifted as well. Quite noteworthy, the GC is aware of the fact that "*If supply bottlenecks last longer and feed through into higher than anticipated wage rises, price pressures could be more persistent*". Moreover, in the current projections the ECB's pre-pandemic end of forecast horizon inflation rate of 1.6% will now be reached by Q4/2023. In the Q&A session President Lagarde also mentioned that the GC is aware of higher market-based inflation expectations. Indeed, they already surpassed pre-pandemic levels. That said, she also made clear that the ECB is no slave to the data and that reaching the 2% target still needs ongoing support.

Change of forward guidance on policy rates still far away: According to the ECB's new strategy a potential increase of the policy rates is crucially tied to reaching the 2% target well ahead of the end of the projection horizon that currently ends in 2023. Even with the inflation path adjusted to the upside, it will remain well below target making the case for an ongoing commitment towards unchanged or even lower policy rates. Lagarde was very clear on this in the press conference by stating that the ECB was "*pretty far away from hiking*".

Less PEPP purchases not a drama for markets: Today's decision about an only "*moderately lower pace*" of PEPP purchases in Q4 is a clear signal that the ECB will proceed very cautiously when withdrawing some its ultra-accommodative policy support. In the previous two quarters weekly PEPP buying average was around € 18 bn. Moderately lower buying from these levels might still imply stronger buying than in the first quarter (€ 15 bn), the period the ECB has chosen in March as a reference period for "*significantly higher*" purchases. Weekly purchases in the € 15 bn to € 17 bn range would not be a drama for financing conditions and financial markets in our view. Keeping in mind that in the last quarter of the year sovereign bond supply is generally meagre, the effect on market will likely be only limited. During the press conference, Lagarde reiterated the ECB's intention to continue providing strong support to corporates, as they have emerged more indebted from the pandemic. We view the reduction in PEPP purchases as neutral for credit markets as the amounts purchased in this program are limited to € 1 to 2 bn per month. This compares with above € 5 bn per month on average within the CSPP that will continue way beyond the end of the PEPP. We believe that the ECB will continue to keep volatility extremely low in IG for the months to come supporting our overweight on credit. Equities are not affected by today's ECB move either in our view. It is not too aggressive and, after all, not too distant from consensus expectations. Overall, we maintain an overweight on equities albeit a cautious one given the current mature phase of the business cycle, our expectations of higher real yields from here and peaking policy stimulus. Positive factors remain the good earnings growth expectations for this year and the next (+50% and 13%, respectively) which back our target of 5% total return in 12 months.



Source: Refinitiv, own calculations



Source: Refinitiv, own calculations

ECB to decide on post-PEPP stance at the December meeting: Today's decision was reached by unanimity. This was not expected given the diverging views GC members publicly exchanged over the past weeks. However, thanks to the boldness of the PEPP and the favorable market as well as pandemic development it could easily afford to announce a recalibration of the program without impacting too much on markets. But if – as the ECB expects – economic activity and the inflation outlook improve further, the post-PEPP policy stance will need to be discussed. Monthly purchases under ordinary QE (the APP) amount to only € 20 bn, compared to a total (APP and PEPP) of at least € 80 bn if PEPP purchases were to recede back to the volume of the first quarter until March. President Lagarde announced that the future of the PEPP will be addressed comprehensively at the December meeting and that the APP was still available. It is perfectly clear to us that all GC members want to avoid a monetary policy cliff. That said, over the coming weeks we will likely hear various ideas. For the time being we stick to our view that the APP will most likely be beefed-up (at least temporarily) to engineer a smooth exit from the crisis measures.