Article | 8 March 2021

ECB preview: Shadow boxing

Rising bond yields on the back of higher inflation have increased the pressure on the European Central Bank to better explain its current reaction function. This week's meeting should bring some clarity but no new action. Higher bond yields are warranted this year

Policy options

A lot has changed since the ECB's January meeting. The first inflation readings of the year have immediately outdated the ECB's own inflation projections, bond yields started to rebound and the extension of lockdowns in many eurozone countries has worsened the short-term economic outlook. At this week's meeting, the ECB will not only present its latest economic forecasts but it's also expected to shed more light on its assessment of the recent increase in bond yields, and, more importantly, present its policy options to tackle the increase.

Fresh round of projections

In December, the ECB's macro projections foresaw GDP growth to come in at 3.9% in 2021 and 4.2% in 2022. The underlying profile, however, already looks outdated as the ongoing lockdowns make the ECB's expectation of 0.6% quarter-on-quarter growth in the first quarter highly unlikely. Headline inflation was expected to come in at 1% in 2021 and 1.1% in 2022. Given the latest developments, that's also a highly unlikely outcome. The reasons for the low inflation forecast were probably much lower oil prices than we have currently and a bit of an underestimation of the potential upward pressure on prices from reopenings.

> *Expect a downward revision of growth and an upward revision of inflation forecasts*

With new assumptions for oil prices and also given higher bond yields, we expect a downward revision of the growth forecasts in 2021 and an upward revision of the inflation forecasts for 2021 and 2022. We don't expect any revisions to the 2023 forecasts as this would suggest a rethinking of inflation momentum at the ECB. Something we don't expect for the upcoming meeting.

The return of inflation

In recent speeches, ECB officials did not really address the latest increase in inflation rates and were rather silent on the ECB's inflation forecasts. In our view, headline inflation could top 2% in the second half of the year and we are very curious whether the ECB shares this view.

> *Headline inflation could top 2% in the second half of the year*

As much and as long as the ECB has been working and hoping for inflation to return to 2%, this is not the inflation the ECB has been looking for. Inflation mainly as a result of supply-side shocks and one-off factors is rather more deflationary than inflationary. Unless there are any second-round effects on wages in the making, the ECB will turn a blind eye to these developments. For any of these second-round effects to materialise, we would need to get significantly more fiscal stimulus and government policies aimed at increasing minimum wages. It will not be an easy task for the ECB to overlook accelerating inflation but any premature normalising of monetary policy would risk choking off the still-fragile economic recovery. However, this blind eye could turn into a black eye if financial markets have different thoughts, as currently witnessed by increasing bond yields. Consequently, the ECB could still be forced into new action.

> *This is not the inflation the ECB has been looking for*

Up to now, the ECB has tried to soothe higher bond yields with words. However, after speeches by Lagarde, Lane, Schnabel and Panetta, the exact reaction function still remains unclear. There is currently a range of alternative targets in order to demonstrate the ECB's willingness to look through higher headline inflation. Favourable financing conditions, nominal yields, real yields and yield curves. The most outspoken ideas came from Fabio Panetta who suggested that the financing conditions in December, when the ECB announced an extension of the Pandemic Emergency Purchase Programme, should be taken as a reference point. Any worsening of the conditions would require a policy reaction. Panetta has explicitly referred to the steeping of the nominal GDP-weighted yield curve since then as “unwelcome”.

In any event, there are currently many ways to say that the ECB could tackle any unwarranted increase in bond yields. And no, German dreams about premature tightening will not come true.

What to expect from the ECB on Thursday

The list of what the ECB could do on Thursday is definitely much longer than the list of what they will do. In our view, the ECB will primarily try to downplay the recent increase in bond yields, calling it small in magnitude, driven by technical factors and focusing on real yields. An increase of the PEPP envelope right now will not find support from the hawks.

> *The ECB will primarily try to downplay the recent increase in bond yields*

Instead, the ECB could frontload its PEPP purchases in the coming weeks to demonstrate its willingness to maintain favourable financing conditions. Also, we expect the ECB to stress that the total size of the PEPP could be increased if deemed necessary. In the Mario Draghi era, the ECB would probably have started with this frontloading during the press conference.

All in all, as much as the ECB would have liked to stay comfortably on the sidelines and see the recovery unfolding, backed by fiscal support, it will now have to do more to avoid the so-called 'unwarranted tightening' of financing conditions. On Thursday, it will mainly be shadow boxing, while still demonstrating a strong punch if need be.

0% Bund yields at the end of 2021

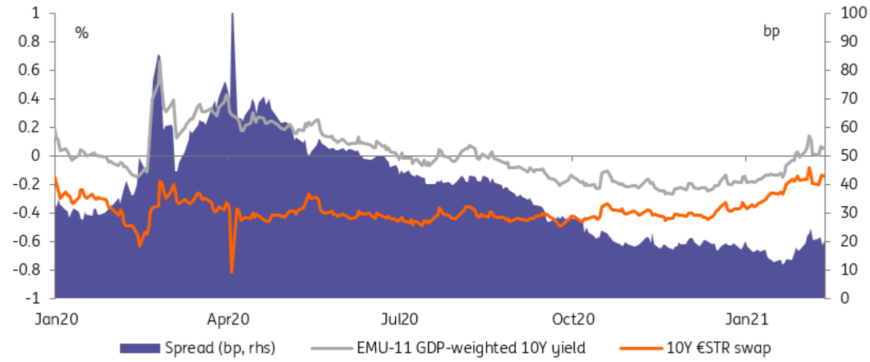
Even if the ECB front-loads purchases

Bond yields: the cat’s out of the bag

The February tantrum has brought about an increase in global government bond risk premia. Investors are now painfully aware of the risk of holding on to bonds offering little compensation against inflation, or an abrupt change in central bank policies. At its heart, it is a US-centric move, but its repercussions are global and hard to reverse in our opinion.

In EUR rates, a retracement lower cannot be excluded, but it would require an almighty effort from the ECB, which we doubt it is ready to make. As we result, we think last month’s events have shifted higher the path for Bund yields, we now see them rising to -0.15% mid-year and 0% by December.

Euro Government Bond (EGB) yields are still low, especially compared to swaps



Source: Refinitiv, ING

Front-loading of purchases, only a bump on the road to 0%

But how much can ECB action next week influence that path? The answer is not a lot.

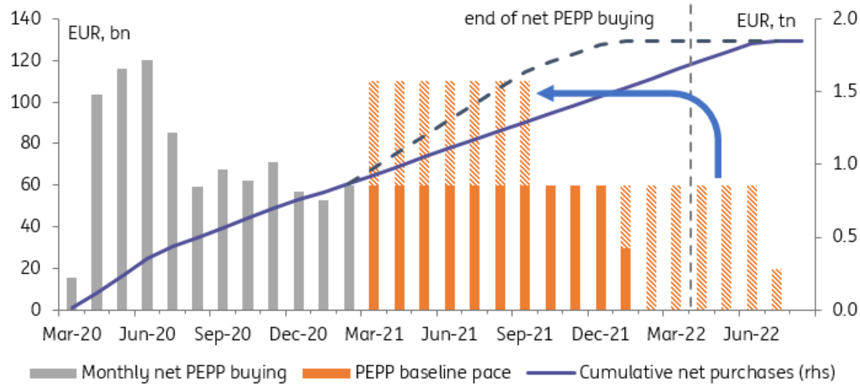
Using an empirical Bund yield model, we estimate that a doubling of PEPP purchases from €60bn/month to €120bn/m for one month would hardly make a dent in the Bund's fundamental value. That impact would easily be drowned out by other factors.

> *Inaction would send a tough signal the market*

Inaction would send a tough signal to the market, however. A failure to react after the verbal intervention of the past few weeks would be understood as a sign that the rise in yields is warranted by economic conditions. It would leave bonds free to sell off further, adding roughly 10bp to our already bearish forecasts in Q1. The endpoint for this year would be unchanged in our opinion.

A prolonged effort would be to increase the pace of purchases to €110bn until, say, the end of September, by which time eurozone countries have a fighting chance to have developed herd immunity. Here the impact would be more significant, in the 20bp area compared to our baseline forecast. However, as this would merely be a front-loading of purchases, we expect the impact to fade entirely by the end of the year.

A prolonged increase in purchases would shorten the programme



Source: ECB, ING

> The prolonged effort however could renew the discussion about the adequate size of the envelope. Assuming that the around €60bn per month average since last summer constitutes a baseline PEPP pace the ECB would want to return to, the buffer the ECB could spend on interventions amounts to roughly €200bn above that baseline.
>
> The ECB could afford to purchase at a pace of €110bn for three months without impacting expectations that net buying would continue at the baseline pace until the envisaged end date (end March 2022). But doing it longer than that as outlined above would imply that net purchases end ahead of the current stated end date or at least a taper of purchases below the baseline ahead of the end date.

Authors

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Disclaimer