

Looking forward to looking back

It's been all about our expectations this week. We've got two major outlook reports on the Telecoms and Energy sectors. We also look ahead to trade prospects for this year. And as the US keeps interest rates on hold, at least for now, what will Europe, Britain and Australia's central banks do next week? Answers - hopefully - here

In this bundle

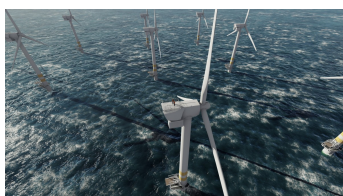


TMT

Telecom Outlook: What's in store for the sector in 2022?

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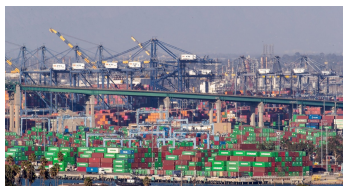


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Telecom Outlook: What's in store for the sector in 2022?

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We are likely to see broadband connectivity improve across Europe

What will 2022 bring to the telecom industry? Digital connectivity is frequently in the news nowadays. Because of strong developments in the industry, but also because it is a key policy area of the European Commission (EC). We believe the main themes of 2022 will be better connectivity as well as mergers and acquisitions (M&A). We, therefore, write in this outlook about the build-out of 5G and fibre networks and rural connectivity. We will also discuss M&A in the telecom sector and specifically about M&A developments in the mobile tower sector. Finally, in addition to the main trends, we will discuss cybersecurity risks, as well as developments in the mobile payments sector.

European agenda for digital and data strategies

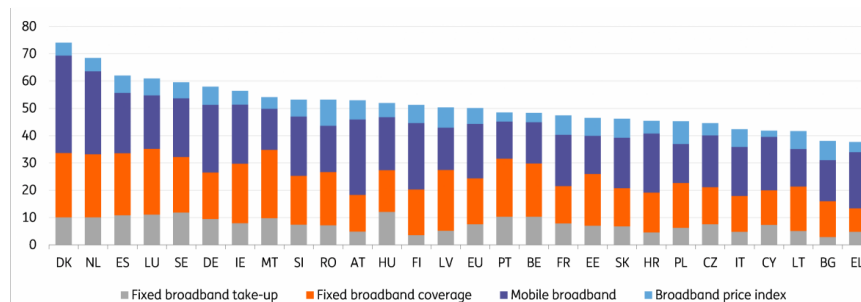
Let's first discuss the subjects that will be discussed by the European policy-making bodies this year. The European Commission will execute its agenda for digital and data strategies in Europe. The EC defines two targets for our Digital Decade: Gigabit broadband for all households and 5G in populated areas, which should be reached by 2030. It has also published proposals for the Digital Services Act (DSA), the Digital Markets Act (DMA), the Data Governance Act (DGA) and the Regulation on a European approach for Artificial Intelligence (AIR). These proposals will likely be discussed this year with the European Council and European Parliament to become legislation.

Many will welcome these proposals if they reduce the dominance of the large technology platforms and create a level playing field in Europe. Hopefully, the competitive position of telecom companies will improve on a relative basis. But more importantly, we hope consumers will benefit from better privacy regulation, as well as fairer competition on platforms that should benefit consumer choice.

This year will also see the likely start of substantial investments from the European Recovery Fund (ERF), aimed at accelerating the digital transition. The European Commission has measured digital competitiveness in EU member states through the DESI index since 2014. The DESI index tracks digital competitiveness with respect to human capital, broadband connectivity, the integration of digital technology and digital public services. In the figure below, the broadband connectivity ranking from the European Commission can be found. It is a sub-index from the DESI index. We can see that Denmark, the Netherlands and Spain are well-connected, while, when looking at the larger countries, Poland and Italy have some work to do. A description of the methodology can be found on their website [here](#).

The European Resilience and Recovery Plan can help with improved broadband connectivity in these countries since 20% of expenditure is allocated to the digital transition. Plans have been presented already to invest €13bn in digital connectivity. Also, other European programmes and facilities will help the rollout of broadband networks in Europe. So, broadband connectivity will likely improve across Europe.

Broadband connectivity ranking European Commission



Source: EU Digital Economy and Society Index, ING

What do we expect to happen in 2022?

A couple of trends will likely continue. 5G is here to stay and we expect that 2022 will be the year when its uses will become more widespread, although there are likely still speed differences across Europe. Mobile operators will need to find good pricing policies for 5G services. The build-out of fibre networks is progressing according to plan, also with the help of EU funds. In this report, we pay special attention to alternative ways to connect in remote areas. The technologies that are discussed in this outlook are Fixed-Wireless Access (fixed broadband connectivity over mobile networks) as well as satellite connectivity. Expect, therefore, that investments in fibre broadband and 5G networks will continue.

The ownership of some telecom operators will likely change, either through M&A or LBOs (leveraged buyouts). The same holds true for the ownership of mobile tower operators. Countries where M&A could take place are the UK, Spain, Italy and France, amongst others.

There are two other trends that are either going to benefit or possibly hurt consumers in 2022. To the possible benefit of consumers is the continuing innovation trend towards mobile banking. We expect financial services to become mobile-centric in 2022, leading to lower costs, more choice, and better ease of use of financial services, also in emerging markets. Better connectivity has the disadvantage that criminals could also profit from it. In 2022 the risk of the disruption of digital services remains high and could become higher, as will be explored in our article on cybersecurity. Nevertheless, providing security services could also provide a business opportunity for telecom operators.

Author

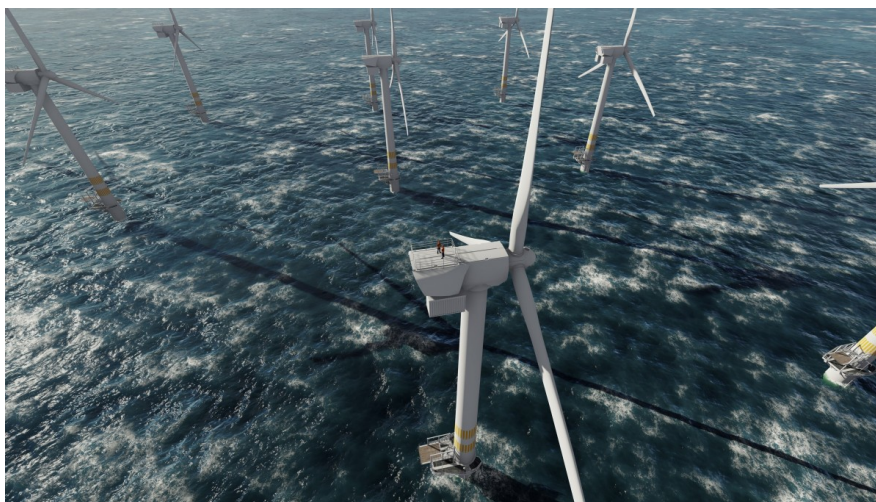
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Energy Outlook: Solid growth for wind and solar amid energy crisis

Today's energy crisis is a wake-up call for Europe, which is increasingly dependent on suppliers outside the continent for gas. That's why we...



The European wind market is set for growth of 8% in 2022

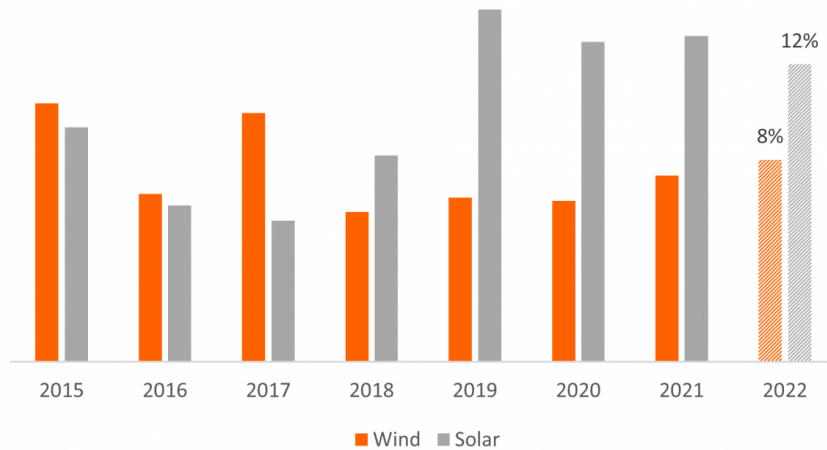
European wind and solar markets expected to grow

The European wind and solar markets are expected to provide solid growth of 8% and 12%, respectively, in 2022, in terms of capacity additions.

Growth in the solar market is highest for large-scale solar plants (+14%), while small-scale rooftop solar is set to increase by 11%. In the wind market, growth is highest in the offshore market (+16%) as some large offshore wind parks will come online in 2022. The onshore wind market is less subject to the timing of large projects and provides steady growth of 7%.

Growth in solar outpaces growth in wind

Annual growth in installed capacity for solar and wind energy in Europe



Source: ING Research based on BNEF

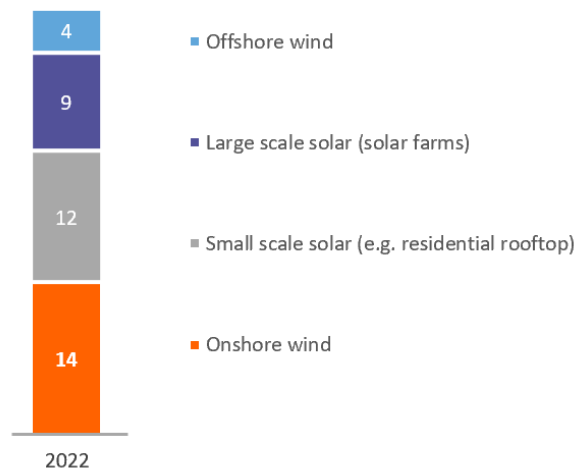
Growth is driven by small-scale rooftop solar and onshore wind farms

In absolute terms, capacity additions are largest in the onshore wind sector (+14 GW) and for small-scale solar projects (+12 GW).

In the offshore wind sector, 4 GW of capacity will be added in 2022. That is relatively small compared to the other segments, but policymakers in the Nordics, UK, Ireland, Germany and the Netherlands continue to work on special planning for offshore wind farms and grid infrastructure. So, much more is about to happen in the coming years for offshore wind farms.

Most capacity is added in onshore wind and small scale solar projects

Added capacity in Europe in gigawatt (GW)



Source: ING Research based on BNEF

Anticipated €50bn investment in wind and solar

All in all, we expect to see 39 GW growth in the combined wind and solar market. This equals €50bn of investment at current capex costs for the different wind and solar projects across Europe.

The energy crisis reveals the shortcomings of the 'sustainability only focus'

Climate change calls for a radical new [future energy system](#) that heavily depends on renewable energy and reduces unabated fossil fuels. Solar and wind power will be driving future power systems in a zero-carbon economy, which Europe aims to reach by 2050.

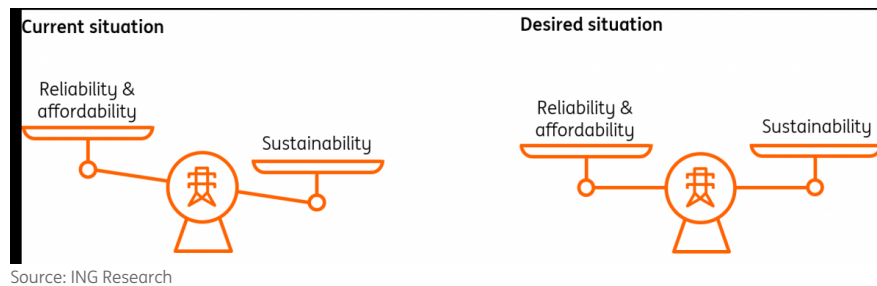
To meet these climate goals, policymakers across Europe have shifted their focus almost entirely to the sustainability aspect of the energy system. The focus has been on phasing out coal- and nuclear-fired power plants, reducing European oil and gas production and increasing power generation from wind turbines and solar panels.

As a result, the supply-side of the energy system has been reformed much faster than the demand-side. Europe now heavily depends on natural gas imports from Russia and Norway and liquefied natural gas (LNG) out of the US and Qatar. That worked fine in abundant energy markets, but not in the current energy crisis for which there is [no quick fix](#).

In short, old energy systems are being taken down faster than the demand for fossil fuels has declined and new renewable energy systems are being built. [Investment in upstream oil and gas is stubbornly low](#) and hence [commodity](#) and [power prices](#) are expected to remain high in the coming years.

Energy crisis calls for a rebalancing of priorities

Weighing of the three main pillars of energy systems: sustainability, reliability and affordability



Calls for a rebalancing towards security of supply and affordability

The energy crisis has put the other two pillars of the energy system; reliability and affordability, in the spotlight again.

The reliability of energy systems is no longer a guarantee, particularly in the case of a severe and prolonged winter, be it in Europe, Asia or both. And bankruptcies of energy providers could be a blow to the perceived reliability of the energy system for energy consumers, even if the energy system remains functioning.

The affordability of energy needs little explanation in the current crisis. A perfect storm occurred, with average power prices last year rising eightfold and gas prices sevenfold.

The current energy crisis calls for a rebalancing of priorities: from a sustainability, or 'renewables only' approach towards a balanced approach that includes the reliability and affordability of the European energy systems.

In that respect, today's energy crisis is a wake-up call. Gas consumption in Europe is becoming increasingly dependent on suppliers outside the European continent. As the 'renewables only' approach is not possible, Europe needs to develop more green energy alternatives, such as hydrogen. Well-balanced and coordinated energy transition plans from member states are needed to solve Europe's energy supply challenges.

Such a rebalancing does not mean that growth in wind and solar will slow down. In fact, coordinating the coal and nuclear phase-out across countries, keeping closed coal plants available as a backup instead of tearing them down, and the building of new gas-fired power plants with carbon capture and storage could in fact enable an acceleration of growth in renewables.

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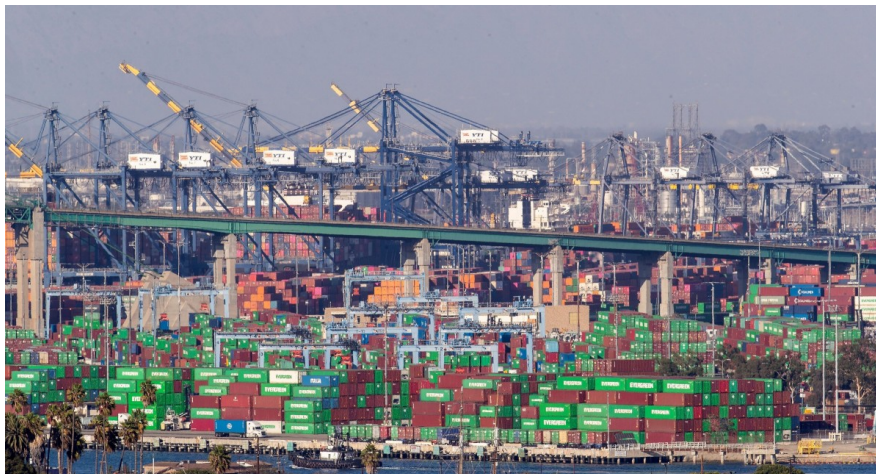
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Trade Outlook 2022: Clogged supply chains won't hold trade back

Demand for consumer goods rose strongly last year despite the profound disruption to supply chains due to the pandemic. We expect global trade not only to...



Bottlenecks in Los Angeles led to a buildup of thousands of containers in October last year

Despite the profound disruptive impact of the pandemic on supply chains, demand for consumer goods rose strongly last year. We expect merchandise world trade volumes to have increased by 10.6% in 2021 compared to the previous year, surpassing its pre-pandemic level by 4.3%. The growth rates of global merchandise trade should return to pre-pandemic levels this year, supported by industrial growth, global demand for goods remaining elevated, and only a limited shift of consumption back to services.

And that double-digit expected increase comes in spite of massive supply chain disruptions and soaring transport costs. It reflects strong demand for goods during the pandemic with China being one of the main drivers of the trade surge.

4.1%

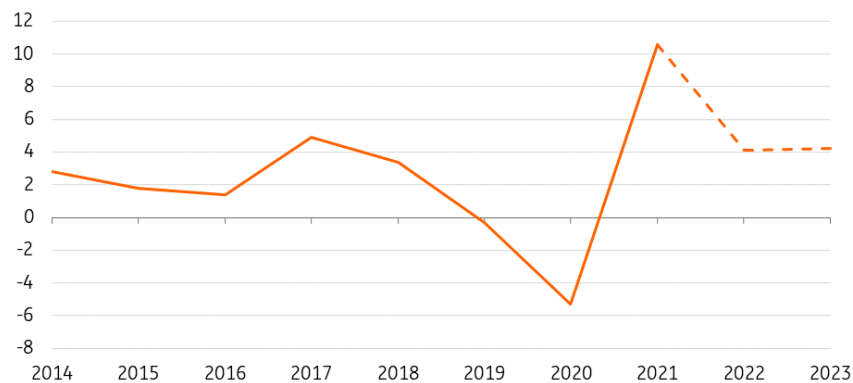
Expected growth in merchandise world trade

Year-on-Year, 2022

When we look at the details, world trade volume increased 2% month-on-month in November 2021, the second increase in a row. That's according to the World Trade Monitor for November from CPB. An increase in exports (+2.8%) and imports (+3.6%) mainly in advanced economies led to the rise in trade volumes, while China's exports decreased 4.1%. Imports showed modest growth of 1.2%. With some delay, this is also reflected in global container throughput which is regaining traction.

World trade in 2022: Return to pre-crisis growth rates

Global goods trade volume, %YoY



Source: CPB, ING estimates

World trade normalises and continues to grow despite challenges

Going into 2022, we expect trade growth rates to return to their pre-pandemic levels in line with a continued but weakened global economic recovery. For this year, we pencil in a growth rate in merchandise world trade of 4.1% compared to 10.6% the year before, while we expect world GDP growth to come in at 4.4% from 6.1% in 2021. 2021 was an exceptional year driven by pandemic-related catch-up effects. Despite ongoing supply chain frictions and average containerised transport costs expected to remain high, we still expect to see a decent growth rate.

Overall, consumers' preference for goods remains elevated

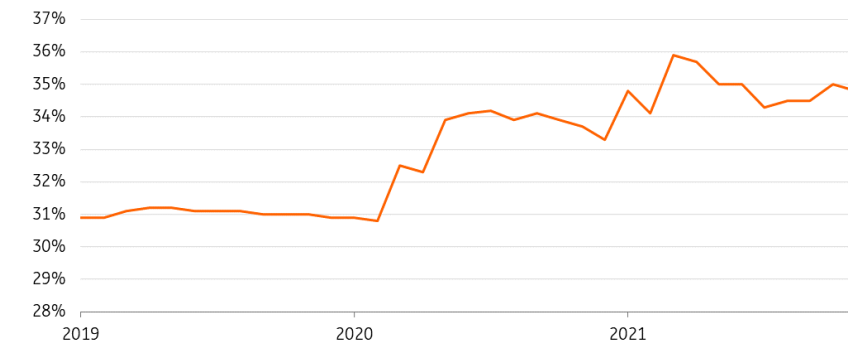
We expect the global economy will gain traction and enter a new phase should the Omicron wave become significantly less of a threat by the European spring. The experience of almost two years of crisis shows that economies can adapt, suggesting any new regional lockdowns should have less of an impact. That said, a shift by consumers back into services will only be moderate in 2022 because of Covid caution. They might reduce some of their increased spending on the likes of electronics and furniture while resuming spending on services all the while seeing higher energy and food prices. Overall, however, the preference for goods remains elevated.

In the US, for example, the share of goods spending as a proportion of total personal consumption expenditure continues to hover around 35%, well above its 31% average in 2019. This indicates a

continued goods' preference in the first quarter of 2022.

US personal consumption expenditure

Percentage share of goods likely to stay elevated



Source: BEA, Refinitiv

Ongoing labour shortages around the globe argue in favour of a rebound in wage growth and an improvement in workers' bargaining power. This, in turn, means we should see an environment of continued elevated demand, fueling world trade volumes. However, there is a risk that real wages will remain negative despite those higher wages with worldwide inflation expected to surge to 4.6% this year.

Through 2022, however, we expect inflation to subside, which leaves room for real income growth to turn positive in the second half of the year. In the eurozone, data seems to confirm this with manufacturers mentioning easing sourcing constraints which in part helped to ease input price inflation to the lowest level since last April. Governmental fiscal support and infrastructure plans, partly related to the green transition, also point to a continued positive investment outlook despite a tightening of financing conditions from major central banks,

Asia to remain a driving force in 2022

Trade growth remains uneven, however, when you look at different regions. The divergence across blocks and individual countries has been - and will be - driven by the progress and speed of vaccinations and the dependence on intermediate goods. Intra-Asia trade still has strong growth perspectives. Following an improvement in Asian industrial production over 2021 as well as significantly higher container throughput in [Shanghai \(+8%\)](#) and other major Chinese ports, the general macroeconomic outlook for Asia and especially China depends on [Covid, chip shortages and the US relationship](#).

A slowing of economic activity in China remains a concern for northeastern Asian industrial economies. Cooling industrial demand for coal and iron ore from China has already led to bulk freight rates easing after a commodity-driven peak. Chinese trade flows may also be more volatile this year due to less real estate construction but more infrastructure investment may help to balance that out.

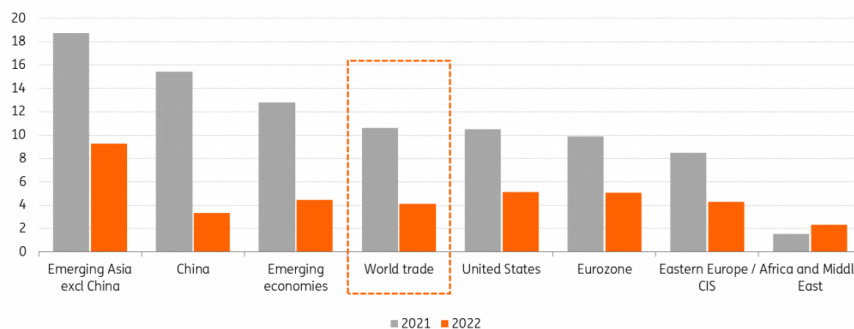
On a global level, we expect larger flows of oil and oil products alongside the global recovery of road and airline traffic and we think that [China should remain a major driver of growth for metals](#)

exposed to the energy transition. We expect global automotive production to increase by up to 10% (we've written more about that [here](#)) and that will create extra trade volumes but the semiconductor shortage will be a limiting factor.

Lastly, the implementation of regional trade agreements such as the Regional Comprehensive Economic Partnership (RCEP) within the Asia-Pacific area coming into force as of the beginning of the year or the African Continental Free Trade Area (AfCFTA) promoting intra-African trade, will likely affect regional trade flows.

Growth of trade in goods volume varies depending on the region

Percentage, Year-on-Year



Source: CPB, ING estimates

Supply chain slump and elevated tariffs will drag through 2022

So it all looks positive but it doesn't mean we don't face any obstacles to our growth outlook. A combination of shipping capacity and container shortages, unforeseen incidents, whether those be terminal closures in China or another blockage of the Suez Canal, and we could also see labour shortfalls which helped lead to spiking container rates last year. And 2022 started off with new records here. Based on UNCTAD data, those costs pushed China to Europe port-to-port container costs up to some 15% of the average goods transported (up from 2-3%).

The effect of massive port congestion occupying 10-15% of the global fleet capacity feeds back to that disruption. We've perhaps seen the biggest impact of that in the US. Container ships waiting at Los Angeles-Long Beach (covering 40% of US containerised imports) hit record levels in January with shortages at port sites and a lack of truck drivers to push goods further down the line. In Europe, the effect is less pronounced but still, ports are packed too. In China, we have seen similar squeezes in the Ningbo, Tianjin and Zhenzhen ports because of the country's zero-Covid policy. After Chinese New Year we do expect things to improve. But when spot rates come down, term contract rates of large shippers are still being negotiated higher.

A record wave range of ultra-large container vessels will come online

We concluded earlier that container rates will [remain under upward pressure](#) and won't return to

pre-pandemic levels anytime soon. A record wave of newly ordered ultra-large container vessels will come online from 2023 and 2024 but the container shipping sector is much more consolidated with three large alliances. Container liners also have learned to manage capacity better. The container sector is also entering the energy transition with retailers aiming to reach zero-emission seaborne trade by 2040 and companies are facing some sort of CO2 pricing. Maersk already started the shift by ordering 12 methanol-ready container vessels. But, in any case, fuel is expected to be more expensive, and that has an upward pressure on prices too, of course.

Risks ahead but trade fundamentals are still solid

The pandemic remains an uncertain factor affecting the outlook for 2022. Supply chain troubles and higher shipping costs also continue to pose risks to growth. At the same time, last year also showed this doesn't necessarily hamper the world from continuing to trade.

The economics of trade still make sense. There are not many examples of re-shoring yet as this takes time; it requires a high level of automation, and it's easier said than done. But shippers do consider multi-sourcing options, buffer stocks and longer contracts and this is still highly supportive.

So, we're optimistic given the economic outlook, a hopefully receding pandemic, and clear evidence of richly filled order books, notably in the automotive sector. We expect trade volume growth to hold up well this year, resulting in a more moderate but still sound growth rate for merchandise world trade.

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ECB preview: How to avoid jumping from patience to panic

Next week's European Central Bank meeting is unlikely to bring any policy changes. Instead, the central bank will have to master a new communication...



Source: Shutterstock

European Central Bank, Frankfurt, Germany

While the Federal Reserve has moved closer to a first rate hike, and more, all eyes will now be on the ECB meeting next week. However, we don't expect the central bank to give any hints on possible rate hikes. The time for this has not come, yet. Remember that the ECB and the eurozone economy are still lagging behind the Fed and the US economy in terms of the cycle, inflation, wages and labour market tightness. We don't expect any policy announcements at next week's meeting. Instead, the ECB's main challenge will be regarding communication - on the one hand, to confirm its more hawkish stance on inflation and on the other, to keep any speculation on premature rate hikes at bay.

The ECB's U-turn on inflation

More generally speaking, the ECB has gone through an enormous change. Within less than half a year, the inflation narrative has changed from calling the surge in prices temporary and warning against too-low rather than too-high inflation in the medium term, to a doubling of its 2022

inflation forecasts and warning against upside risks to price stability. Despite the change in its take on inflation, the ECB is in no position to consider tightening any time soon. The drivers behind high inflation and higher inflation projections are still mainly driven by supply-side constraints and not by demand. In other words, tightening monetary policy would do little to ship containers faster from Asia to Europe or reduce energy prices. Consequently, the ECB must make a fine distinction between the need to continue stimulating the economy and actually bringing higher inflation down. While the latter would only be possible at the risk of choking off the economic recovery, the former is clearly under discussion.

The minutes of the ECB's December meeting suggested that the ECB has definitely left 'team transitory' when it comes to inflation but without transferring into 'team permanent', yet. This means that the discussion on the drivers behind inflation not only at the current juncture, but also in the longer term, will continue and won't be solved any time soon.

Three stages of the ECB's road to normality

There won't be any changes to the ECB's monetary policy stance next week but the Bank's discussion on the future path of monetary policy will obviously be closely linked to the inflation debate. We think that this debate and the ECB's road to normalisation can be divided into three different stages: tapering, the end of negative interest rates, and finally moving towards a more neutral monetary policy stance.

- **Tapering.** The longer headline inflation remains at elevated levels and the faster the eurozone economy rebounds from the fourth wave of the pandemic, the weaker arguments to continue with asset purchases will be. Here, the short-term inflation assessment will matter most.
- **The end of negative rates.** Once net asset purchases are brought to an end, the next crisis tool will be discussed and likely returned to the toolkit. Returning the deposit rate back to zero could bring relief to the banking sector and could be an adequate signal that the era of unconventional measures is over.
- **Hiking interest rates beyond zero.** The timing of rate hikes once the deposit rate has been brought back to zero will be highly dependent on the ECB's longer-term inflation view, in particular, its view on whether or not structural factors, such as the fight against climate change, demographic factors and deglobalisation will push up inflation. If they do, a series of rate hikes is the most likely option once all crisis tools are back in the toolkit. That is unless the ECB starts to realise that rate hikes have as limited impact on inflation driven by global drivers as rate cuts had on deflation driven by global drivers.

In the absence of any major economic accident, we see a growing majority at the ECB calling for an end to the crisis-fighting tools. This would first imply an end to net asset purchases and then an end to negative interest rates; probably over the next 12 to 18 months. The discussion on rate hikes, once the deposit rate is back to zero, will be more controversial as views in the ECB's Governing Council about structural and longer-term inflationary drivers like decarbonisation, demographics and deglobalisation still differ significantly.

Next week's challenge: avoid jumping from too much patience to too much panic

The December meeting not only marked a new and more hawkish inflation stance at the ECB, it

was also the start of a gradual asset purchase reduction. At the current juncture, it is highly unlikely that we'll see any new policy announcements next week. However, the ECB will have to steer market expectations cautiously. The Bank will have to confirm its new hawkishness without sounding too hawkish. If market expectations surge too quickly, higher interest rates could undermine the economic recovery. On the other hand, too much dovishness could damage the ECB's credibility as an inflation fighter. This is why the ECB needs to avoid rushing from 'inflation patience' to 'inflation panic'. How could they do it? Confirm the December decisions, keep the door open for faster asset purchase reductions and stress the sequencing of policy rates hikes only after the end of asset purchases.

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Four scenarios for the Bank of England's February meeting

We expect a 25 basis-point rate hike next Thursday, and that will kick-start the process of 'quantitative tightening'. Markets are still...



Bank of England

Four scenarios for the Bank of England's February meeting

Bank of England actions/comments			
	Decision	Growth/inflation	Future tightening
①	No rate hike Unanimous decision	Concerns that Omicron has materially altered growth path. Signs of earlier supply chain recovery	Rate hike still likely, but hints clearly that market expectations are too aggressive
②	No rate hike Split decision	Lifts inflation forecasts but opts to gather more data on Omicron before acting again	Signals clearly that a rate hike is likely at the March meeting assuming economic data is as expected
ING base case			
③	25bp rate hike 8-1 vote in favour	Medium-term growth unaffected by Omicron. Raises inflation forecast on higher gas prices. Jobs market tight	More 'modest' hikes coming, but vague about when. Quantitative tightening begins (by ending reinvestments)
④	25bp rate hike Unanimous decision	Omicron unlikely to derail UK recovery. Inflation risks have risen since last meeting	Explicitly signals another hike in March/May. Signals clear desire to accelerate QT via bond sales in coming months

EUR/GBP: **0.8500**10Y yield: **1.1%**EUR/GBP: **0.8450**10Y yield: **1.2%**EUR/GBP: **0.8300**10Y yield: **1.3%**EUR/GBP: **0.8250**10Y yield: **1.5%**

? Will the Bank of England hike at this meeting?

Most likely, yes.

If December's surprise rate hike decision taught us anything, it was, firstly, that the Bank – and especially Governor Andrew Bailey – is clearly worried about elevated rates of headline inflation and the risk of a virtuous wage-price cycle. New forecasts showing both a higher inflation peak and a more gradual down-trend will only amplify those concerns.

Secondly, December's decision – taken when Omicron was very much in its ascendancy – signalled that the committee is no longer fazed by Covid-19. Policymakers posited that the medium-term outlook is unlikely to change due to Omicron, and most of the early data suggest they were right.

True, one lesson from November's surprise on-hold decision was that policymakers are not afraid to wait when much greater clarity will be available within weeks. Back then the Bank of England (BoE) paused to get more jobs market data, and the same logic could apply to Omicron.

But the high-frequency data points to a modest and short-lived impact, and that makes a 25bp rate hike likely at Thursday's meeting.

?

How many policymakers will vote for a hike – will it be virtually unanimous?

December's rate hike was almost a unanimous decision, a detail that was arguably much more surprising than the rate hike itself. Only Silvana Tenreiro, the most dovish member of the committee, voted to keep rates on hold.

We expect another 8-1 vote on Thursday, though there's not much recent commentary to go on. Officials have been unusually quiet since the last meeting. But silence often speaks louder than words, and we can probably surmise that most policymakers are comfortable with markets pricing in a February move.

If we're wrong though, and we get a more divided vote, then that should act as a warning for investors. We think we're likely to see more visible disagreement on rate hikes as the year goes on. And note that two BoE hawks – Dave Ramsden and Michael Saunders – see their terms expire in the third quarter of this year, unless extended.

In short, an aggressive tightening cycle may struggle to command enough support from the committee.

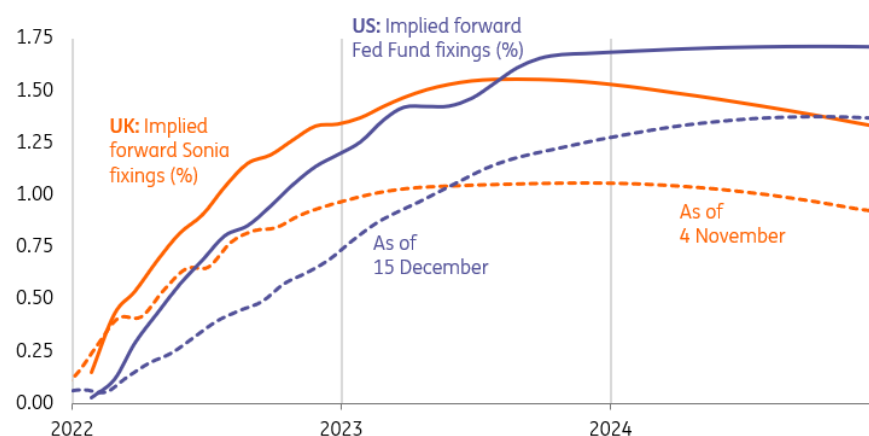
? Will the Bank kick-start quantitative tightening immediately?

Yes. The BoE has said it will stop reinvestments of maturing bonds in its quantitative easing (QE) portfolio when the Bank rate hits 0.5%, which is where we'll be at this meeting assuming there is a hike.

Governor Bailey noted recently that this early phase of quantitative tightening (QT) is unlikely to have a huge impact – in the same way the latter stages of QE didn't either – and that the Bank "[certainly cannot rely on it](#)".

That suggests that QT will start before March, which is when a sizable quantity of gilts are due to mature. And it also implies the Bank doesn't view the policy as a rate hike substitute, at least in the near term.

Market expectations: Bank of England vs Federal Reserve



Source: Refinitiv, ING Rates Strategy Team

? Will the Bank hint at a more gradual rate hike path ahead?

In practice, the five rate hikes now being priced in by financial markets for this year sounds like too much. We expect two, or maybe three.

But even if the Bank quietly agrees, we doubt it will say so. By pricing a steep rate hike path, markets are effectively providing the BoE with the inflation protection it is looking for.

That said, watch out for hints in the Bank's forecasts that it thinks market pricing has gone too far. These projections are based on the latest swaps curve, which has shifted higher since November's publication. All else being equal, that would increase 'excess supply' in a couple of years time, which in central bank speak means that less tightening is likely to be needed to achieve the Bank's goals.

But there are some potential offsetting factors. The Bank may well upgrade its wage growth forecast. And the inflation projections are likely to go up too, though that's partly down to a technical assumption that gas prices will remain fixed beyond six months (when in practice they are more likely to fall back).

In short, expect the Bank to keep the door firmly open to further tightening, without committing itself to any specific path.

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What to expect from Australia's central bank next week

The Reserve Bank of Australia will probably say they'll keep rates as they are until all, not just most, of the evidence points to a hike. But we...



RBA Governor, Philip Lowe holds up a mug reading 'Half Full' when he spoke to Australian lawmakers last year

Bye bye asset purchases?

The 1 February RBA meeting was always going to be an interesting one. Back on 7 September 2021, the statement accompanying the RBA's rate decision noted that the asset purchase programme would be extended until at least mid-February 2022, pushing a decision on any change on that policy to this forthcoming meeting.

It is worth just quickly rewinding to the [guidance given at that meeting](#) before seeing how far we've come since then. And back in September, the RBA maintained that:

"The Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 percent target range. The central scenario for the economy is that this condition will not be met before 2024. Meeting this condition will require the labour market to be tight enough to generate wages growth that is materially higher than it is currently".

So barely 4 months ago, we were guided that there would be no rate hikes until 2024 on a central

scenario - this itself was a slight watering down from the earlier guidance that even as late as [June 2021](#) it took the line that 2024 would be the "earliest", that rates might be hiked.

Fast-forward to [the last meeting in December](#) and the guidance was very different. Gone are all references to any dates for rates liftoff:

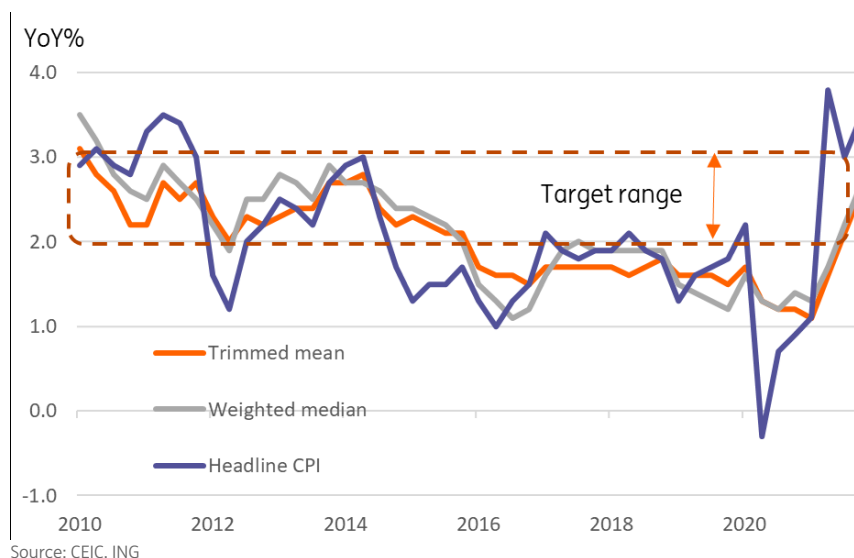
"The Board will not increase the cash rate until actual inflation is sustainably within the 2 to 3 per cent target range. This will require the labour market to be tight enough to generate wages growth that is materially higher than it is currently. This is likely to take some time and the Board is prepared to be patient".

It is actually the previous paragraph in the statement that deserves more attention though, as it sets out a blueprint for the RBA's reaction function. It states that:

"In reaching its decision in February, the Board will be guided by the same three considerations that it has used from the outset of the program: the actions of other central banks; how the Australian bond market is functioning; and, most importantly, the actual and expected progress towards the goals of full employment and inflation consistent with the target".

Let's take a look at these three considerations in more detail.

Australia inflation measures



1 The actions of other central Banks

If the underlying goal of the RBA has been at all times to be somewhat more dovish than the US Federal Reserve (our view), perhaps with one eye on the currency markets for the Australian dollar, then the goal-posts have shifted substantially. The last FOMC meeting teed up the Fed for a [March rate hike](#). The Fed also indicated that they would be ending their asset purchase scheme soon after. The wonder is that the Fed didn't end QE on the spot this month, given that they have already acknowledged that their balance sheet is larger than it should be given the economic backdrop.

So that fact alone may give the RBA some room to taper further before an end to their own

programme. This could be, say, by reducing the monthly asset purchase total from AUD4bn to AUD2bn, and then reviewing in May. That would leave a slightly ambiguous end to the programme, which might also be viewed as less disruptive for markets than an immediate end or a more definite end date. So that's the asset purchase scheme dealt with. But with the Fed clearly signalling a March hike, this opens up the door for a 2Q RBA hike, and further hikes over the second half of the year.

2 How the Australian Bond market is performing

10Y Australian government bonds currently yield a shade over 2%. That's up from about 1.52% in mid-December. but it is more or less in line with what we have seen in terms of US Treasury bond yields of the same maturity. Fighting the slight spread over US Treasuries is unlikely to be a constructive or effective approach to the Australian bond market, and in all fairness, a 2% yield is hardly a signal of a stressed government bond market, considering the growth and inflation backdrop, on which more shortly. As far as excuses to leave monetary policy unchanged, it looks as if the RBA can leave box 2 unchecked.

3 The actual and expected progress towards the goals of full employment and inflation is consistent with the target

As the RBA notes, this is the most important of the three reasons. And the 4Q21 CPI reading immediately suggests that it has been met, with a 3.5%YoY inflation print, above the top of the RBA's 2-3% inflation target range. That release was only slightly preceded by a sharp drop in the unemployment rate from 4.6% to 4.2%. Now if the RBA wants, it can note that at least some of the latest inflation increase is probably down to factors that are unlikely to persist (though the term "transitory" is looking somewhat cliched these days).

They can also note that trimmed mean inflation remains within target, as do weighted median measures - though both have risen substantially in recent quarters. What becomes much harder to ignore, would be evidence that wage inflation had also picked up to a level that might generate self-fulfilling inflation gains above the RBA's target.

The RBA Governor, Philip Lowe, last year gave a speech entitled "[The Labour Market and Monetary Policy](#)". In this, he provided two useful metrics. The first was that he believed that in order to consider the economy to be operating at full employment, the unemployment rate needed to be sustained in the low 4's. Well, we are there now, though it may need one or two months to persuade the RBA that this is "sustained".

The other metric was that to generate inflation consistent with the RBA's 2-3% CPI target, wage growth would need to exceed 3%. We get the 4Q21 Wage price index on 23 February - still a few weeks after this coming meeting. This is perhaps the only piece of the puzzle that remains absent from any argument for raising rates. But we will know soon enough. If the 4Q21 figure remains below 3%, then perhaps the RBA can put off raising rates a bit longer. If not, then a 2Q rate hike does become a possibility, as do further hikes in the second half of the year.

10Y Yields, Australia, US



Markets already there?

None of this, bizarrely, has all that much relevance for financial markets. Rates markets have been pricing in an aggressive series of hikes from the RBA for some time now. The implied yield on the December 2022 3m bank bill futures contract is currently 1.37%, which even allowing for some term premium over the cash rate is quite aggressive. And our longstanding view has been that although the RBA's forward guidance was likely to have to be substantially ratcheted back, so too would the market rate hike view. This leaves open the possibility of a counter-intuitive softening of market-rate expectations as the RBA walks back from its earlier dovishness.

While a key determinant of some major FX rates (EUR/USD, for instance) rate differentials have not been a major driver of AUD/USD in the past year, even after the RBA dropped the 2-year yield target: back then, the FX reaction was indeed more contained than the one in the bond market. In a similar fashion, the aggressive hawkish pricing of RBA tightening had a quite limited pass-through into AUD. Ultimately, AUD/USD has appeared to be pretty much glued to EUR/USD and global risk sentiment dynamics lately.

The link between FX and short-term rates may pick up once both the Fed and the RBA have initiated their tightening cycles, but for now, the weakness of this link means that hawkish signals by the RBA at next week's meeting may provide only some time-limited support to AUD/USD, also considering the rates market is already pricing in around 120bp of tightening in the next 12 months.

A positive AUD reaction after the RBA announcement next week may largely be a consequence of some short-squeezing ([AUD is the most oversold currency in G10](#)), but the fragile global risk environment, strong USD, AUD exposure to China's zero-Covid approach and unresolved Sino-Australian diplomatic/trade tensions all mean that a hawkish tilt by the RBA should fall short of truly revamping a strong bullish sentiment on AUD/USD in the near term. We continue to expect any AUD/USD rally to stall around 0.72 in 1Q22, with a balance of risk that remains tilted to the downside.

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Fed: Countdown to March lift-off!

The Federal Reserve admits rate hikes are coming "soon" and this will be the primary tool to tighten monetary policy. They are also laying the...



Source: Shutterstock

Inching towards action despite ongoing QE

The Federal Reserve has left policy unchanged, but signaled "it will soon be appropriate to raise the target range for the federal funds rate". They are also continuing to buy assets as part of their QE plan until early March, which seems a strange decision to us. Fed Chair Jerome Powell had said earlier this month that "we're mindful the balance sheet is \$9 trillion. It's far above where it needs to be". Why on earth are they adding to it? This seems even more peculiar given they have released a document titled "principles for Reducing the Size of the Federal Reserve's Balance Sheet". We can only conclude that the recent volatility in financial markets has led them to tread cautiously and not surprise.

In terms of the press release the Fed talks of strengthening activity and "solid" job gains while acknowledging that "supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation". Consequently, we are expecting a 25bp rate rise at the March FOMC meeting and in the press conference Powell admits FOMC members are "of a mind" to do so.

Minimum of four rate hikes, but it could be more

The data between then and now isn't going to be pretty though with a clear risk that December's awful consumer spending numbers are repeated in January given all the Covid caution around. The January jobs number could also be very subdued for similar reasons and this is likely to dampen the very niche calls for a 50bp rate hike in March.

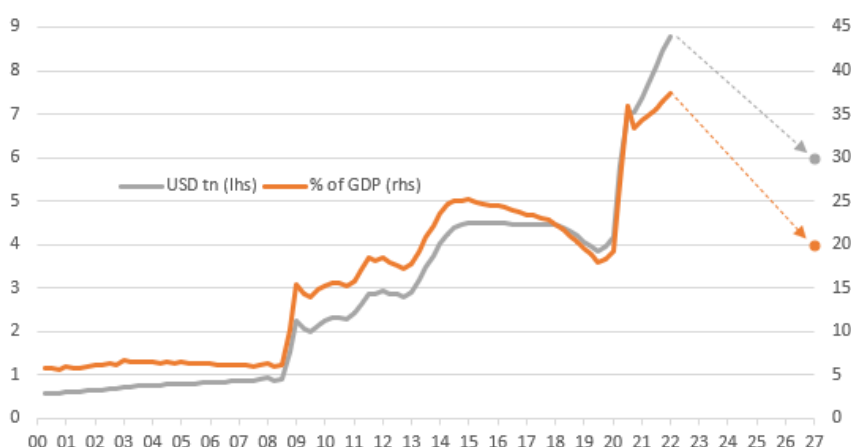
Nonetheless, we are hopeful of a second quarter rebound given solid income fundamentals and this will set us up for at least four rate hikes in 2022. Indeed, in the press conference Fed Chair Jerome Powell did not rule out raising rates at every FOMC meeting, arguing that the Fed has plenty of room to raise interest rates without hurting the jobs market.

The balance sheet will contribute too

In the second Fed document regarding the balance sheet they confirm that the primary monetary policy tool is changing the Fed funds target rate and that "reducing the size of the Federal Reserve's balance sheet will commence after the process of increasing the target range for the federal funds rate has begun". Balance sheet reduction will be done "in a predictable manner primarily by adjusting the amounts reinvested of principal payments". It also wants its balance sheet "in the longer run" to be "primarily" composed of Treasury securities.

It is fairly vague stuff and there is nothing in there that is surprising. It will be a similar pattern to past times. The Fed hikes a couple of times (March and June) and then presumably in July/August starts allowing a capped amount of maturing assets to run off its balance sheet. It will start slowly, probably at around \$10bn for Treasuries and \$8bn for MBS and then be accelerated, assuming economic conditions allow, up to around \$50bn and \$40bn respectively per month. Given the Fed states it primarily wants to hold Treasury Securities "in the longer run", agency MBS may be allowed to run off at a slightly quicker rate than Treasuries.

Assets on the Federal Reserve's balance sheet and the potential path to "normalisation"



Source: Macrobond, ING

They don't give us a figure for the size of balance sheet that they think might be warranted in the medium to longer term, merely stating the Fed "intends to maintain securities holdings in amounts

needed to implement monetary policy efficiently and effectively". Currently we are at \$8.75tn, equivalent to around 36% of nominal US GDP. Board of Governor member Chris Waller has suggested he thinks the balance sheet should over the long run be around 20% of GDP. Assuming they aim for a 5-year run down this would imply \$2.8tn of assets leaving their balance sheet. The longer the time frame, the less reduction required, obviously.

Market rates choose to edge higher, on a calming influence for risk assets

A small uptick in rates along the curve has been the impact reaction from the Fed's statement. This has been driven by a nudge higher in real rates; inflation expectations remain steady.

The lack of new news from the Fed's statement allows the market to latch back on to the path of least resistance, which right now is up in market rates, a bit. Risk assets have not seen any new shock from the Fed, which is supportive. There is arguably a window of tranquility now for risk assets as we roll forward to the March meeting, which is quite some distance away.

In the meantime the Fed has cut nothing and continues to build its balance sheet (no tapering yet). No panic tightening here. No overreaction, despite the market talk. Relief for risk assets leaves room for market rates to re-test higher. But overall, we are back to monitoring the pulse of the economy.

Notwithstanding the headwinds that come from Omicron, and can come from Ukraine-related issues, the bond market is minded to look up in yield rather than down. The counter to this is ongoing Fed and external buying of Treasuries. The Fed's statement has done little to change that narrative, at least for today.

FX: All very orderly

The initial reaction in FX markets to today's FOMC statement has been relatively muted – since the market had already priced the start of the Fed tightening cycle in March. If there has been a slight movement, it has come from the dollar moving higher against the low-yielders, such as the JPY, EUR and CHF – currencies most susceptible to higher US interest rates.

Marginally outperforming have been the high beta currencies. Here one can argue that surprises in neither the FOMC statement nor the Fed's balance sheet down-sizing guide support views of an orderly rate normalisation cycle – reducing the risks of shocks to risk assets.

Given the current tension in Ukraine, which should demand a geopolitical and macro risk premium of European currencies, and the looming Fed cycle, we would continue to back North American currencies in 1H22. Those currencies in the orbit of the strengthening Renminbi should also be better able to withstand Fed and geopolitical risks over coming weeks and months.

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