18 January 2022

The ECB's complicated exit

Global assets remain highly correlated, but it seems we are on the cusp of a more significant divergence in monetary policy and indeed the macro landscape, comparing the Eurozone with the US. That should begin to erode these linkages, particularly in bond markets. While there are clearly risks on the eurozone inflation front, the ECB looks well placed to deal with these. Many of the price pressures present in the US, that are contributing to persistent inflation stateside are not embedded in the single currency zone. So while the Fed tries to catch up, the ECB has more room than the market thinks.

This will feed the weaker euro trend this year. Geopolitical events, such as developments about Ukraine, could make the euro weaker still and spur flows into US dollar assets. Diverging monetary policies also mean that 10-year Treasuries will underperform similar-duration Eurozone debt. We remain short 10-year US Treasuries. We would swap short 10-year Bunds for short 5-year Bobl positions. We remain short Italian 10-year BTPs.

The evolution of inflation globally and a rapid reassessment of these risks by the Federal Reserve increases pressure on the ECB's measured approach to policy normalisation. President Lagarde remains committed, as ever, to the ECB's price stability mandate. But part of that pledge is the view that the verbalisation of the central banks' price stability commitment will by itself help anchor inflation expectations. Such self-fulfilling thinking might have worked in an era where global disinflation was the dominant force, but post-pandemic the balance of price risks has shifted. And at this stage it is not clear whether these changes are temporary or will develop into a longer-term shift in price dynamics.

The transient view clearly still has some validity in the Euro area. Breaking down Eurozone HICP, price pressures remain concentrated — energy being the key culprit (Figure 1, page 2) — with some further distortions coming from things like the temporary German VAT cut. Services prices have increased slightly, as have industrial goods, but there is little sign of any significant shift

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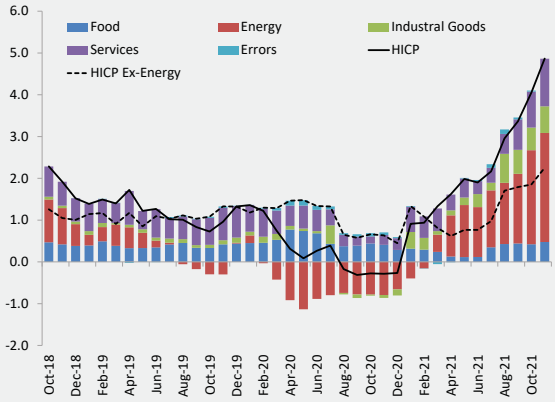


Figure 1. *Source: Eurostat, Independent Strategy*

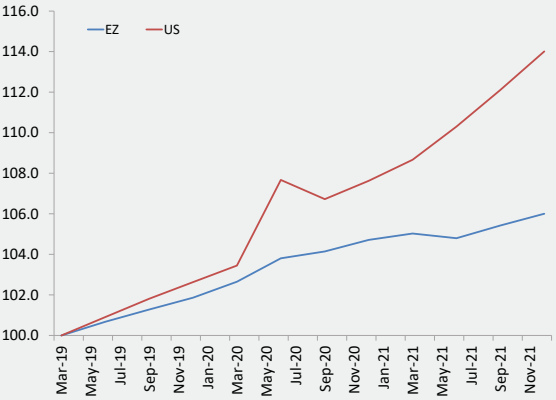


Figure 2. *Source: Refinitiv, Independent Strategy*

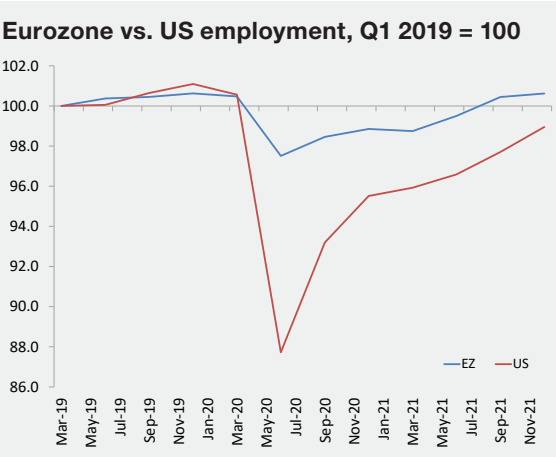


Figure 3. *Source: Eurostat, BLS, Independent Strategy*

in underlying momentum and they have not broken beyond levels the Governing Council has managed before. We've seen none of the inflationary pressure from things like car prices that have made a significant contribution to the US CPI spike (1.7% pts of the 7.0% y/y rate in December), nor significant pressure in durable goods. Other components in US inflation, like shelter, are also pushing higher and will continue to do so. The upswing in prices, in other words, is far broader-based on the other side of the Atlantic.

Furthermore, the Eurozone hasn't seen any corresponding jump in wage pressures (Figure 2), which are a further push factor or at the very least an input into prolonging the adjustment higher in prices.

That is largely due to the differing policy responses to the pandemic, with the US prioritising blanket fiscal transfers (enjoyed even by those who did rather well out of the crisis) compared to the focused schemes operated in Europe. Those were designed to keep workers in their jobs via direct wage subsidies. Employment has consequently recovered (Figure 3) without the competitive scramble (and wage jump) for workers seen stateside. While the next German wage round is likely to lead to demands for a higher settlement, negotiated wages have actually declined during the pandemic.

But the ECB still needs to fend off price risks. Energy distortions are proving persistent amid a broader energy squeeze across the single currency area, to which the pandemic is only partly to blame. Low gas inventories, not enough wind and the closure of nuclear plants have all added to tight conditions in wholesale power markets. These have generated price spikes across the region that have eclipsed the more normal impact of oil price volatility.

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Indeed, household energy bills are likely to continue rising throughout this year as these costs pass through the regulated utilities sectors.

Pre-Covid this would have been seen as a disinflationary force overall, acting as a drag on discretionary spending. But perceptions have shifted amid strong post-Covid demand and concurrent supply-chain disruptions, which have left prices to act as the balancing factor.

For the ECB, navigating this backdrop will be challenging. The central bank's long-standing policy failure has been its inability to meet its price stability goals. So the prospect of a return of more "traditional" inflation, that can be dealt with classical monetary policy tools, is something some might see as desirable. But this comes with risks after years of negative interest rates and easier and easier money, particularly for an institution that has more often than not been late to react to economic and policy risks (the pandemic being the notable exception to this generalisation).

ECB independence is well enshrined, but that is somewhat different from being apolitical. Balancing monetary policy across a diverse collection of national economies (and differing social ideologies), is always going to be a more complex endeavour than the Federal Reserve has to deal with. Forging a consensus is difficult — the procrastinated way in which the ECB's asset purchases programmes came to life being a good example.

Clearly more orthodox members already feel the current inflation rate warrants some degree of tightening. But the counter-argument that the risks of miscalculation and moving too early after the shock of Covid are equally persuasive. Hence Lagarde's reliance on verbalising the ECB's commitments, a vital link to fill the gap as a new consensus evolves over the immediate and longer-term impacts of the crisis.

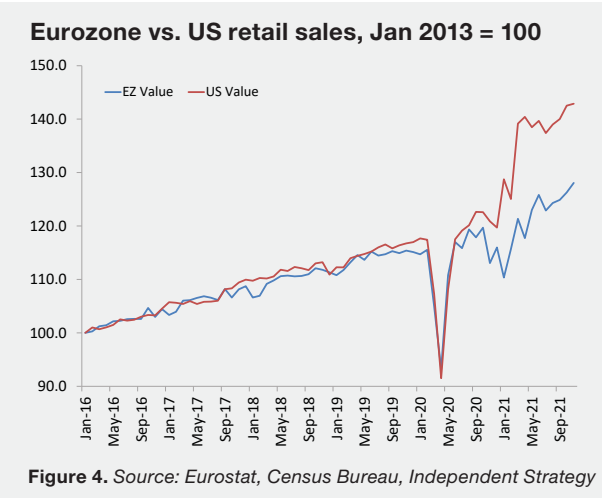


Figure 4. *Source: Eurostat, Census Bureau, Independent Strategy*

We'd certainly argue that the Eurozone is far closer to returning to its pre-Covid state (and an equilibrium) than is the US. The distortions from the pandemic are simply far less extreme on the continent. For example, although Covid restrictions elevated savings and bolstered household balance sheets across economies, the Eurozone consumer hasn't embarked on a spending binge of anything close to US levels. Indeed, Eurozone retail sales look closer to their pre-Covid trend, in stark contrast to the US, where shoppers continue to spend from already excessive levels (Figure 4).

As the recovery extends in the US and the labour market continues to tighten, we've also seen consumers start to reach for credit

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INDEPENDENT STRATEGY

Bank lending standards — consumer credit

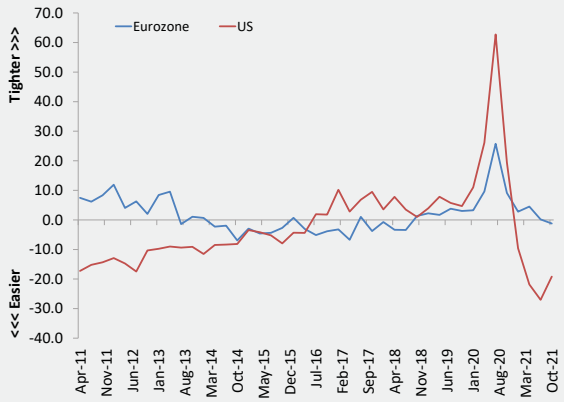


Figure 5. *Source: Federal Reserve, ECB, Independent Strategy*

Chg in 10-year bond yields (%), last 6-months

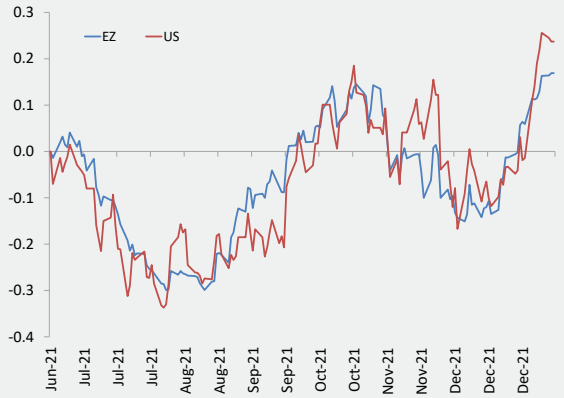


Figure 6. *Source: Refinitiv, Independent Strategy*

Fed tightening cycles & chg in yield curve (10-year UST - Fed funds), %

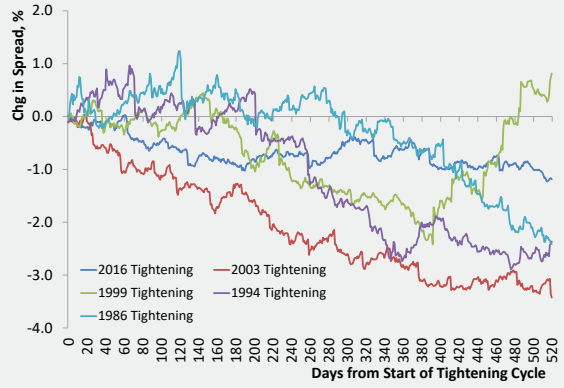


Figure 7. *Source: Refinitiv, Independent Strategy*

again. This is being facilitated by a relaxation of lending standards, based on the Fed's latest loan officer survey, and a corresponding acceleration in consumer credit into the end of last year. This contrasts with European institutions which remain conservative, having only recently begun to ease lending criteria for consumer loans (Figure 5) while mortgage lending standards have actually been tightened.

Looking at the overall backdrop it is clear the ECB has more breathing space, allowing it to run down its asset purchase programmes gradually, turning to the path of short-term interest rates only at the start of next year. By then, based on market pricing, the Fed will have tightened four times. And if inflation turns out to be more embedded than the FOMC expects, it may have to do more. The Fed Funds rate was at 1.75% pre-Covid (having already been cut from 2.5%), a period where demand and inflation conditions were notably weaker than they are today.

The divergence of central bank policy requirements should continue to underpin the dollar at the expense of the euro. While rate hikes are priced in, it could be argued the expectation of dollar appreciation is already baked in the cake. But we think that the differences in these respective macro landscapes is still underappreciated. Indeed, long-end yields are still too correlated for our liking. Sure, short-end yields have diverged as Fed hikes have been priced in, but the sell-off in the longer-end of the curve is still too similar (Figure 6).

There is some expectation that as we see policy lift-off there will be further flattening of the yield curve. Indeed, we've seen this in every US cycle (Figure 7). But we'd note that this does not correspond necessarily to falling long-end yields. It represents more a relative

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shift as the entire yield curve adjusts higher. That is the playbook we'd use for the US, particularly given the current inflation backdrop which looks more challenging than in any period since the early 1980s. So being long duration will only work as a relative value trade, not on an outright basis. We still see significant upside in longer-dated Treasury yields and remain short.

In the Eurozone while we might see 10-year yields nudge higher in solidarity with Treasuries, this move has it limits. We think Bunds should outperform both Treasuries and the Eurozone short-end and mid-curves as the ECB edges slowly towards lift off while the Fed moves quickly to catching up. We would swap short 10-year Bunds for shorter duration 5-year Bobl. We remain short Italian 10-year BTPs.

This story is bullish for the US dollar and we remain short euro against it.

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