Bond Blog

PGIM FIXED INCOME

December 15, 2022

A Confused Message from the ECB

By Katharine Neiss, PhD, Chief European Economist,
and Guillermo Felices, PhD, Global Investment Strategist

The ECB surprised investors with an exceptionally hawkish message at its December policy meeting. President Lagarde was emphatic that interest rates would need to rise significantly more than investors previously expected. In addition, the ECB announced that quantitative tightening would start in March 2023.

The lack of rationale behind this tighter stance and the minimal detail around plans to shrink the ECB's balance sheet amount to a considerable increase in uncertainty. The sharp adjustment in tone raises the spectre of a Trichet-like policy reversal and loss of credibility.[1] That could set the scene for a rocky start for financial markets in 2023.

The ECB adopted a most hawkish stance at its meeting. The question is: why?

As expected, the Bank raised interest rates by 50 basis points (bps), taking its deposit facility rate to 2.0%. But President Lagarde made clear that investors should expect more - much more. In particular: a succession of rate rises is to come, that the level to which rates need to rise is significantly higher than what investors expected, and rates would need to remain restrictive for some time to bring inflation down to target.

The messaging on the outlook for rates was clear, but its rationale less so. ECB staff now projects inflation in the second half of 2025 - the final year of their medium-term horizon - to be in line with the ECB's 2% inflation target.

There also seems to be a disconnect between rate hikes being "data dependent" on one hand and, on the other hand, today's specific forward guidance on a succession of 50 bps rate rises at forthcoming meetings. Overall, this sharp shift in stance suggests a degree of confidence regarding the inflation outlook that is at odds with weakening economic activity.

The ECB's latest announcements on quantitative tightening surprised us as well. Instead of outlining principles - such as prioritising the roll-off of corporate bonds over sovereign bonds - and clearly signposting future plans, the ECB announced that it would cease to reinvest €15 billion of maturing assets for four months, starting in March 2023. The lack of rationale and detail around these announcements is an additional source of uncertainty.

In our view, the ECB's sharply tighter policy stance and increased uncertainty raise the risk to financial stability in the euro area. Significant, sustainably higher interest rates at a time when secondary markets will need to absorb increased government bond issuance could trigger a market revolt. That clash, in turn, could trigger a swift retreat by the ECB, potentially damaging its credibility.

The ECB adopted a most hawkish stance at its meeting. The question is: why?

The ECB's hawkish message caught investors by surprise. Given the extent of that surprise, their reaction was predictably aggressive.

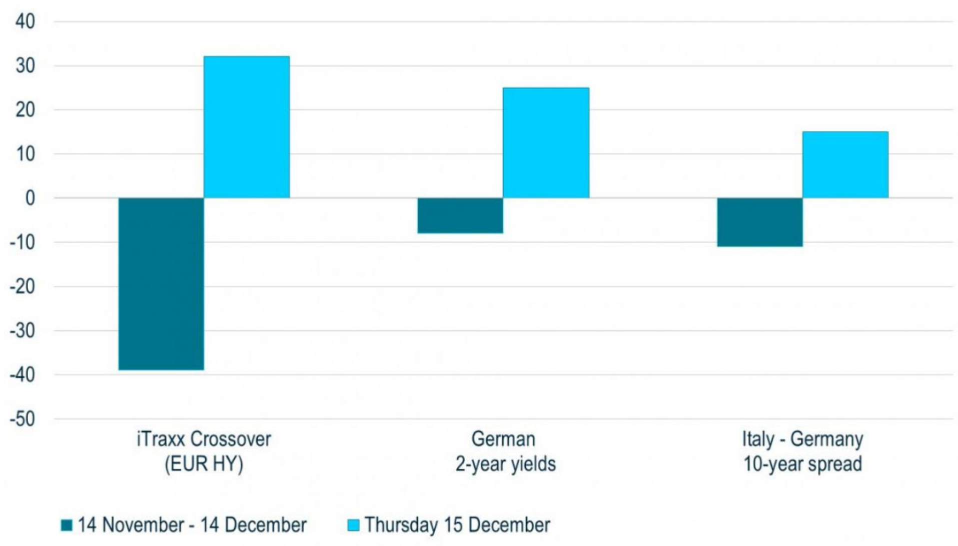
German Bund yields rose sharply, and the yield curve inverted further. At one point, 2-year German Bund yields rose a significant 30 bps. Indeed, 2-year German Bund yields have reached new cyclical highs and levels not seen since the global financial crisis. Peripheral spreads widened materially as well. At the time of writing, 10-year Italian BTP spreads to German Bunds are 14 bps wider, their widest spread since October 2022.

Corporate credit spreads widened, too. Credit default swaps for euro-denominated high-yield bonds ("iTraxx Crossover") were 27 bps wider, while the corresponding index for euro-denominated investment-grade corporate bonds ("iTraxx Main") was 5 bps wider (Figure 1).

Risk assets were also hit hard. At the time of writing, the EuroStoxx 50 index was down 3.5%, a move comparable to the sharpest daily move registered as the war in Ukraine commenced.

Interestingly, the euro weakened versus the U.S. dollar during the day, which reflects two conflicting forces. Interest rate differentials clearly shifted in favour of the euro, but the higher risk premium on euro assets, due to tighter financial conditions, had the opposite effect.

FIGURE 1: The ECB's hawkish message led to higher front-end rates and wider spreads during the day



Source: PGIM Fixed Income.

Looking ahead to 2023

Following today's ECB meeting, multiple indicators point towards a disruptive market environment going into 2023.

First, the message that the ECB is determined to continue increasing interest rates means higher interest rates for longer. That, in turn, implies an elevated risk premium for cash-generating assets that will already be starved of growth in 2023.

Second, the ECB's QT programme raises serious questions about financial stability. The Bank has used quantitative easing ("QE") to engineer European government bond markets for years, leaving them illiquid and delicate. The pace of QT announced today is larger than we expected and will act as a drag on risk assets, the reverse of what QE delivered. The combination of higher interest rates and QT raises question marks about fragmentation risks and debt sustainability because it comes at a time when governments are expanding fiscal policy and increasing bond issuance.

Third, the ECB's message today leaves many questions unanswered, which introduces policy uncertainty that could add to risk premia in asset markets. These questions include investors' assessment of the terminal policy rate, the possible conflict between forward guidance and data dependency, and the roadmap and details for QT. The latter is particularly worrying as the ECB has little experience with QT. It is, in the Bank's own words, "a new experiment."

In the European strategies we manage, we have preferred high-quality spread products, less enthusiastically so after the recent rally in October-November. If the current selloff continues, as we would expect, European investment-grade bonds would be our first port of call to add risk. European high-yield bonds are more sensitive to recession risk, so would need wider spreads for investors to be adequately compensated.

Conclusions

The ECB's message today was resolutely hawkish, but the Bank has not adequately explained why it changed its reaction function. This introduces uncertainty about how high interest rates may go. It also increases the risk of a "taper tantrum" and concerns about financial stability given the extent of QT. Finally, it has generated policy uncertainty in an environment where the euro area is entering a supply side-driven recession.

As a result, today's bearish market reaction is understandable. Worryingly, it leaves investors exposed to a further selloff in bonds and risk assets as markets enter the illiquid festive period. With that context, wider spreads might represent a clearer opportunity in investment-grade corporate bonds than in riskier spread products at this stage.

[1] Trichet refers to Jean-Claude Trichet, who was ECB President from 2003 to 2011.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of December 15, 2022.

Important Information

PGIM Fixed Income operates primarily through PGIM, Inc., a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and a Prudential Financial, Inc. ("PFI") company. Registration as a registered investment adviser does not imply a certain level or skill or training. PGIM Fixed Income is headquartered in Newark, New Jersey and also includes the following businesses globally: (i) the public fixed income unit within PGIM Limited, located in London; (ii) PGIM Netherlands B.V., located in Amsterdam; (iii) PGIM Japan Co., Ltd. ("PGIM Japan"), located in Tokyo; (iv) the public fixed income unit within PGIM (Hong Kong) Ltd. located in Hong Kong; and (v) the public fixed income unit within PGIM (Singapore) Pte. Ltd., located in Singapore ("PGIM Singapore"). PFI of the United States is not affiliated in any manner with Prudential plc, incorporated in the United Kingdom or with Prudential Assurance Company, a subsidiary of M&G plc, incorporated in the United Kingdom. Prudential, PGIM, their respective logos, and the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide.

These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary. Clients seeking information regarding their particular investment needs should contact their financial professional. These materials represent the views and opinions of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person's advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Fixed Income is prohibited. Certain information contained herein has been obtained from sources that PGIM Fixed Income believes to be reliable as of the date presented; however, PGIM Fixed Income cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Fixed Income has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. All investments involve risk, including the possible loss of capital. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or an y investment management services and should not be used as the basis for any investment decision. No risk management technique can guarantee the mitigation or elimination of risk in any market environment. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Fixed Income or its affiliates.

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Conflicts of Interest: PGIM Fixed Income and its affiliates may have investment advisory or other business relationships with the issuers of securities referenced herein. PGIM Fixed Income and its affiliates, officers, directors and employees may from time to time have long or short positions in and buy or sell securities or financial instruments referenced herein. PGIM Fixed Income and its affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. PGIM Fixed Income's personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to PGIM Fixed Income's clients or prospects or proprietary investment ideas that differ from the views expressed herein. Additional information regarding actual and potential conflicts of interest is available in Part 2A of PGIM Fixed Income's Form ADV.

In the United Kingdom, information is issued by PGIM Limited with registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority ("FCA") of the United Kingdom (Firm Reference Number 193418). In the European Economic Area ("EEA"), information is issued by PGIM Netherlands B.V., an entity authorised by the Autoriteit Financiële Markten ("AFM") in the Netherlands and operating on the basis of a European passport. In certain EEA countries, information is, where permitted, presented by PGIM Limited in reliance of provisions, exemptions or licenses available to PGIM Limited under temporary permission arrangements following the exit of the United Kingdom from the European Union. These materials are issued by PGIM Limited and/or PGIM Netherlands B.V. to persons who are professional clients as defined under the rules of the FCA and/or to persons who are professional clients as defined in the relevant local implementation of Directive 2014/65/EU (MiFID II). In certain countries in Asia-Pacific, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan Co. Ltd., registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is provided by PGIM (Hong Kong) Limited, a regulated entity with the Securities & Futures Commission in Hong Kong to professional investors as defined in Section 1 of Part 1 of Schedule 1 (paragraph (a) to (i) of the Securities and Futures Ordinance (Cap.571). In Australia, this information is presented by PGIM (Australia) Pty Ltd ("PGIM Australia") for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the FCA (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws. In South Africa, PGIM, Inc. is an authorised financial services provider – FSP number 49012. In Canada, pursuant to the international adviser registration exemption in National Instrument 31-103, PGIM, Inc. is informing you of that: (1) PGIM, Inc. is not registered in Canada and is advising you in reliance upon an exemption from the adviser registration requirement under National Instrument 31-103; (2) PGIM, Inc.'s jurisdiction of residence is New Jersey, U.S.A.; (3) there may be difficulty enforcing legal rights against PGIM, Inc. because it is resident outside of Canada and all or substantially all of its assets may be situated outside of Canada; and (4) the name and address of the agent for service of process of PGIM, Inc. in the applicable Provinces of Canada are as follows: in Québec: Borden Ladner Gervais LLP, 1000 de La Gauchetière Street West, Suite 900 Montréal, QC H3B 5H4; in British Columbia: Borden Ladner Gervais LLP, 1200 Waterfront Centre, 200 Burrard Street, Vancouver, BC V7X 1T2; in Ontario: Borden Ladner Gervais LLP, 22 Adelaide Street West, Suite 3400, Toronto, ON M5H 4E3; in Nova Scotia: Cox & Palmer, Q.C., 1100 Purdy's Wharf Tower One, 1959 Upper Water Street, P.O. Box 2380 - Stn Central RPO, Halifax, NS B3J 3E5; in Alberta: Borden Ladner Gervais LLP, 530 Third Avenue S.W., Calgary, AB T2P R3.

2022-8155

留意事項

※本資料はPGIMフィクト・インカムが市場動向に関する情報提供としてプロの投資家向けに作成したものです。PGIMフィクスト・インカムは、米国SECの登録投資顧問会社であるPGIMインクの債券運用部門です。

※本資料は情報提供を目的としたものであり、特定の金融商品の勧誘又は販売を目的としたものではありません。また、本資料に記載された内容等については今後変更されることもあります。

※記載されている市場動向等は現時点での見解であり、これらは今後変更することもあります。また、その結果の確実性を表明するものではなく、将来の市場環境の変動等を保証するものでもありません。

※本資料で言及されている個別銘柄は例示のみを目的とするものであり、特定の個別銘柄への投資を推奨するものではありません。

※本資料に記載されている市場関連データ及び情報等は信頼できると判断した各種情報源から入手したものですが、その情報の正確性、確実性について当社が保証するものではありません。

※過去の運用実績は必ずしも将来の運用成果等を保証するものではありません。

※本資料は法務、会計、税務上のアドバイスあるいは投資推奨等を行うために作成されたものではありません。

※PGIMジャパン株式会社は、世界最大級の金融サービス機関プルデンシャル・ファイナンシャルの一員であり、英国プルーデンシャル社とはなんら関係がありません。

PGIMジャパン株式会社
金融商品取引業者 関東財務局長（金商）第392号
加入協会 一般社団法人日本投資顧問業協会、一般社団法人投資信託協会
PGIMJ95237