Bond Blog

June 9, 2022

PGIM FIXED INCOME

The ECB Bangs the Inflation Drum

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

The European Central Bank (ECB) surprised investors with a hawkish message from its policy meeting today. It backed that message up with a clear roadmap for the coming months, out of net asset purchases and out of negative interest rates.

The ECB was less clear on how it would contain Italian government bond spreads if they widen again. Investors' reaction remained muted, for now. But potential flashpoints loom on the horizon, such as a sudden halt in Russian gas or elections in Italy in 2023. These could create considerable strains on the monetary union.

Our view remains that, because of a weakening economy, the ECB won't follow through on the aggressive pace of tightening that investors expect in 2023.

The End of an Era

The ECB's decision today confirms that it will end net asset purchases at the end of this month. In addition, the bank indicated that it will raise its policy rate in July and September, leading it out of negative territory for the first time in over a decade.

Most investors expected the broad contours of this near-term normalisation. But the ECB surprised many by essentially confirming a substantial 50 basis points (bps) rate increase in September - barring a significant weakening in the inflation outlook.

During her press conference, ECB President Lagarde indicated that the Governing Council's decision was unanimous. Such unanimity confirms our view that policymakers see these changes as a "policy reset", and that they no longer deem net asset purchases and negative rates necessary.

Moreover, the Governing Council's hawkish messaging probably aims to contain further rises in inflation expectations or wage growth above levels consistent with the ECB's 2% inflation target.

Actions Speak Louder than Words

Today's policy statement was silent on a rumoured "backstop" facility to reduce peripheral government bond spreads. Unsurprisingly, journalists repeatedly asked President Lagarde about the ECB's commitment to the monetary union's cohesion. Her words demonstrated the ECB's clear commitment, but the lack of detail remains a risk.

For now, the widening in Italian bond spreads appears contained. But this risk will remain live for the foreseeable future. Europe's energy crisis could worsen, and Italy is particularly vulnerable to a sudden halt in energy from Russia. The bottom line is that the lack of a credible backstop could constrain the ECB's proposed normalisation.

How High Can Interest Rates Go?

It remains an open question if the euro area economy can withstand interest rates significantly above 0%. The shock of Russia invading Ukraine has yet to feed through to the real economy. We expect further pressure on the economy in coming quarters as the boost from post-pandemic reopening fades, global growth slows, and tighter financial conditions continue to take hold. The ECB's updated projection for 2023 GPD growth, at 2.1%, strikes us as optimistic. We estimate euro area GDP growth at 1.3% next year.

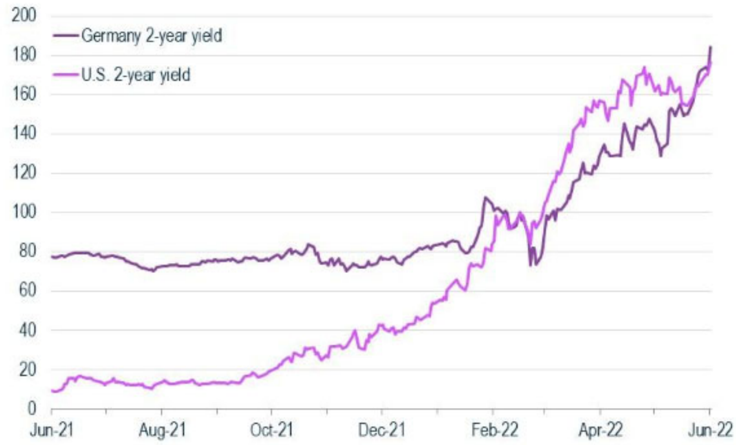
This economic picture suggests that the ECB's policy rate will rise faster than previously expected in coming months. However, it will be capped at close to 1% one year from now – considerably lower than investors currently expect.

Market Reaction and Investment Implications

Today's hawkish tilt raised investors' expectations of ECB tightening beyond the six-month horizon. As a result, safe rates (German government bond yields) rose across the yield curve. It is notable that, since Russia's invasion began, German two-year Bund yields have risen more than two-year US Treasury yields (Figure 1). This reflects the level of concern about European inflation.

But growth prospects are more challenged in the euro area than in the US. In our view, that backdrop suggests that investors' current pricing of ECB policy is too aggressive. It is difficult to know when the rise in euro area yields will reverse, given the short-term risk of higher inflation, but we believe that German yields are likely to fall over the medium term.

FIGURE 1: German 2-year Government Bond Yields Have Risen More than 2-year U.S. Treasury Yields Since Russia Invaded Ukraine (bps).



Source: PGIM Fixed Income, Bloomberg.

The unexpected rise in safe rates against the backdrop of weakening growth is bad news for risk assets. Unsurprisingly, equity prices weakened and credit spreads widened today. Euro high-yield bond spreads[1] had already widened more than U.S. high-yield spreads this year, and that gap extended after today's ECB meeting (Figure 2).

FIGURE 2: Euro high-yield credit default swap (CDS) spreads widened relative to US high-yield CDS spreads after today's ECB meeting.

Source: PGIM Fixed Income, Bloomberg.

Beyond obvious concerns about stagflation and tighter monetary policy, today's ECB meeting also raised questions about financial stability. As interest rates rise, so does the risk that the eurozone might fragment.

Market participants are used to the ECB dealing with this risk against a backdrop of low inflation and easy monetary policy. But this time peripheral spreads are widening as financial conditions tighten (Figure 3).

It is concerning that the ECB couldn't convince investors that it has a plan to deal with fragmentation risk as financial conditions tighten. Worse, the ECB suggested that tighter financial conditions are desirable to reduce what it sees as excessive valuations in certain asset markets.

Looking ahead, this view paints a dismal picture for risk assets. As long as the fight against inflation compromises the euro area's financial stability, risk premia are likely to widen. These include peripheral countries' bond spreads, corporate credit spreads and other risk premia.

FIGURE 3: Peripheral Government Bond Spreads Have Widened as Financial Conditions Have Tightened (bps).

Source: PGIM Fixed Income, Bloomberg.

Conclusion

The ECB's hawkish surprise today aims to contain inflation expectations and wage growth. As a result, we expect rates to rise faster in coming months than investors expected until now.

But the ECB's ability to raise rates is capped by the absence of a detailed plan to contain peripheral bond spreads. Weak economic growth and subdued wage growth also mean that, 12 months from now, interest rates will probably be lower than the aggressive tightening that investors currently expect.

In financial markets, today's hawkish surprise lifted bond yields across the yield curve and hurt risk assets. In our analysis, however, investors in safe rates (German government bonds) are pricing in an overly aggressive path for policy rates and too upbeat a growth outlook.

As a result, we see value in holding German bonds. By contrast, bonds of peripheral euro governments, corporate bonds and other risk assets remain vulnerable. The combination of high inflation, weakening growth and tighter financial conditions warrant investor caution.

[1] We proxy euro high-yield bond spreads by credit default swaps (CDS) in Figure 2.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of June 9, 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.

2022-3853

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
PGIMJ90929