Bond Blog

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Voilà! Is the ECB Capable of Going Big?

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The European Central Bank (ECB) surprised investors with an outsized 50 bp rate hike today, taking its policy rate out of negative territory in one fell swoop. But the ECB's Governing Council underwhelmed with its vague announcement of a new tool, known as the transmission protection instrument (TPI). This tool is meant to ensure the even transmission of monetary policy across the euro area.

Our concern is that, as the ECB raises interest rates, these rises are magnified in some countries, such as Italy. In the extreme, uneven rises could threaten a euro area breakup. Clearly the ECB will want to guard against such a situation. But it needs a credible instrument to do so. Today's lack of details means that some questions - and hence market vulnerabilities - remain.

A Policy Reset

The ECB's decision to take interest rates out of negative territory follows on the heels of its June decision to end open-ended asset purchases (See "The ECB Bangs the Inflation Drum"). It marks the end of an era for the ECB – a policy reset that, in our view, is warranted.

Today's decision reflects a re-anchoring of both inflation expectations and nominal wages around the ECB's 2% inflation target. The situation was different in 2019, when the ECB restarted asset purchases and pushed rates further into negative territory. Back then, inflation expectations were drifting further and further away from the target.

Front-Loaded Interest Rate Hikes, but Destination Unchanged

The euro area's energy crisis is becoming more acute by the day. So, the ECB's outsized move probably reflects its view that the window for rate hikes is narrowing.

Moreover, the Governing Council's unanimous approval of the TPI facilitated today's aggressive move out of negative territory. Following the Federal Reserve's playbook with a surprise outsized hike gives the ECB cover for abandoning its guidance of just a few weeks ago.

That said, President Lagarde was clear in her press conference: the accelerated pace of tightening does not signal a change in destination of interest rates, as they "progressively move towards neutral." The ECB has yet to decide, however, what that neutral rate may be.

The Energy Crunch will Cap Rates

Our view remains that growth in the euro area will be challenged and that this will ultimately limit the extent to which the ECB can raise interest rates. We expect GDP growth in 2023 of 1.3%, with significant risks to the downside.[1]

A wave of factors is pushing down on the region's outlook. This includes the slowdown in global growth, particularly in China, and significantly higher energy prices. The situation could materially worsen still, if Russian energy flows were to suddenly stop.

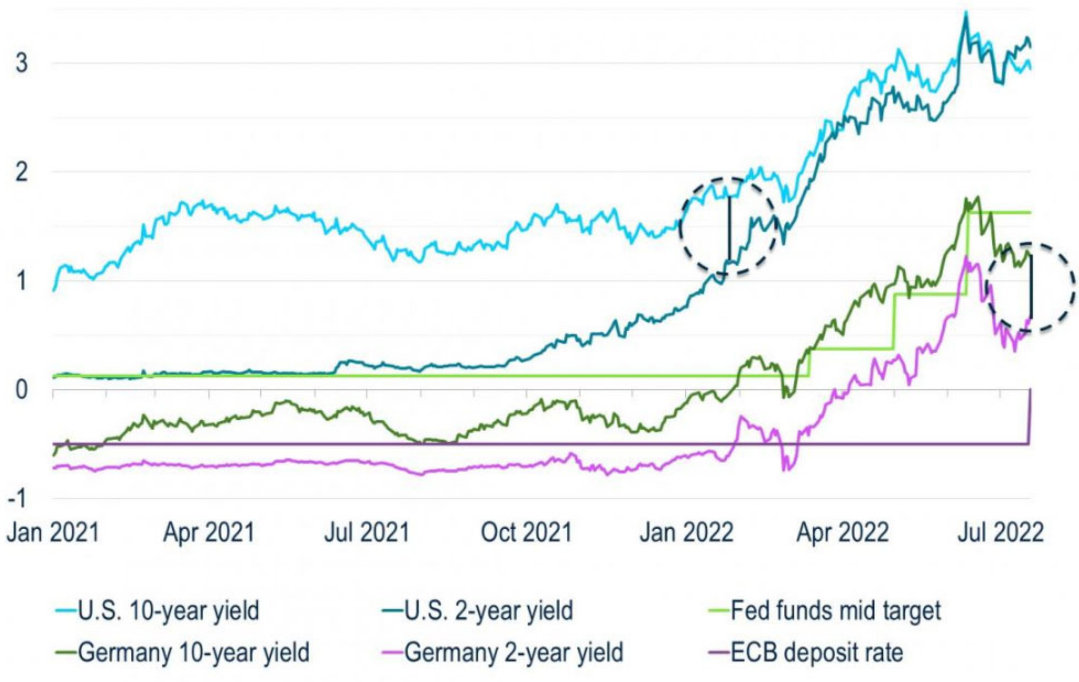
All this suggests that the ECB will need to pause its rate hiking cycle below 1%. If the ECB's rate hikes take its policy rate well above 1%, it will likely need to reverse them as the energy crunch impacts the real economy.

Market Reaction

From investors' point of view, the ECB's aggressive steps today are nascent in two respects.

First, from the perspective of interest rate trajectory, the U.S. Treasury yield curve has flattened this year, which signals that investors sense an end point for the Fed's hiking cycle. By contrast, the slope of the 2-year/10-year German yield curve stands at 57 basis points (bps). This suggests that investors see the ECB on a gradual, less restrictive path, i.e., it is early days in the ECB's hiking cycle (See Figure 1).

FIGURE 1: The current state of the of 2-year/10-year German yield curve is reminiscent of the US curve earlier this year – implication: it's early days yet in the ECB's hiking cycle



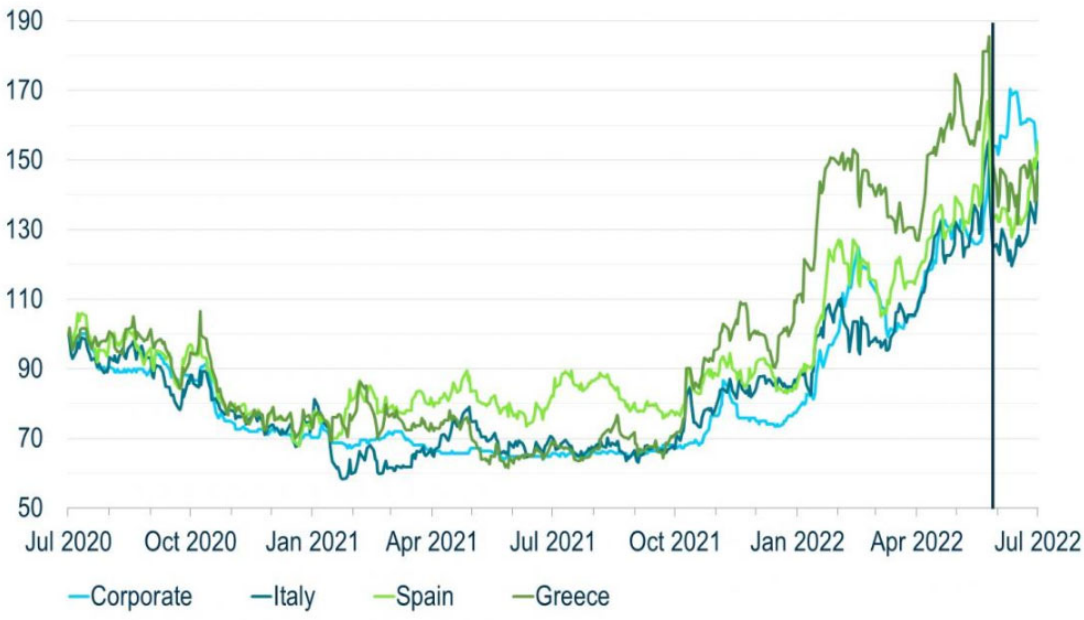
Source: Bloomberg, PGIM Fixed Income as of July 21, 2022.

Second, the Germany yield curve significantly flattened, by nearly 10 bps, after today's meeting. That move suggests that today's 50 bps hike - rather than the previously suggested 25 bps - moved the needle of investor sentiment. It also suggests that the ECB may need to hike rates at least another 50 bps – 100 bps to flatten the yield curve - a typical end point of the economic / rate cycle - if and when the threat of Russian energy cuts recedes and Europe's growth horizon clears.

The ECB has a history of establishing bond buying programs, such as the SMP (2010), OMT (2012), APP (2014) and PEPP (2020).[2] Unfortunately, today's TPI is off to a vague start, with subjective conditions and processes.

Investors may perceive German Bunds as ultra-low risk, but the same cannot be said of Portuguese, Italian, Cypriot and Greek government bonds: the highest credit rating among these is BBB, near the bottom rung of the investment-grade category. As a result, yields on peripheral government bonds typically fluctuate in concert with investment-grade corporate bonds (See Figure 2).

FIGURE 2: Yields on peripheral government bonds typically fluctuate in concert with investment-grade corporate bonds



Source: Bloomberg and PGIM Fixed Income as of July 21, 2022.

Given peripheral bonds' trading history, therefore, it was a mystery why the ECB hit the panic button in June and signaled a mechanism to check their spreads. Did it expect these medium-grade bonds to trade as if they were riskless? The answer is unclear but, at a minimum, the ECB clearly sought a safety mechanism.

After its emergency meeting on June 15th, the ECB "pledged to act against resurgent fragmentation risks." That announcement and today's meeting raise several key questions: does the ECB have unrealistic expectations for low peripheral spreads? Or does it just want a "break the glass" emergency tool in case of distress?

So, Did the ECB Reassure Investors About the Sanctity of Peripheral Debt?

Spreads on Italian government bonds initially widened, before recovering their pre-ECB meeting levels. Greek bonds, however, ended the day wider by more than 10 bps. Overall, trading after today's meeting suggests that investors remain unmoved by the TPI programme. They are therefore unlikely to rerate peripheral bonds to tighter spreads unless the ECB shows further commitment and / or action.

Given the vagueness of TPI's objectives and the mixed success of the ECB's earlier, ill-defined Securities Markets Programme (SMP), investors seem destined to crash-test the TPI. They might do so by pushing spreads wider to probe for the edges of the ECB's comfort zone.

In summary: the ECB took a positive step today towards normalising policy and establishing a safety net for peripheral debt. But it will be challenged to keep markets on an even keel, with threats to euro area growth, inflation, energy security and political stability – as demonstrated by the fall of Mario Draghi's government in Italy yesterday.

1. We expect GDP growth of 2.9% for 2022, revised down from more than 4% before Russia's invasion of Ukraine. Since then, consensus expectations have come down broadly in line with that figure. Nevertheless, the rather punchy headline annual growth rate for this year flatters to deceive, as it reflects base effects coming out of the pandemic. It masks the sluggish growth that we expect for the second half of this year.

2. Securities Markets Programme (SMP), Outright Monetary Transactions (OMT), Asset Purchase Programme (APP) and Pandemic Emergency Purchase Programme (PEPP)

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of July 21, 2022.

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