QT on the European Radar

- The “pause at neutral” – once the European Central Bank (ECB) policy rate gets to or close to 2% - to examine whether more is needed is already in the hawks’ crosshair. The debate will be rife this winter. It won’t be the only battle. QT could be on the menu earlier than expected. This combination brings bad news to the fragile sovereign signatures, irrespective of their political developments.

Upon hiking by 75 basis points last week, the ECB conveyed the message that this was merely a front-loading of its policy normalisation, which may keep the terminal rate unchanged. We suspect that the hawks are more ambitious and would prefer to emulate the Federal Reserve (Fed) and relentlessly bring the policy rate into restrictive territory, without necessarily “pausing at neutral” to examine whether more is needed. Their approach is at least simple: hike until observed inflation is back to 2%. This can be dangerous. Monetary policy operates with lags. Committing today to continue raising rates into restrictive territory even once inflation is converging back to target is taking the risk to trigger – or rather prolong – a recession needlessly. As the goal posts constantly move, we suspect this is the next battle which will be waged within the Governing Council. When will this “moment of truth” occur? Sometime between December 2022 and March 2023, since Christine Lagarde, two months after formally ditching forward guidance, told us it would take between two and five meetings to get the policy rate “where it should be”. Although the ECB President was on purpose evasive on the quantum of hikes which could take place within this time window, it is an ambitious statement given the heightened uncertainty in which the central bank operates.

Another crucial battle will emerge on Quantitative Tightening (QT). Indeed, although Christine Lagarde said last week that this debate was “premature”, leaks obtained by Reuters suggest a conversation could take place at the October meeting already. The combination of further hikes with an earlier-than-expected QT would be another headwind for the fragile sovereign signatures of the Euro area, irrespective of their domestic political developments.

In the US we expect the Fed to move away from another “jumbo hike” of 75 bps to hike by “only” 50 bps on 21 September, but it’s fair to say that the “Fedspeak” has been very hawkish last week. We need a convincing deceleration in consumer prices in the August print released this week to keep the Fed away from 75.

Towards the upper end of neutral

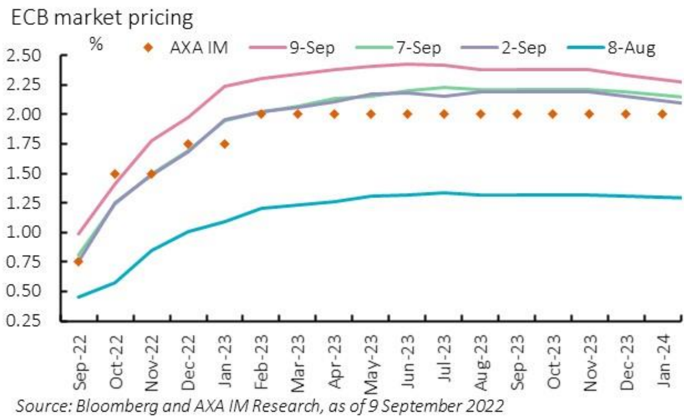
Last week, the ECB presented its 75-bps hike as **“front-loading” the normalization of its policy stance**. While Christine Lagarde was very careful – despite many attempts from journalists – not to indicate where the neutral rate precisely is, what is clear is that more hikes would be needed to get there. Beyond the explicit mention of “further hikes‘ in the policy paragraph of the prepared statement, the sense the ECB is very far from “done” stems from both Lagarde’s words *(“we are so far away from rate that will help us return inflation to 2%”)* and the ECB forecasts: while inflation would fall back at the end of its forecasting horizon, there would remain a margin of 0.3 percentage point above its target by 2024 – on which the ECB President insisted during the Questions & Answers (Q&A).

The ECB could have left its message at that, but **Christine Lagarde, rather curiously given the ECB’s decision in July to formally “ditch” forward guidance, chose to provide more information on the likely trajectory for the next few months.** She made the point that normalization would take “*more than 2 [meetings], including this one, and less than 5”*). This means that the normalization would be over at the earliest in December 2022 (our baseline so far) and March 2023. The ECB has however given itself a lot of leeway on the quantum of the hikes at each meeting, by stating that *“75 bps is not the norm*” without however rejecting the possibility to deliver another of these “jumbo hikes”. So, we have a measure of forward guidance, but it’s a very loose one. Lagarde reiterated they would be driven by the dataflow on the two dimensions (timing and quantum).

If the ECB is very sensitive to the dataflow, it may react badly to what we expect to be another elevated inflation reading for September, which will be the last print they will have before their next policy meeting. **This makes us believe they will go for another 75-bps move (instead of 50 bps), to 1.5%, on 27 October**. While some doves – such as Bank of Portugal’s Mario Centeno – are now coming out implicitly against a replication of the September move, the chorus of hawks calling for another “clear hike” to borrow from Nagel’s words, is loud.

What follows is however much more uncertain in our view. While Christine Lagarde re-used Villeroy de Galhau’s line in Jackson Hole that once the neutral rate would be reached, the central bank would take time to carefully re-examine the situation before going into restrictive territory, it’s easy to read in the ECB’s current attitude a readiness to “cross that bridge’. **The market has certainly crossed it, now pricing a policy rate level above 2.25%** into 2023 noticeably higher than before last week and more than 100 bps above where the market put it at the height of the short-lived “dovish pivot” rally in early August (see Exhibit 1).

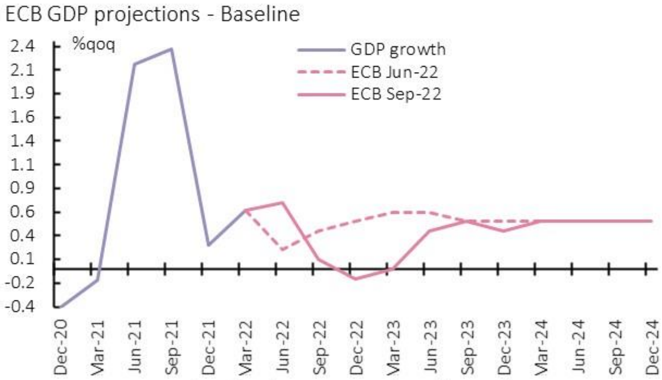
Exhibit 1 – Market prices the ECB into restrictive territory next year



Source: Bloomberg and AXA IM Research, as of 9 September 2022

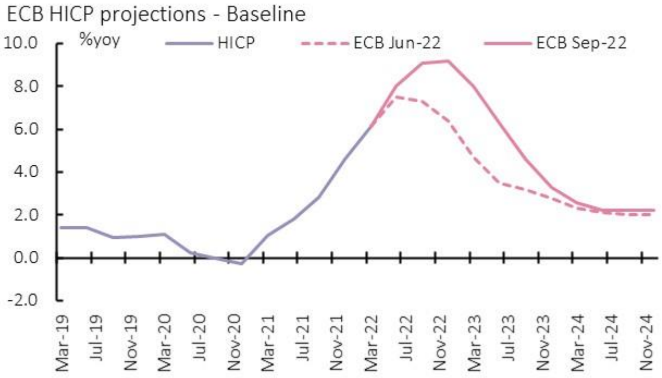
We are a bit more circumspect. Taking the ECB at its word, the following moves will depend on the state of the economy. The ECB’s latest batch of forecasts is optimistic on the GDP side, with a 0.9% growth for 2023 and an almost imperceptible "brush" with contraction at the end of this year (see Exhibit 2). We are less optimistic, projecting +0.4% in annual average, with a proper contraction in Q4 2022 and Q1 2023. While it's obvious the central bank is ready to "look through" a recession per se, a significant contraction in activity would normally loosen the labour market and curb a "wage/price" loop which has not even started in earnest in the Euro area. According to the ECB's own prepared statement, *"incoming data and recent wage agreements indicate that wage dynamics remain contained overall").*

Exhibit 2 – Only a brush with GDP contraction



Source: European Central Bank and AXA IM Research, as of September 2022

Exhibit 3 – Higher and later inflation peak



Source: European Central Bank and AXA IM Research, as of September 2022

We would thus expect a slower pace of tightening after October, with 25 basis points in December (unchanged call), to 1.75%. **We agree that the ECB's "natural slope" at this stage will probably push it to the upper end of the neutral range in a "last hike" to 2% in February 2023, but we would remain prudent on that one**, especially if by year-end we start to see the impact of the measures under discussion in Brussels to cap wholesale energy prices filter through the consumer price index. We have thus the ECB stopping at 2%, noting that Bank of Greece Governor Stournaras mentioned 1.50%/2% as the "neutral range", thus agreeing with Villeroy de Galhau on the upper hand of the range.

Uncertainty is of course massive. **The course of the war could be significantly altered by the recent Ukrainian success in the North-East, but it's far too early to draw any conclusion on its macroeconomic ramifications. For now, it's probably prudent to consider that through the winter, Russia's pressure on the European Union (EU) will remain maximal via gas shipments**, so that the price of energy at the retail level is still ultimately dependent on decisions made in the EU. It seems that there remain disagreements among the member states on whether a price cap on Russian gas specifically should be implemented, or if caps should be imposed on imported gas prices irrespective of their geographical source, but what is in our view key – as we discussed last week – is that the margins of "infra-marginals" could be used to curb electricity price at the point of consumption. There seems to be a consensus on this.

Models are bad – but better than no models at all

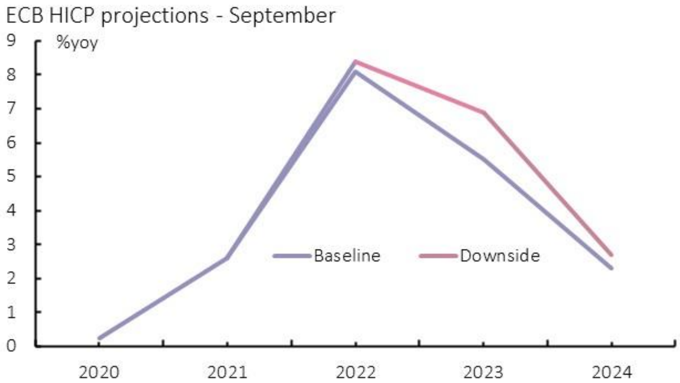
While for now the ECB has not "crossed the Rubicon" of emulating the Fed is stating that they intend to bring policy rates in restrictive territory, which is suggestive of a "pause" around 2%, **pressure from the hawks is rising on disposing of this theoretical threshold and simply relentlessly hike until inflation is back under control**. This point was made explicitly by Klas Knot at the end of last week. We read this "implicit forward guidance" as the symmetric, hawkish version of the explicit forward guidance which the ECB was pursuing when it was laying out the conditions for the rate lift-off. In the "old" forward guidance, rates would not be hiked as long as core inflation would not move to 2% for several months. Such focus on actual developments was justified by the risk of precipitating the Euro area into another bout of deflation, with a tacit acceptance that inflation may well over-shoot, since the central bank could well be late in tightening monetary policy while inflation had already hit 2%.

Today, the hawks' approach could be summarized as "we will hike as long as we are not satisfied inflation is back towards 2% - and we will need clear proof of this". In the framework presented by Isabel Schnabel in Jackson Hole, in times of heightened uncertainty and substantial risks to inflation expectations, the ECB should be guided less by forecasts and a model-based approach, and more by the dataflow “as it comes”. Naturally, this means that **the ECB – as remote as this possibility now seems to be at the current stage – would be ready to take the risk that its tightening goes too far and ultimately sends inflation back below 2% while triggering an “excessive recession”.** Indeed, given the lags in the transmission of monetary policy, continuing to go further into restriction while inflation is already back to 2% could take the economy into another below inflation regime. **We detect there a “revenge of the hawks” against the change in the objective of the ECB**. It used to “below but close to 2%” – reflecting an asymmetric preference from the ECB and morphed into “close to 2%”.

Christine Lagarde was certainly right in the press conference last week to insist on the limits of any models – especially in the current highly uncertain environment – but discarding explicit quantified and internally consistent models often means in reality relying on an implicit, unquantified, and not necessarily internally consistent “gut feeling models” fuelled as much by data observation as by policy priors. **At some point, looking at where observed inflation is instantaneously is not going to be a good enough guide.** The ECB will have to resort to a Phillips curve type of analysis and decide whether the deterioration in the labour market and the general weakening of demand is likely to create a slowdown in wages and a contraction in profit margins signalling plausible disinflation is in the pipeline. If this is consistent with a return to 2% inflation within the ECB’s policy horizon, then the ECB should stop hiking even if observed inflation remains temporarily above its target. This is clearly the battle to which doves are preparing themselves. It will probably start with the next 2 to 5 Governing Council meetings…

For the time being, the ECB seems to be willing to look only into various shades of atrocious inflation trajectories. Since the trigger of the adverse scenario in its forecasts is a price shock stemming from an exacerbation of the pressure on gas, the only trajectory of “proper recession” which the ECB is ready to contemplate is also a “heightened inflation” one in which the deceleration in consumer prices would take even longer (see Exhibit 4). This is of course understandable given the balance of risks at the current juncture, but after under-estimating inflation for too long, the economists at the ECB may have gone a bit too far in the other direction.

Exhibit 4 – The “low growth” ECB scenario is a higher inflation one



Source: European Central Bank and AXA IM Research, as of September 2022

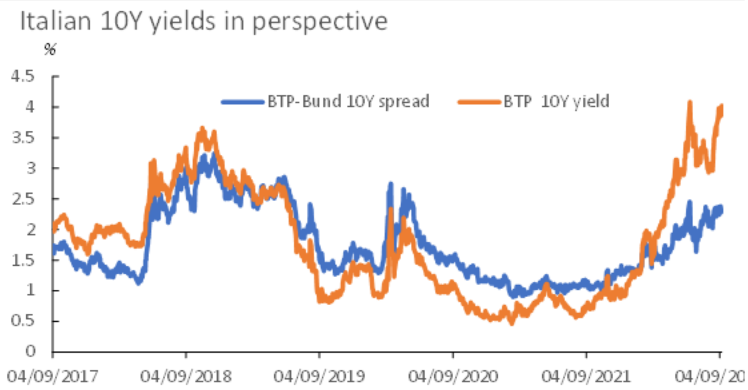
Italian pain ahead

There was only one question on Transmission Protection Instrument (TPI) and the fragmentation risk during the ECB press conference last week, and Christine Lagarde merely responded that she doesn’t *“have much more to say on TPI than I did last time around in July. I don't think that you should expect much more”.* There is less urgency on this issue now that a measure of quietness has come back on the “peripheral issue”. Market consensus has it that Giorgia Meloni upon becoming Italy’s Prime Minister (PM) after her coalition wins the general elections on 25 September – regularly confirmed by the polls as the likeliest outcome – will focus on security and immigration and will refrain from engaging in heterodox economic policies in her first months in office (we agree). Consequently, the Buoni del Tesoro Poliannuali (BTP)-Bund spread has remained below the peaks seen during the previous major episode of political uncertainty in Rome (in 2018).

Yet, from a macroeconomic point of view, focusing on the spread may be misleading. What matters for the fiscal trajectory is the absolute level of the government's funding costs. Last Friday, the Italian 10-year yield stood above 4% for the first time since 2014. If this is the new "floor rate" under a new post-pandemic monetary policy regime, this will force the Italian government, over time, to return to its previous "high primary surplus" policies. Moreover, it's not obvious that the current yield is actually the real floor. Indeed, **BTPs – just like all European bond markets – need to be tested for Quantitative Tightening (QT),** i.e., when the ECB starts reducing the quantum of bonds it re-invests. The securities acquired under the Pandemic Emergency Purchase Programme (PEPP) (EUR 1.7tn) will be reinvested until at least 2024, but the guidance for the old Asset Purchase Programme (APP) (EUR 1.3tn) is that a reduction in the pace of reinvestment for this programme could start any time now that the rate lift-off is behind us.

Christine Lagarde stated during the press conference that a decision on this issue would be "premature", but Reuters, mentioning "ECB sources" suggested that a conversation on the topic could take place at the next Governing Council already, with a technical discussion already on 5 October, possibly paving the way for the beginning of QT at the beginning of next year. The rationale for such move would be threefold. First, it would be part of the "normalization" of monetary policy, complementing the ECB's efforts to tighten financial conditions throughout the yield curve. Second – and working opposite the first point - this would improve monetary policy transmission. Indeed, without QT, the risk of a curve inversion is higher as the central keeps on hiking its policy rate, and this would adversely affect banks by reducing their transformation margin, potentially reducing their appetite to lend, thus triggering an excessive tightening in financial conditions. Third, reducing the ECB's holding of sovereign bonds would recreate some space in the future for new purchases under the TPI framework.

Exhibit 5 – Italian spread is not spectacular, but cost of funding highest in 8 years



Source: Macrobond, AXA IM Research, September 2022

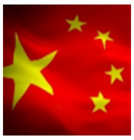
If such a conversation is imminent, **it may make sense to discuss it in connection with the ECB's decision not to dampen the impact of moving the deposit rate into positive territory on the remuneration of banks' reserves.** Indeed, as long as the level of excess reserves is huge, banks will receive significant payments from the ECB. Some members of the Governing Council may consider that this "subsidy" from the ECB to the banking sector – ultimately paid by the taxpayers, since it will reduce the dividend paid by the national central banks to their governments – may offset the cost of an inverting or flattening yield curve. However, the absence of tiering may also reflect a belief at the ECB that excess reserves will decline faster than expected with QT starting in earnest in 2023 (which would compound the effect of expiring Targeted Longer-Term Refinancing Operations (TLTROs)).

So, **it seems that we need to add to the list of potential headwinds for fragile signatures in the Euro area the possibility that support along the curve would diminish drastically next year.** We assume that, just like the quantum of rate hikes, the timeline and pace of QT will be data dependent. But now that the "genie is out of the bottle", the ECB will have a hard time not coming up with answers on this front at the coming meetings.

US: reversing the burden of proof?

Last week we expressed our expectation that the ECB would hike by 75 bps but also that in two weeks the Fed would stop relying on "jumbo hikes" and could revert to a 50-bps hike on 21 September, thanks to some good news on the labour market front – some deceleration in wages (albeit at a pace still inconsistent with a return to 2% inflation) and a rebound in the participation rate. "Fedspeak" has been very hawkish though over the last week, and the market has been spooked into pricing 75 bps again after Jay Powell's tough message at an event with the Cato Institute, stating that *"We need to act now, forthrightly, strongly, as we have been doing and we need to keep at it until the job is done".* We note that his choice of words is not necessarily inconsistent with sticking to 50 basis points – which would in our book also qualify for "strong and forthright" action now that Fed Funds have already reached neutral territory - but the fact that some Federal Open Market Committee (FOMC) members usually seen as dovish, e.g., Charles Evans, mentioned the possibility they would support another 75-bps move is certainly suggestive of the level of alert at the Fed.

We suspect that this week's inflation print for August, out on Tuesday, will be crucial in the Fed's deliberations. The market, according to Bloomberg consensus, is pricing a visible further deceleration to 8.1% from 8.5% in July, which may be ambitious. We probably need a convincing improvement to get the Fed to stick to 50 bps.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Fed's Beige Book: activity unchanged, outlook "generally weak", 9 of 12 inflation moderated • Fed commentary in last week before purdah. Most say 50 and 75bps on the table • Sell-side sees several move to 75bp, we stick to 50bp • ISM servs (Aug) 56.9 from 56.7, prices 71.5 from 72.3	• US CPI (Aug), expect higher than consensus 8.1% • PPI inflation (Aug), expected 7.0%yoy from 9.7% in March • Retail sales (Aug) volumes expected supported amidst easing inflation pressures • Jobless claims after 3 wks declines, but rising cont claims • Empire and Philly Fed surveys (Sep)
	• ECB increased three policy rates by 75bps, bringing the depo rate to 0.75% as we expected • Nordstream 1 gas flow did not restart • Bank of France and INSEE foresee French Q3 GDP growing by 0.3-0.2% q/q respectively, in line with our forecasts	• EC to present tangible proposals in next few days on EU wide temporary measures against energy crisis • Full details of euro area final HICP for August • Euro are July industrial production, expected to drop (consensus: -0.4%mom)
	• Queen Elizabeth II passed away on 8 Sept. The UK enters a period of national mourning • PM Truss announced plans to cap HH energy at £2,500 for two years and freeze business energy for 6 months. Cost not confirmed but expected to cost north of £130bn (5% GDP) • BoE meeting postponed to 22 Sep from 15 Sep	• Most Government business pauses as UK observes period of national mourning • CPI inflation (Aug) expected to rise to 10.3% (cons) • GDP (Jul) expected to rebound 0.3%mom (cons) • ILO employment (Jul) and HMRC payrolls (Aug), employment gains expected to slow mirroring vacancies
	• BoJ Gov Kuroda meets PM Kashida following fresh yen weakness • Final Q2 GDP estimates revised up to 0.9% from 0.5% • PM Kashida announced plans for a fresh stimulus package in October to support households with rising inflation	• PPI (Aug) expected to rise to 8.9% • Industrial production and core machine orders (Jul) • Trade balance (Aug) expected to widen on weaker Yen • Further details on the stimulus package to be announced
	• Slower growth of exports could be the first sign of impact of softening external demand • Spread of the COVID outbreak to major cities is worrying, with Shenzhen and Chengdu tightening COVID curbs significantly • Rapid depreciation of CNY/USD prompts the PBoC to cut FX deposit reserve requirements	• Credit growth likely rebounded sequentially due to policy easing and window guidance • Holiday travel and spending during Mid-Autumn will be hampered by COVID controls • August activity to confirm a faltering of sequential growth momentum amidst COVID flare-up, deepening property stress and severe heatwave causing power shortages
	• CB: Chile hiked +100bp to 10.75%, Peru +25bp to 6.75%, Malaysia +25bp to 2.5% & Poland +25bp to 6.75% • Chile voted to reject new constitutional draft • Annual inflation (Aug) picked up in Mexico (8.7%), Chile (14.1%), Colombia (10.9%) & Hungary (15.6%)	• CB: Russia is expected to cut 50bp to 7.5% • GDP should contract again in Russia in Q2 • Aug CPI (yoy) figures in Brazil, Czechia, India & Romania • Export data (Aug) for India & Indonesia • Industrial production (July) numbers for Turkey & Romania

Upcoming events		
	US:	Tue: NFIB small business optimism (Aug), CPI (Aug); Wed: PPI (Aug); Thu: Retail sales (Aug), Weekly jobless claims (Aug), Philly Fed Indx (Sep), Empire State manf. Survey (Sep), Ind prod (Aug), Business inventories (Jul); Fri: Michigan consumer sentiment & inflation expectations (Sep), Long-term investment flows (Jul)
	Euro Area:	Mon: It Ind. prod. (Jul); Tue: Ge HICP & CPI (Aug), ZEW surveys (Sep); Wed: EU19 Ind prod (Jul), EU27 von der Leyen delivers state of EU address; Thu: Fr HICP (Aug); Fri: EU19 CPI (Aug), It HICP (Aug)
	UK:	Mon: Monthly GDP, Index of services, Ind prod, Manf. Output, Construction output, Trade balance, Trade in goods (all Jul); Tue: Unemp. (Jul), Employment (Jul), Ave. earnings (Jul); Wed: CPI, CPIH, RPI, PPI (Aug); Thu: MPC announcement & Bank Rate vote; Fri: Retail sales (Aug)
	Japan:	Wed: Private 'core' machinery orders (Jul);
	China:	Fri: Ind prod (Aug), Retail sales (Aug), Fixed asset investment (Aug)