Sunday Wrap

Happy Sunday,

this is Marco Valli from Milan, the UniCredit Chief European Economist. It's been another tense week in financial markets, where the key themes remain the increase in long-term US yields, its spillover to other asset classes globally, and the response (or lack of) by central banks.

Erik is off this weekend, so I take the opportunity to elaborate on the contradictory policy signals from the ECB, and why this makes me nervous looking at the communication challenges the central bank will face in about six months' time. But before I discuss eurozone monetary policy in greater details, let me briefly summarize my take on what is going on in the US.

On Thursday, at a virtual event hosted by the Wall Street Journal, Fed's Chair Powell had a good opportunity to pour some cold water on the red-hot UST market, if he had wanted to. He did not. This confirms that the Fed regards the recent repricing of yields as fairly consistent with the improvement in the growth outlook originating from the vaccination progress and, especially, the massive fiscal stimulus already in train and in the pipeline.

Of course, Powell stressed that the Fed will be patient because full employment remains far away. Even after Friday's stronger-than-expected labor market report, payrolls are still about 9.5 million below their pre-crisis level, and under its revised monetary policy strategy the Fed is likely to want to push employment above the pre-pandemic level. Powell also left the door open for future intervention in the market if the increase in yields were to accelerate substantially and cause a measurable tightening of financial conditions – presumably also through pressure on equity markets, where some valuations in the tech sector look stretched.

Overall, however, the message from the Fed remains one of comfort. Unsurprisingly, yields took this as a green light to resume climbing. After having briefly hit 1.60%, the 10Y UST yield closed the week at 1.55%, almost 50bp higher than a month ago.

In the euro area, the reaction of the ECB has left me wondering. The GDP-weighted sovereign yield curve has shifted higher by some 30bp, largely, if not entirely, dragged along by the move in USTs. Real yields have been the main driver of the increase. However, unlike the US, the eurozone economy is still in a recession, restrictions on activity and mobility remain tight amid the spread of new variants of the virus, while the speed of vaccination is underwhelming, to say the least. This suggests that the tightening of financing conditions in the euro area has been largely "imported" from the US and should, therefore, be regarded as unwarranted. As such, I think that the ECB should fight the market move.

Instead, the week started off with a disappointedly low number for the weekly PEPP purchases. Also due to relatively high redemptions – but it would be strange if the market operations team of the ECB was not aware of this technical factor – the net PEPP purchases fell well below those of the previous two weeks. This is a regrettable signal, because the data cover the first days of verbal intervention (kicked off by Lagarde in person) aimed at signaling the ECB's unease with rising yields.

Then over the course of the week several other members of the Governing Council conveyed a variety of views about the bond sell-off, ranging from Panetta's call to "resist" the steepening of the yield curve (as far as I can remember, this was one of the boldest statements in favor of de facto yield-curve control from an ECB official; his speech is very effective and worth a read, and you can find it here: Mind the gap(s): monetary policy and the way out of the pandemic) to Knot's statement that the market is pricing-in increased optimism for the second half of the year, when lockdowns will be lifted. Adding to the ECB's communication struggle, a Bloomberg story with a catchy headline ("ECB said to see no need for drastic action to curb bond yields") was enough to inject fresh volatility in bond markets, despite containing little new information – it basically said that the Governing Council is not considering an expansion of the PEPP envelope at this stage.

If I were in the ECB's shoes, I would feel uncomfortable in seeing eurozone government bonds hostage of exogenous factors and self-inflicted volatility, at a time when the eurozone economy remains in the doldrums and governments are still busy drafting bills worth tens of billions to support locked-down businesses and furlough workers. I think that a lot is at stake here for the central bank.

It's a credibility issue

My first concern is this: I do not dispute that a 30bp rise in eurozone yields occurring from very low levels should prove manageable even in the current dire circumstances, this is not the point. The real issue is the signaling effect of ECB words and actions, which ultimately makes it a credibility issue.

Back in December, the ECB told us that they were happy with the level of accommodation they had achieved, hinted that a further flattening of yield curves would not be desirable due to possible side effects, and therefore stated they were going to focus on preserving the degree of accommodation prevailing at that time. I thought that announcement made sense, although it was not clear-cut why they had refrained from gearing up their stimulus when their projections signaled only 1.4% inflation at the end of the forecasting horizon in 2023.

Three months later, the macroeconomic backdrop for the euro area has hardly changed – I expect this to be reflected in the ECB's new macro forecasts to be published on Thursday – yet the central bank is timid, if not reluctant, to counter the yield increase. If some investors were skeptical about the symmetry of the ECB's reaction function, the latest events will not help make them change their minds. And when this skepticism feeds into market dynamics, the ECB ultimately has to buy assets more aggressively and for longer if it wants to secure financing conditions that are consistent with their inflation goal.

But I remain confident the ECB will soon do the right thing, as they have always done in the past, after some initial hesitation. They will have to start tomorrow when they publish data on net weekly PEPP purchases, which I expect to be in the EUR 20-25bn range, and continue at Thursday's press conference, with Lagarde doubling down on their commitment to avoid any undue tightening of financing conditions. Hopefully, weekly PEPP flows will then stabilize above EUR 20bn for some time, and at least until the market gets the message right.

The challenges ahead

My second concern is that the ECB's communication struggle has happened when the diagnosis of the challenge (ie imported tightening of financing conditions) seems to be relatively clear. I wonder what might happen in six months' time when the ECB will be facing a much more finely-balanced, and likely more controversial, decision on what to do with the PEPP beyond March 2022. By late summer, we expect that the euro area would finally start growing robustly, while temporary factors would likely push inflation to 2%. Add to this that we would be approaching the time when the Fed will announce its tapering plans, and you can easily end up with a lot of market volatility if communication is not perfectly calibrated.

I would expect Lagarde to step up her leadership role here, because in six months' time the eurozone is likely to have recovered only part of the huge output loss suffered during the pandemic, and policy support, both fiscal and monetary, is still going to be needed in large size.

On the fiscal front, this week, the European Commission published its considerations that will serve as input to the ECOFIN Council and Eurogroup discussions on how to coordinate the conduct of budgetary policy at EU level in the aftermath of the pandemic. The Commission argues that the overall fiscal impulse, stemming from the combination of national budgetary measures and the Recovery Fund, needs to remain supportive in 2021 and 2022, although Member States' fiscal policies should become more differentiated and targeted in 2022 as the economy is expected to progressively normalize. Importantly, the Commission states that the decision on when to deactivate the general escape clause of the Stability and Growth Pact should be taken "as an overall assessment of the state of the economy based on quantitative criteria". And the Commission argues that these criteria should be the level of output in the EU or euro area compared to pre-crisis levels. Given that the Commission expects GDP to recover its pre-pandemic level around mid-2022 (a forecast in line with ours and the ECB's), they conclude that fiscal policy should remain in crisis-mode also next year, as signaled by their suggestion "to continue applying the general escape clause in 2022 and to de-activate it as of 2023". You can find the Commission's document here: One year since the outbreak of COVID-19: fiscal policy response

Given the unprecedentedly close cooperation between fiscal and monetary authorities during the pandemic, the Commission's assessment is likely to have implications also for the ECB, which should continue to play its important role in tandem with fiscal policy.

I continue to see the need for the ECB to stick to the PEPP and very favorable TLTRO conditions throughout next year. If a traditionally prudent institution like the Commission states that “risks of an early withdrawal (of fiscal stimulus) are higher than the risks associated with keeping support measures in place for too long”, I do not see why this should not apply to the ECB and its monetary policy.

In practice, I think the ECB should “control” yield curves at least until vaccination progress allows for a true reopening of the economy, which still seems to be some months away. To say it with Panetta’s words, this strategy requires the central bank “to broadly identify what level of nominal yields it is aiming to achieve; to tailor its purchases to achieve that level; and to be ready to intervene to the extent necessary”. This would help the ECB prevent a premature pick-up in real yields. Moderately higher real rates should only be tolerated when the economy can finally stand on its own feet, presumably over the course of next year. In this process, the ECB should make it clear that they will look through any temporary price increases driven by base effects, higher input prices or supply-chain disruption, and transient episodes of strong demand for services that have been severely hit by the pandemic.

Tricky times for the ECB ahead. This makes it all the more important to get communication and action right already now. Stumbling and losing credibility at this stage would then make their task later this year and into 2022 even more difficult.

Best

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