Sunday Wrap

Happy Sunday,

This is Marco Valli from Milan, the UniCredit Global Head of Research. This past week has seen another wave of sell-off in European fixed-income markets. Following an earlier leg of repricing mainly caused by strong US data, this time the market-mover was domestic, as eurozone core inflation disappointed expectations for a stabilization and rose from 5.3% to a new all-time high of 5.6%, mainly driven by services prices.

This upside surprise is likely to have implications for ECB policy because influential members of the Governing Council (GC) have pretty explicitly linked the future rate trajectory to the evolution of core inflation. To be perfectly clear, I do not refer to the ECB's official communication, which intentionally refrains from putting too much emphasis on a single price gauge and prefers to consider a broader range of indicators of "underlying price pressure". Instead, I refer to individual statements of the more hawkish members of the GC, for which core inflation has clearly become the key driver of policy (and you know who has been leading the debate at the ECB since last year…).

This is my agenda for today:

- **A higher and later peak in core inflation is likely to push the ECB to tighten beyond 3.50%. We have put our forecast for policy rates under revision;**
- **The ECB is increasingly looking at the important role played by buoyant corporate profits in the post-pandemic inflation outbreak. While this might ease exaggerated fears of a wage-price spiral, it is unlikely to affect the trajectory of policy rates in the short term.**

1. ECB likely to tighten beyond 3.50%

This past week's nasty surprise on eurozone core inflation came as a reminder that the road towards disinflation will be a rough one.

A big problem for us forecasters is that traditional models have become less reliable since the beginning of the pandemic and the conflict in Ukraine. This is largely due to the exceptional nature of the two crises and the bold policy response that followed, both of which led to unprecedented large shocks affecting both the supply and demand sides of the economy within a short period of time. Just think of the lockdowns and reopenings, the decline in labor-force participation experienced by some countries, the disruption to global supply chains, the surge in energy and food commodity prices and the massive increase in household savings globally.

Lacking reliable estimates of potential growth and output gaps, forecasters have increasingly relied on alternative gauges that can provide forward-looking and timely information on underlying price pressure. I have developed a few such indicators based on firms' selling price expectations in the different sectors of the eurozone economy, which I use to complement the information from producer price trends in manufacturing. Overall, they have been suggesting that a turning point in eurozone core inflation might be reached by the end of 1Q23, at a level below 5.5%. This past week's data challenge this view and push a turning point into 2Q23, when base effects should hopefully support the beginning of a broader disinflation process.

Under more normal circumstances, this would not be a major change of scenario. However, these are not normal times. Inflation has been too high for too long, central banks have become very risk-averse and the ECB has de facto linked its policy response to the path of core inflation under a meeting-by-meeting approach. Moreover, market-based inflation compensation is re-testing historical highs.

The hawks of the GC doubt that the current level of rates is already restrictive and, if I understand correctly their thinking, they will not be keen to scale down the pace of tightening before core inflation starts turning. This will very likely strengthen their call to retain a 50bp pace of hikes also in May, after the already flagged increase of the same size on 16 March. Therefore, our current forecast for a 3.50% peak in the deposit rate requires a reassessment. Markets have repriced the peak deposit rate to 4%, something which Buba's Nagel quickly gave the thumbs up to.

Overall, I do not think that the ECB's strong focus on core inflation is desirable. One important reason is that not all the ECB's indicators of underlying price pressure are currently sending the same message. For example, the PCCI (Persistent and Common Component of Inflation) already turned a few months ago. Moreover, a narrow focus on core inflation raises financial market volatility and exposes the central bank to the risk of setting policy by looking in the rear-view mirror. But I see one positive aspect of it. It helps clarify the ECB's reaction function, shedding light on the otherwise obscure concept of "sufficiently restrictive" level of policy rates.

2. The role of corporate profits: a new inflation narrative for the ECB?

This past week also saw the publication of the ECB's account of the February meeting, when the central bank sounded more confident on the economic outlook and slightly less concerned about inflation risks. In the discussion, it was noted that falling energy prices, higher market rates and a stronger euro were expected to reduce price pressure at the policy-relevant horizon of 2025, compared to the December forecasts. I think that this assessment will not change after the latest inflation data, and we should expect the new projections to be published at the upcoming meeting to show inflation for 2025 below the current forecast of 2.3%.

Interestingly, the account also showed that the GC had started to focus more in depth on corporate profits as a key driver of inflation, as can be inferred from the following: "It was therefore widely stressed that developments in profits and markup warranted constant monitoring and further analysis on an equal footing with developments in wages." A Reuters article published this week confirmed the ECB's increased attention on profits, which seems to have been an important topic of brainstorming at a GC retreat in a Finnish village some days ago.

Some "rebalancing" in the ECB's inflation narrative would be welcome, if the focus broadens from labor costs (adjusted for productivity) to the drivers of firms' profitability, which has been surprisingly strong in the last couple of years despite a massive increase in the price of commodities and intermediate inputs in general. Such rebalancing would simply reflect facts. The gross operating surplus of eurozone firms – the national account equivalent of EBITDA – is already back above its pre-pandemic trend and last year its contribution to the change in the GDP deflator was broadly similar to that of unit labor costs, with the most recent data (up to 3Q22) showing a growing role for the former.

But will this potentially new narrative have meaningful implications for ECB monetary policy? While it might help mitigate the exaggerated obsession with the risk of a wage-price spiral, I do not expect dovish consequences, at least in the next six to nine months.

There are mainly three reasons why I think that the trajectory of ECB policy rates will not be materially affected. First of all, if firms are able to pass on to customers their higher production costs in full, it means that demand for their goods and services remains resilient even at higher prices. From the point of view of a central bank that wants to accelerate the return of inflation to target, this would continue to require demand compression. If demand continues to hold up well, it would be legitimate to expect firms to be slow to pass on to their customers the easing pressure on energy bills and other commodity prices. Second, high corporate profits contribute to explaining why firms' hiring intentions remain solid even at times of weakening GDP growth, hence delaying the adjustment in the labor market needed to better balance demand and supply of labor. Also here, the ECB's only way to intervene would be by dampening demand for goods and services. Third, high margins create a buffer that reduces firms' vulnerability to rising interest rates. Other conditions remaining equal, this would require more tightening, not less.

The second question I ask myself is why firms have been so capable of passing on their higher production costs in the post-pandemic environment. The exceptionally high level of household savings is likely to have been a major factor here. If so, firms would continue to enjoy robust (although declining) pricing power as long as households remain willing to spend some of their extra savings.

Dissaving is already well advanced in the US, while it has probably just started in some (not all) of the eurozone countries. But the starting points were different, much higher in the US than in the eurozone, mainly reflecting different size and targets of fiscal stimulus during the pandemic. What the ECB is trying to do with its tighter policy is to bring forward the time when eurozone consumers will stop tapping their extra savings to purchase additional goods and services. This would reduce the pricing power of firms and support disinflation – if not, firms might lose market shares.

Therefore, I suspect that the ECB was not pleased with the impressive resilience of the European equity market to the repricing in market rates since the hawkish December policy meeting. Since then, 10Y Bund yields have increased by a whopping 80bp, yet the Euro Stoxx 50 has managed to gain 8% (and this is not all a banks story). Higher equity prices despite a steep increase in the discount factor for future cash flows suggest that investors expect firms' profits to remain resilient, probably too resilient to be consistent with the ECB's timeline for achieving its price-stability mandate.

If one believes that the ECB will remain firmly committed to its inflation target, and I do, one should expect corporate profits to head south from here. Ms. Lagarde has repeatedly stated that a mild recession would not be enough to bring inflation back to target. This implies that either the ECB will have to cause a deep recession by hiking rates well beyond current market expectations, or it will have to restrain economic growth to below-potential rates for several quarters ahead.

The latter is more desirable and looks more likely, but in either scenario, margin compression will have to happen, playing an important role in the disinflation process. The longer it takes to get there, the higher the risk that the ECB would need to tighten aggressively, pushing the eurozone in the nasty-recession scenario.

Best

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