

ECB: Hike while you can!

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EXECUTIVE SUMMARY

- **At tomorrow's policy meeting, the ECB will sound the starting gun for its first rate-hiking cycle since the Global Financial Crisis.** We expect the ECB to announce the end of net asset purchases and to pre-commit to a 25bps rate hike in July – the first one in 11 years. Meanwhile, all eyes will be on any recalibration of the ECB's forward guidance for its policy-normalization path, including any indication of the envisioned pace and the terminal rate.
- **Despite high inflation pressures, the ECB is likely to pursue a gradual but resolute normalization of its monetary stance in H2 2022.** After July, we expect to see two additional 25bps rate hikes this year (September and December). Market expectations of a much more aggressive normalization pace, including a 50bps rate increase, seem unlikely to materialize. After all, medium-term inflation prospects look much more contained and high uncertainty around the macroeconomic outlook calls for gradualism.
- **In 2023, the ECB's normalization drive will increasingly run out of steam before the effective policy rate reaches neutral territory.** In addition to mounting growth headwinds due to higher-for-longer energy prices, supply-chain bottlenecks and geopolitical uncertainty, rising Eurozone fragmentation risks will weigh on the ECB's normalization plans. With the Fed likely to hit the pause button on its hiking ambitions in 2023, it will become harder for the ECB to swim against the tide and continue on its normalization path. Therefore, we only pencil in two rate hikes for 2023 – both of which should take place in the first half of the year.
- **Where are thou, neutral rate?** Rates markets put the ECB to the "hawkishness test" by pricing in a 220bps increase in the policy rate within the next 12 months – identical to the tightening speed priced in the US. Behind this is the search for the upper limit for the neutral rate, which also drives the long end of the curve upwards with 10y Bund yield trading above 1.3%. We see the neutral rate below current market pricing and expect the 10y Bund to stabilize at 1% at year-end.
- **Risky assets will remain extremely sensitive to the ECB's evolving monetary stance.** If the ECB comes out more hawkish than expected, this could spook market participants, leading risky assets deep into a bear market. In this situation, corporate risk would be quickly repriced and the lower end of the rating spectrum would struggle to find financing. However, a more-dovish-than-expected ECB (as in our baseline scenario) should provide some cushioning for both equity and corporate credit, especially within the high-yield spectrum. In this scenario, we expect European equities to finish 2022 close to flat while investment grade corporate credit remains range-bound (130-160bps).

Current inflation outlook

Sounding the starting gun for the first hiking cycle since the Global Financial Crisis. At tomorrow's policy meeting, the ECB will step up its normalization drive. It will come equipped with a new set of macroeconomic projections, including significant forecast revisions that will add a much stronger stagflationary taste to its base-case scenario. In line with recent communication by members of the Governing Council, the ECB will most likely announce the end of net asset purchases. Moreover, we expect it to pre-commit to a rate hike in July – the first one in 11 years. Meanwhile, all eyes will be on any recalibration of the ECB's forward guidance for future rate hikes, which will greatly depend on how the trade-off between fighting inflation and managing slowing growth evolves.

Table 1: Macroeconomic projections (to finalize EZ forecasts by tomorrow)

	"Allianz Research**"			ECB (March)			Consensus (April)		
	Headline HICP	Core HICP	GDP	Headline HICP	Core HICP	GDP	Headline HICP	Core HICP	GDP
2022	7.0	3.3	2.6	5.1	2.5	3.7	6.8	3.3	2.7
2023	3.0	2.3	1.3	2.1	1.8	2.8	2.6	2.4	2.2
2024	1.9	2.1	1.4	1.9	1.9	1.6	-	-	-

Sources: ECB, Consensus Economics, Allianz Research.

Note: */ tentative forecast (updated at end-June 2022).

Sky-high Eurozone inflation is showing no sign of cooling down. After a short-lived pause in April, when government measures helped keep energy inflation temporarily in check, inflation dynamics picked up notably again in May. Eurozone headline inflation jumped by 0.7pp to a new all-time high of 8.1% (consensus: 7.8%), mostly due to re-accelerating energy inflation (up 1.7pp to 39.2%) and surging food prices (7.5% after 6.3% in April). However, price pressures continue to broaden, with core inflation rising 0.3pp to a fresh record high of 3.8%. The inflation outlook remains highly uncertain and a further increase cannot be ruled out. While fiscal support measures will help contain inflation by about 0.5pp through the year (e.g. fuel rebate in Germany and electricity price caps in France, Spain and Portugal), we expect that the post-Covid rotation back to services and increasing commodity prices (with Brent oil soaring following the EU embargo on Russian oil) will keep inflation elevated going into summer. Overall, we expect Eurozone inflation to come in at 7.0% in 2022 and 3.0% in 2023.

Finding the right monetary stance

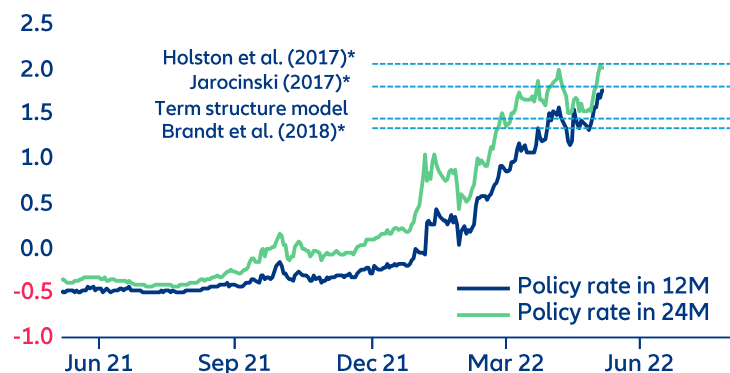
Uncertainty around the economic outlook remains elevated, with rising downside risks calling for a gradualist normalization of rates. Eurozone economic momentum has held up remarkably well amid the energy price shock, prolonged supply-chain bottlenecks and elevated geopolitical uncertainty. However, forward-looking sentiment surveys point to more economic pain ahead. For instance, in contrast to the resilient PMI headline, the forward-looking components, such as those for new manufacturing orders, fell below the neutral 50 mark, joining export orders, which turned negative in March. We expect the Eurozone economy to expand by +2.6% in 2022 – largely thanks to a solid growth carry-over of 1.9pp from 2021 – before slowing to only +1.3% in 2023 (almost a full percentage point below the consensus estimate). Meanwhile, risks remain clearly tilted to the downside. We see a “coin toss” chance for a sharp recession to hit the region.

In 2023, the ECB’s normalization drive will increasingly run out of steam before the effective policy rate reaches the neutral rate. The pace and extent of policy normalization towards the neutral rate will depend on the speed with which the current price pressures abate, the evolution of the tight labor market (and implications for wages) and the extent to which inflation expectations will continue to remain anchored. While the risk of second-round effects is clearly elevated, we see little evidence of a wage-price spiral. Even in Germany – the Eurozone country with the lowest unemployment rate – wage pressures are rising but not alarming (with negotiated wages excluding bonuses expanding by +1.1%/y in Q1 2022). Gloomy growth prospects will help keep a lid on trade unions’ wage demands as job security concerns stage a comeback. Moreover, longer-term inflation expectations remain in check. The ECB’s favorite expectation metric, the 5y5y inflation forward swap, trades at 2.2%. Similarly, market-based inflation expectations over a 10-year horizon still remain broadly anchored.

We also expect rising Eurozone fragmentation risks to weigh on the ECB’s ability to rein in its policy stance. Already there are warning signs hinting at a comeback of tensions in sovereign credit spreads as well as the FRA-OIS swap spread widening to levels last seen at the height of the Covid-19 crisis. Widening peripheral spreads in particular will make it harder to agree on a swifter policy normalization within the Governing Council. The ECB is currently working on a spread-control program to ensure that bond-market stress is no obstacle to policy normalization. However, no matter its design, such an instrument is unlikely to be effective in addressing redenomination risk. On that note, Italy will hold general elections in H1 2023 and the right-wing “Brothers of Italy” party, which is currently leading opinion polls with 22% of all votes, will likely play a major role in the formation of the next government. Finally, with the Fed likely to hit the pause button on its hiking cycle in 2023, it will become harder for the ECB to swim against the tide and continue its normalization path. Therefore, we pencil in two rate hikes for 2023 – both of which should take place in the first half of the year.

Where are thou, neutral rate? Market participants continue to look for the anchor of the neutral rate to determine the terminal value of the Eurozone hiking cycle. According to our estimates, the upper limit has not yet been tested, but the air to the upside is getting thinner (Figure 1). In this discovery process, the Eurozone is lagging the US, where policy-rate expectations have topped out around 3%. Any indication of where the ECB estimates the neutral rate could help anchor market expectations. We think the ECB will not be able to deliver on the very hawkish market pricing of a 220bps policy-rate increase in the next 12 months and expect the 12M OIS forward to stabilize around 1.25% after the meeting.

Figure 1: Policy-rate pricing exploring the neutral range (OIS forwards)



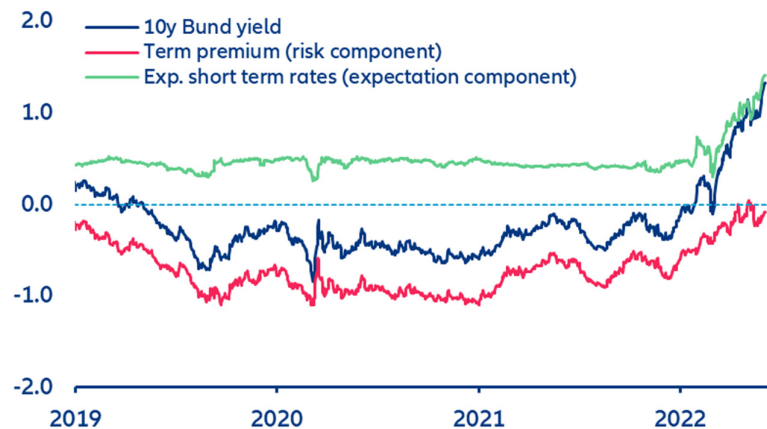
Sources: Refinitiv, Allianz Research

Note: *real neutral rate estimate + inflation target (2%)

The short-term rate outlook is driving up the entire yield curve. The 10y Bund yield is now trading at over 1.3%, i.e. 100bps higher than three months ago. This rise is almost entirely driven by policy rate expectations. The risk component (term premium) that contains uncertainty about the rate outlook, inflation risk and the expected effect of terminating asset purchases remain in neutral territory. A repricing of policy rate expectations following the ECB meeting should thus also lead to lower yields at the long end. We expect yields to stabilize at 1% at the end of the year.

Figure 2: Short-term rate expectations are driving long-term yields

Term structure decomposition of 10y Bund yield



Sources: Refinitiv, Allianz Research

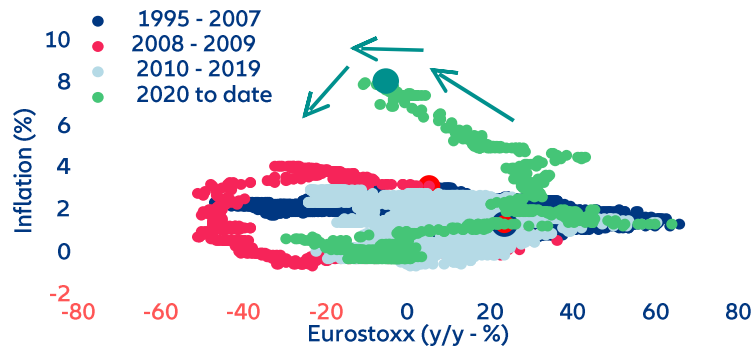
Note: *based on Abrahams et al. (2016)

Hawkish surprise for the ECB? Should underlying inflation dynamics continue to surprise on the upside and second-round effects show signs of further strengthening – the Survey of Professional Forecasters to be released in late July will be closely watched – the ECB could opt to drop the “gradual” normalization path and pursue a more aggressive course of action. In such a scenario, 50bps hikes in 2022 would become likely, with a more hawkish tilt in the monetary stance (similar to that of the Fed made earlier this year). However, such a hawkish surprise for the ECB would hardly be one for markets, which are already positioned for this scenario, pricing a 50bps hike in July with a 70% probability and a policy-rate increase of 220bps in the next 12 months. Only a 75bps hike could really be considered a hawkish surprise by them. But that would probably be seen as a sign of panic and do more harm than good to the credibility of the ECB.

Capital market implications

Risky assets will remain extremely sensitive to the ECB’s evolving monetary stance. Equity markets in particular seem to be in a very unstable position as investors tend to feel comfortable when inflation remains positive but contained between 1% and 3%. At the extreme of the inflation distribution, equity markets tend to underperform. At current inflation levels, equity markets have never been so high in the eyewall of the “equity-inflation hurricane” (Figure 3), hinting that a sharper correction cannot yet be ruled out.

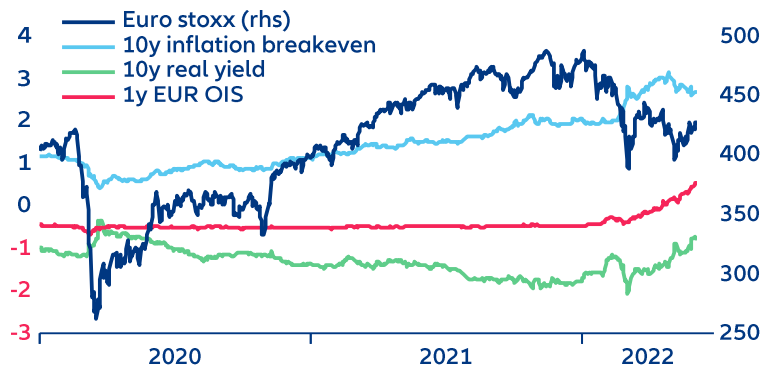
Figure 3: Eurozone equity – inflation hurricane



Sources: Refinitiv, Allianz Research

A direct consequence of the elevated inflation environment has been the continuous readjustment in monetary policy futures as market participants try to front-run the ECB's policy path. These changes in short-term expectations continue to weigh on equity performance, with equities having structurally underperformed since the beginning of the year. In this regard, the relevant time frame for investment decisions has shrunk, with equity markets lacking short-term directionality and suffering from exacerbated intra-day volatility (Figure 4).

Figure 4: Equities, short- and long-term rates (% and €)



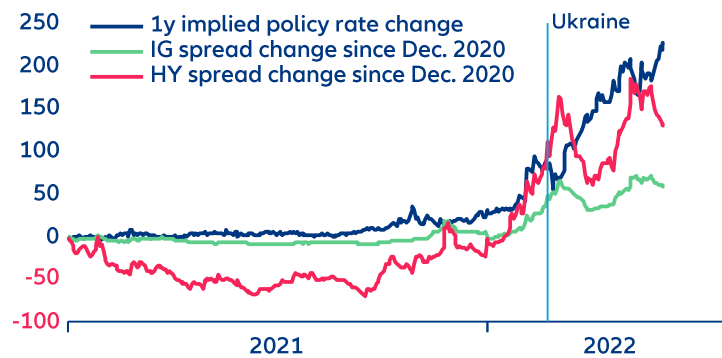
Sources: Refinitiv, Allianz Research

As of 07 June, the relationship between equities and monetary policy has shifted from heavily positive in 2020 and 2021 to a close to, but not fully, inverse relationship since the beginning of 2022. Despite the gradual change in influence, an immediate -25bps revision in 1y ahead policy expectations would still lead to an immediate -2% equity correction. Nonetheless, if the reversal in policy expectations is triggered by the anticipation of a recessionary and disinflationary environment combined with further policy support, equity markets could experience the correlation quickly turning fully negative and leading to an equity outperformance of around +1-3%.

All in all, if the ECB undershoots market expectations by 25-50bps compared to what is currently priced, equities could probably gain some momentum, especially towards year-end, with EUR equities posting a close to flat 2022 performance. Despite the optimistic outlook, the intra-year uncertainty is expected to remain high, with equity markets capable of revisiting 2022 lows within this readjustment process.

Credit spreads have exhibited a pattern similar to that of equity markets. The early repricing of monetary policy expectations has led to a substantial repricing of corporate credit risk, a relevant slowdown in primary markets and an increasing share of corporate bonds trading below par. The move has been more violent within high yield, where the expectations of higher financing costs have almost “killed” the primary market. Surprisingly, and despite the increase in credit-risk pricing, credit spreads have stopped widening and even tightened as the combination of “higher” yields and expectations of a “whatever it takes” put protection should something go wrong has remained present in the mind of corporate credit investors (Figure 5).

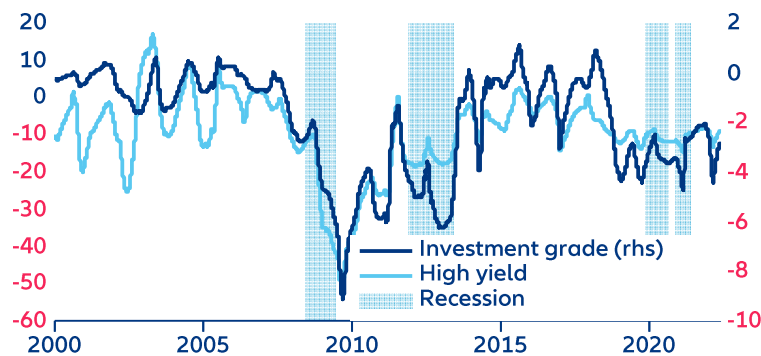
Figure 5: EUR policy expectations vs corporate credit (bp)



Sources: Refinitiv, Allianz Research

This cutback in volatility dependence is also visible in the sensitivity between equities and credit, a sensitivity that has recently declined but that, most importantly, remains low in a historical context. Put simply, in recessionary or close to recessionary periods, one would structurally expect a -1% decline in equity prices to lead to a 6-8bps widening of EUR investment grade corporate spreads. Today, this relationship indicates that for a -1% decline in equity prices, only 2.5bps are added to corporate spreads (Figure 6).

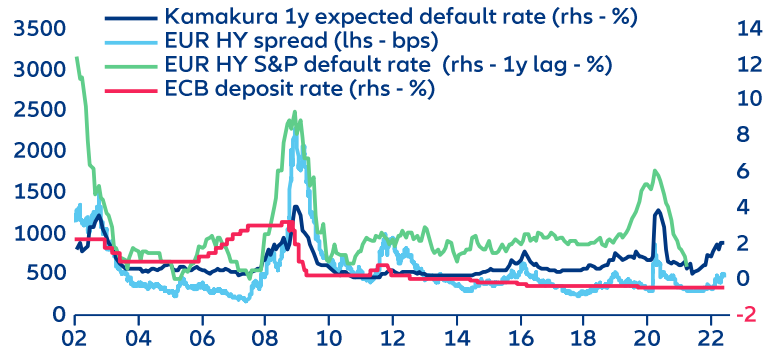
Figure 6: 1y beta of equity returns vs EUR corporates



Sources: Refinitiv, Allianz Research

Despite the recent resilience of corporate credit risk, the asset class is not yet out of the woods as the danger of a higher-than-expected policy path and a more meager-than-expected fiscal impulse could lead to a rapid repricing of credit risk, especially within high yield. This is especially true as the implied market default probability of corporate credit remains slightly elevated despite the still contained credit spreads, with default rates remaining extremely low (lagging by one year) (Figure 7).

Figure 7: EUR HY spreads vs probability of default and ECB rate



Sources: Kamakura, S&P, Refinitiv, Allianz Research

Within our more dovish than expected ECB scenario, we expect corporate credit to remain resilient and to defend the 130-160bps range for the remainder of the year. The expectations of lower-than-expected financing costs should calm market participants and lead to accelerated inflows into the asset class as market participants try to quickly lock in higher coupons and yields.

These assessments are, as always, subject to the disclaimer provided below.

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