Morning Comment

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AFS Insights

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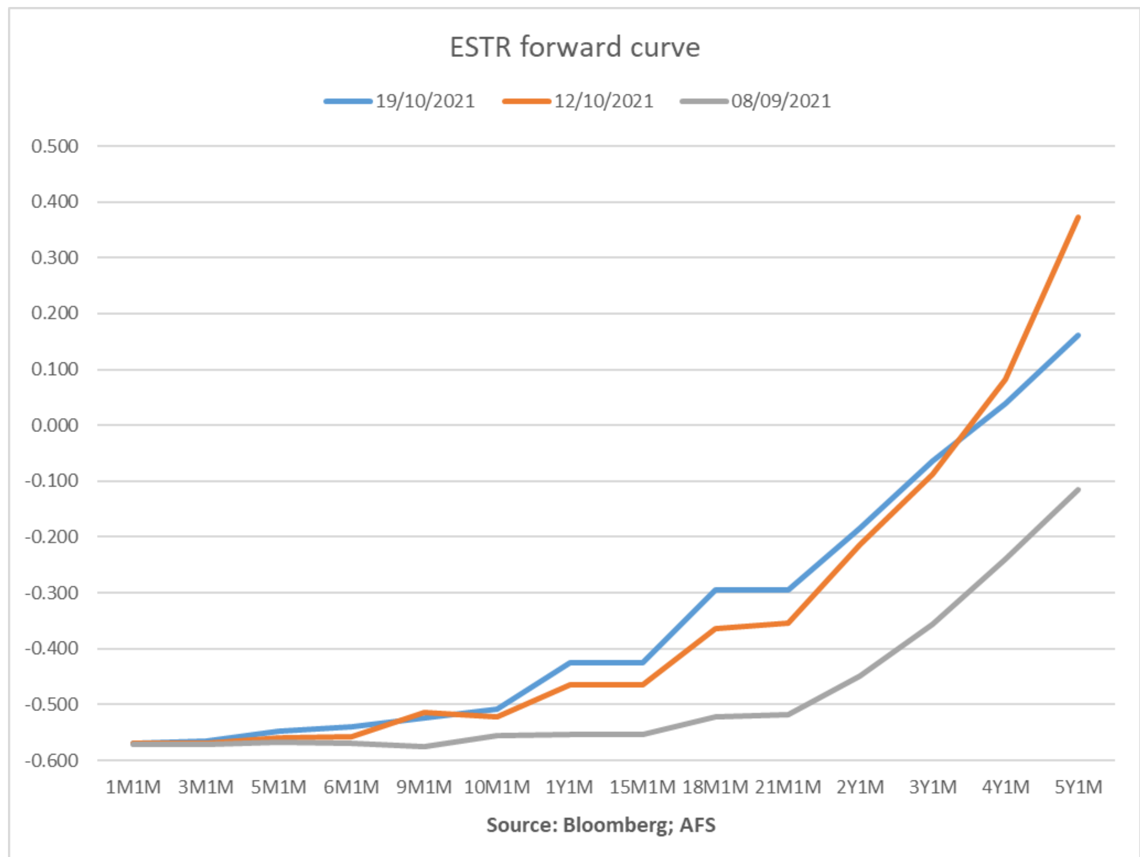
Headline Sweep

- Lane Says Hard to Reconcile Market Rate Bets with ECB Guidance
- German SPD, Greens Mull Off-Budget Debt to Fund Climate Push
- Fed's Waller Sees Tapering Next Month, Rate Hike 'Some Time Off'
- Democrats Move to Break Stalemate on Biden Plan by Scaling Back
- Powell Sold More Than a Million Dollars of Stock as the Market Was Tanking
- China's RRR-Cut Expectations Have Eased, PBOC's House Paper Says

The puzzle that is ECB rate hike pricing

- **Let's get this out of the way first: the sharp rise in ESTR OIS forwards for the near future – so, up to 18 months or so ahead – and Euribor futures for the same period, have caught us by surprise.** Like every rusty ECB-watcher out there and probably the ECB's top brass themselves, in predictions for the central bank's next step we were tinkering with post-pandemic QE purchase volumes and a smooth decline in the balance sheet by preventing too sizeable TLTRO repayments. We didn't expect anything to happen to unsecured overnight and short-term rates between now and the end of 2022. When we made the call, money market pricing was still a see of calm. What difference one and a half month makes.
- **Below is the ESTR OIS forward curve for 1-month tenor, which is still the best gauge of ECB pricing**. Note that we took the pricing from late Tuesday afternoon. For the purpose of this note, the 1-year ahead forward and forwards in close proximity are the most interesting because we can tie them directly to the ECB's own guidance. Notice that a rate hike has been priced in for the September ECB meeting:

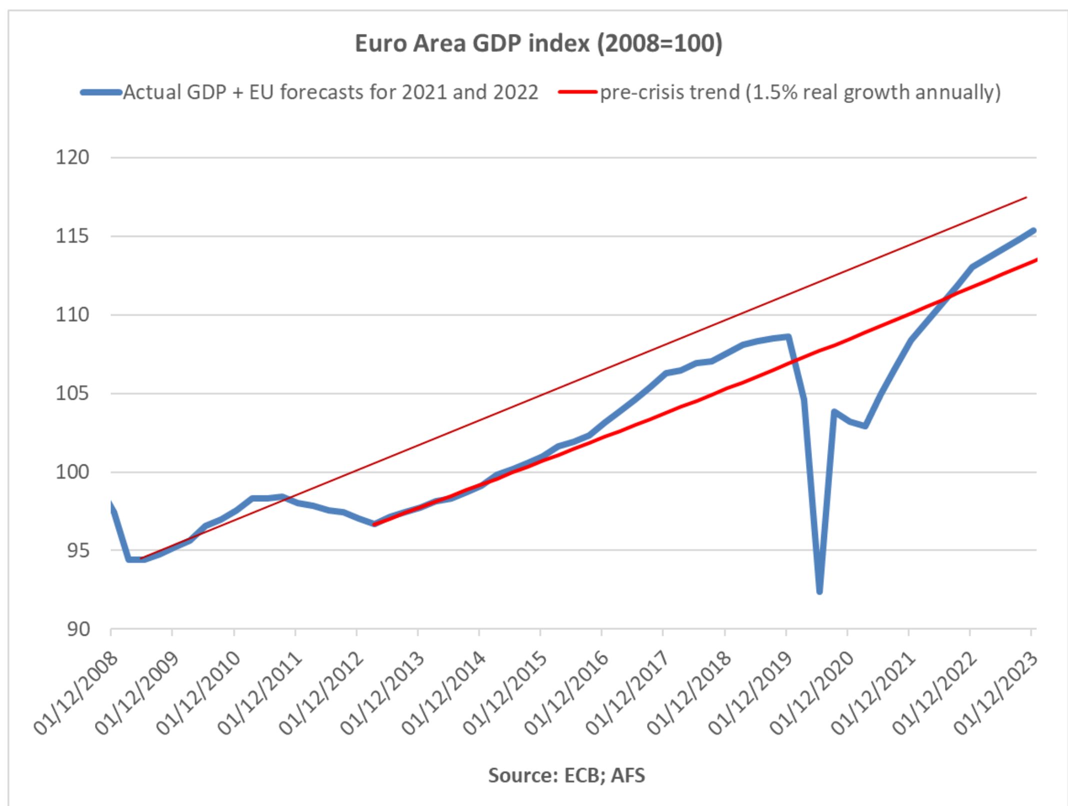


Also note that late yesterday afternoon the March, June and September Euribor are at 100.495; 100.45; and 100.37, respectively. Yes, you read that correctly: the March 2022 Euribor future is above the ECB deposit rate, even when – in all likelihood – excess liquidity will peak in March of next year and OIS forwards suggest an unchanged settlement of ESTR.

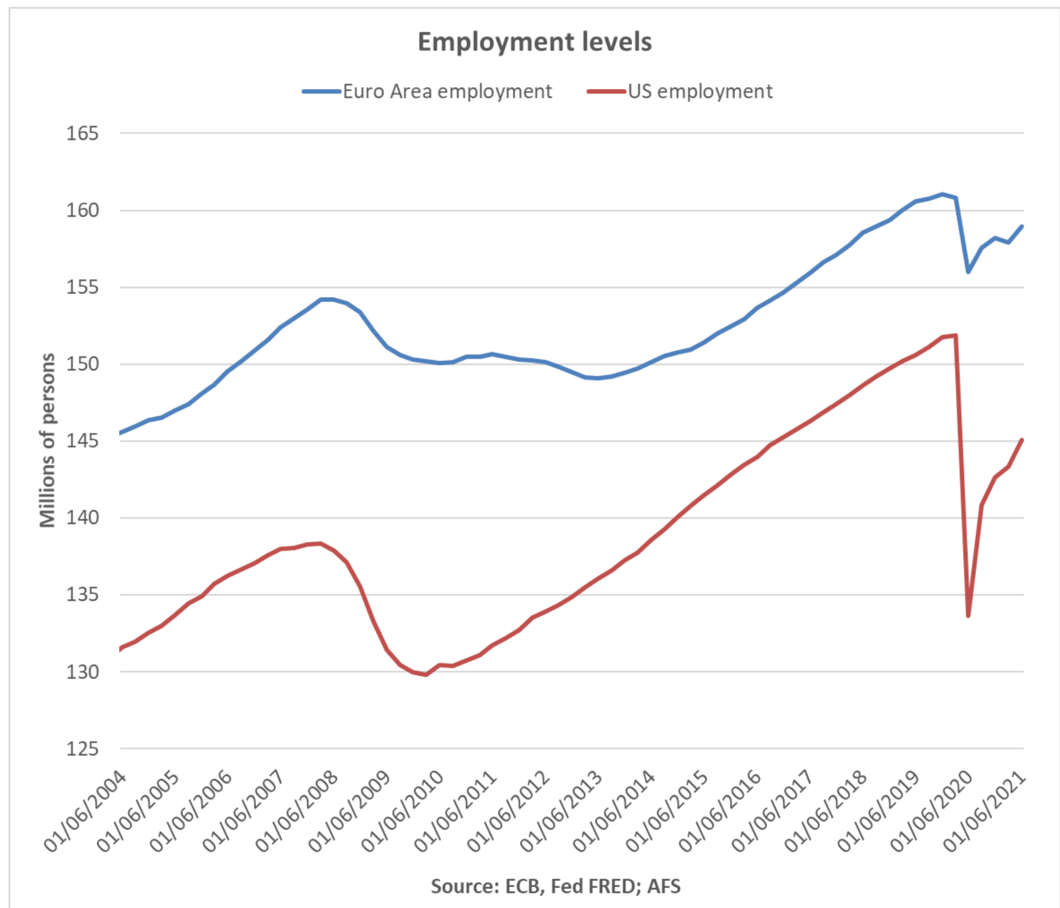
- **If we have to make sense of market pricing with regards to the ECB's own guidance and (implicit) timetable for tightening, it will go something like this: a screeching U-turn.** The ECB would wind down pandemic QE by March 2022 as expected. But instead of running the 'old' APP bond buying program for an indefinite period by buying 20 billion euros a month in bonds (or a somewhat higher amount),[1] the ECB will be tapering. In the first quarter of 2022, the ECB will sharply lower pandemic QE purchase volumes. Then, in the second quarter, the ECB will wind down the APP too. Perhaps as a constellation prize for the periphery the ECB would buy bonds every now and then in an attempt to quash spread widening. It's an interesting take on the flexibility debate that's raging in the Council. In any case, the days of a fixed amount of monetary base expansion through bond buying would be over. Finally, the ECB will let the TLTRO teaser rate expire in June 2022. If there is going to be a replacement, the teaser rate will be meagre and the hurdle to receive it will be quite high indeed. Predictably, there will be a wave of repayments literally overnight, with the stock of TLTROs falling by close to 75% and returning to its pre-pandemic level of 600 billion euros. Next, the ECB will start to raise interest rates in September of 2022.

[1] The ECB putting the APP on autopilot at 20 billion euros a month or slightly higher at 30 to 40 billion euros a month is consensus.

- **Suffice to say, the above-mentioned scenario stands in stark contrast with the ECB's guidance and ECB talking heads**. Even the hawks call inflation mostly transitory. We now count four Governing Council members – the heads of the French, Italian and Greek central banks and the Chief Economist Phillip Lane – who have publicly rebuked OIS forward pricing. At least one Governing Council member has likened the above-mentioned tightening scenario to former President Trichet's epic policy mistakes of 2008 and 2011, when he raised rates during similar inflation scares. We're certain that 2008 and 2011 are on every ECB Council member's mind – including the hawks.
- **From a fundamental perspective, is there method to the (apparent) madness that is OIS forward/Euribor pricing?** A quick glance at the data shows that the Eurozone economy is doing well and better than expected. But it's not that the ECB or the EU Commission can declare victory after having gone through a lost decade for growth. Even if the (optimistic) growth forecasts turn out be right, growth must exceed its potential pace for the rest of the decade if the aim is to make up for the ground lost because of the Eurozone crisis:



And by the summer, employment in the Euro Area was still 2 million persons below its pre-pandemic level:

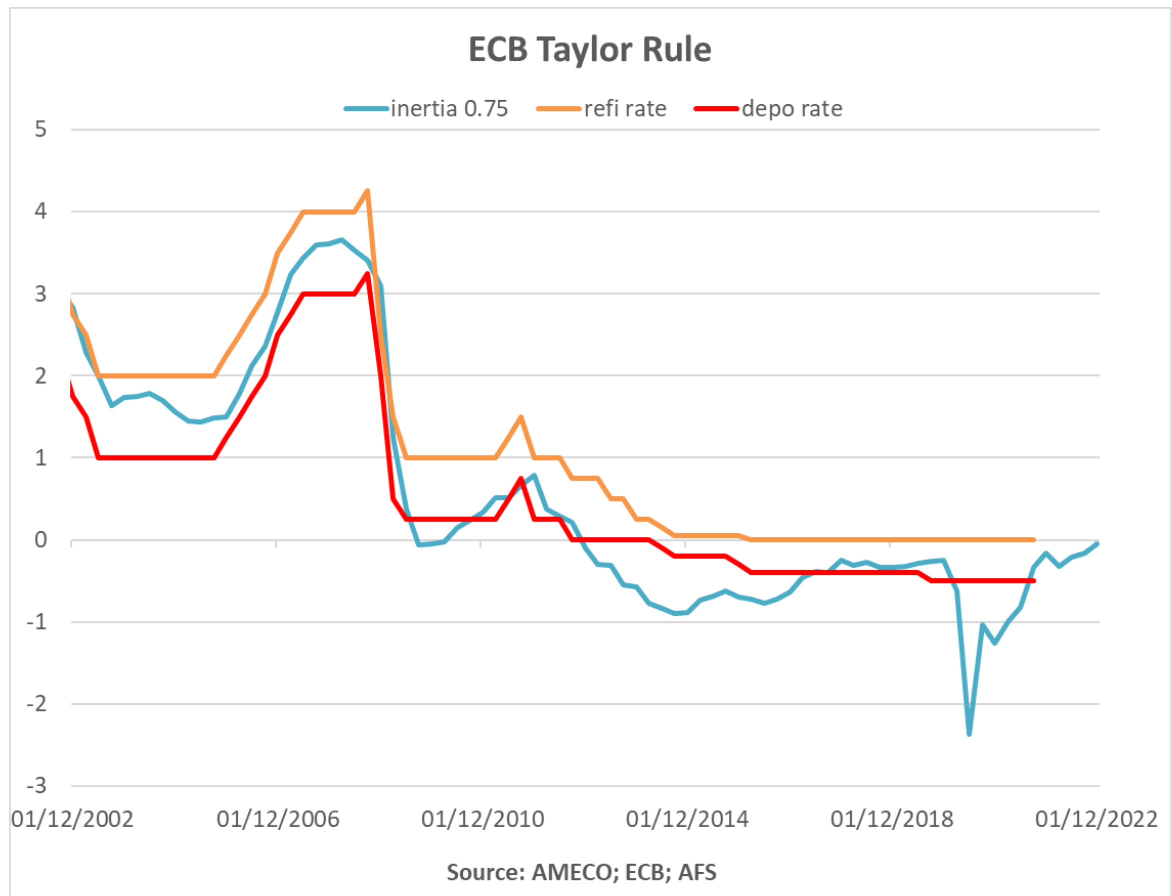


In a good year, the Euro Area economy creates about 2 to 2.5 million jobs. But such an increase would only put us back at the pre-pandemic level. It won't make up for the job growth that we would have had without the pandemic.

- **Finally, a few words about inflation expectations**. Market-based measures of expectations (OK, compensation) don't tell a story of runaway inflation. The widely-tracked 5y5y- forward is trading at 1.90, which is the highest level since disinflation took hold earlier last decade. While the rebound in long term inflation expectations has given the ECB comfort and hope that there is the possibility of an exit from the monetary largesse, the current forward rate is still way below historical levels. Furthermore, it's not that inflation swaps have priced in a UK-like surge in inflation in the near term. The 1-year inflation linked swap rate 1-year forward is at 1.83, down from an earlier high this month of 2.0%. Notice that the ECB guidance states that it is perfectly fine with a period of above target inflation.
- **Another perspective is models**. Our go-to model, the Orphanides and Wieland rule, has become useless as the inputs – 1- and 2- year ahead GDP and inflation forecasts – have become too volatile because of the pandemic and shutdown. The model's outcomes are all over the place. Thus, we turn to our other model, a forward-looking Taylor rule.
- **For the Taylor rule model we use the following inputs: the Laubach-Williams estimate for the neutral rate of interest[2]; the European Commission estimate for potential GDP; and the latest consensus estimates from sell-side economists for real GDP and core inflation.** Consensus calls for core inflation to peak at 1.9% in

[2] The New York Fed stopped updating the model since mid/late 2020. Since we cannot replicate the model, we simply assumed the neutral rate to have remained broadly stable.

Q4 and average 1.3% to 1.4% over 2022. For exercises like these we prefer to use the most hawkish forecasts, but unfortunately Bloomberg did not disclose individual forecasts (that, or we couldn't find them). For real GDP we use nowcasts for Q3 and Q4 and sell-side forecasts for 2022 (consensus is at 4.3%). Finally, we use a factor that represents 'inertia', or the ECB's slow policy response to changing conditions. The factor we use has the best historical fit. The results can be seen below:



- **The model results should not be interpreted as a forecast or an exact estimate of what the ECB policy rate should be**. Instead, it's a rule of thumb for what the ECB policy rate should be in a given economic scenario that doesn't take anything else into account besides output and consumer prices excluding food and energy. The tweak we made to the Taylor Rule, is that we incorporate forecasts instead of just the latest data point available for each variable. Having said that, the model clearly does vindicate market pricing of ECB lift-off in the second half of 2022, something that it never did in the prior cycle. But remember – and we can't stress this enough – we use historical data and not forecasts up until the latest data point available, which is the second quarter of 2021. Forecasts are always iffy. Furthermore, with forecasts for inflation likely to be revised up further in the months ahead and not (yet) much in the way of GDP forecasts downgrades, expect the model to call for an even higher policy rate path.
- **So, a simple Taylor rule vindicates market pricing of a rate hike a year from now**. Furthermore, there is a historical precedent in play here as well. The last time the Eurozone economy did well, which was in 2017 and 2018, the forward curve consistently priced in a rate hike 1-year ahead. But does this all mean that market

pricing is right? We do not believe this is the case. From a fundamental perspective, for the ECB to tighten aggressively next year, the Eurozone economy would have to overheat or about to overheat. We do not think this will be the case. Our interpretation of OIS forwards and Euribors is that it reflects a mild panic around the time of the TLTRO repayments and the – for a lack of a better word – the natural tendency of the OIS curve to err on the side of hawkishness. But cooler heads should prevail here. A September 2022 ECB rate hike really is a long shot. The ECB would do more than enough tightening if banks repay all the pandemic TLTROs and if QE runs at a lowly pace after March 2022, which would be consistent with the liquidity creation being absorbed by autonomous factors.

- **One way to interpret the September 2022 Euribor future (trading at 100.37) is that it reflects expectations that excess liquidity will return to its pre-pandemic level of around 1 trillion euros, as suggested in this ECB paper**. Again, this pricing reflects an inordinate amount of tightening. In a hawkish scenario, where banks repay all their TLTRO emergency borrowing, excess liquidity net of tiering would still be north of 2 trillion euros. The ECB would have to sterilize more reserves by raising the tiering allowance. Again, such a policy would imply aggressive tightening, which we still do not see as realistic.

Calendar

TIME	REGION	EVENT	PERIOD	CONSENSUS	PRIOR
09:00		Norges Bank Governor Olsen Speaks to CME at BI			
09:00		ECB's Villeroy speaks in Paris			
09:20		ECB's Frenk Elderson Delivers Speech in Vienna			
10:00	Eurozone	Current Account SA	Aug	--	21.6b
10:30	Italy	Current Account Balance	Aug	--	7947m
10:30	Greece	Current Account Balance	Aug	--	538m
10:30	Portugal	Current Account Balance	Aug	--	-211m
11:00	Eurozone	CPI YoY	Sep F	3.40%	3.00%
11:00	Eurozone	CPI Core YoY	Sep F	1.90%	1.90%
11:00	Eurozone	CPI MoM	Sep F	0.50%	0.50%
11:30	Germany	Sells 3 Billion Euros of 0% 2031 Bonds			
12:00		EU Sells Bills			
15:40		ECB's Holzmann Speaks at Financial Regulation Conference			
17:00		ECB's Villeroy speaks in Paris			
17:20		ECB's Visco speaks on net zero emssions and finance			
18:00		Fed’s Bostic, Kashkari, Evans and Bullard Speak			
19:00	US	Sells USD24 Bln 20-Year Bonds			
19:00		Fed’s Quarles Discusses the Economic Outlook			
20:00		Federal Reserve Releases Beige Book			

Consensus data: Bloomberg News; All Times Are in Central European Time

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