ALLIANZ RESEARCH

MONETARY POLICY: OMICRON MANAGEMENT & BEYOND

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At their December policy meetings, the US Federal Reserve and the ECB will be tested on their monetary policy stance amid higher omicron-related uncertainty. The possibility of a slightly more hawkish tilt in response to rising inflation has raised the stakes for credible forward guidance. Nonetheless, we still expect the overall tightening cycle to be less aggressive than suggested by current market pricing: shallow and protracted relative to historical standards in the US and little real tightening in the Eurozone. As pandemic-related one-off factors are fading, one of the key questions relates to what will happen to underlying inflationary pressures if the emergence of the potentially more damaging omicron Covid-19 variant slows the recovery momentum and delays the pace of re-opening. The Fed and the ECB have been careful about tightening their accommodative monetary stance too early, which has increasingly been challenged by markets. Figures 1 and 2 show that effective policy rates (Fed Funds for the US and EONIA in the Eurozone; shown as orange dots) are far too low at current inflation rates based on conventional monetary policy rules while market expectations (green dots) indicate a tightening stance. Rising inflation expectations triggered by broadening price pressures could considerably erode the effectiveness of forward guidance and alter the scale and duration of monetary policy normalization (i.e., the "hiking cycle").

Figure 1: US monetary stance vs. market pricing

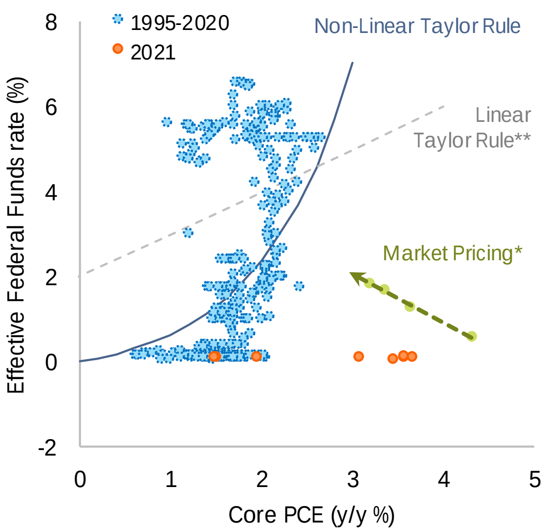
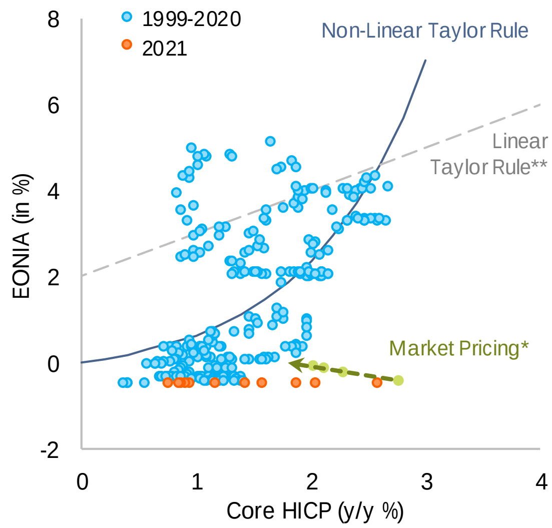


Figure 2: EZ monetary stance vs. market pricing



*Note: HICP= harmonized indices of consumer prices, PCE=personal consumption expenditure price index. */ based on market expectations of inflation and short-term rates between 1 and 4 months in the future, **/ based on Fisher equation of the natural interest rate and the inflation target (2%).*
Sources: Refinitiv, Allianz Research

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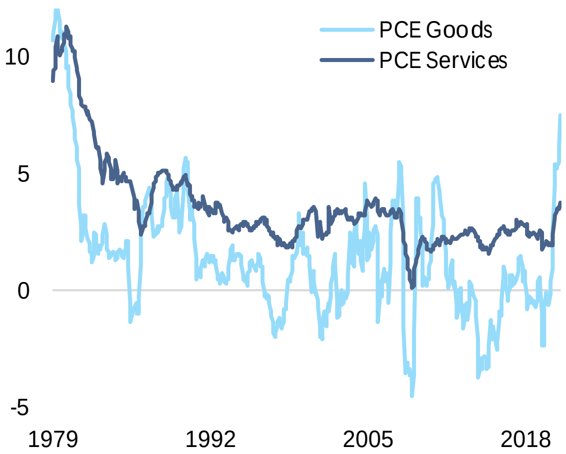
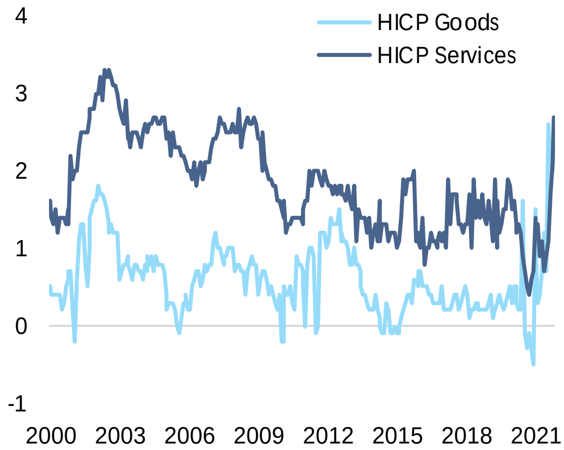
A new Covid-19 wave could significantly prolong supply-demand imbalances and slow the recovery momentum. Tighter restrictions as well as partial (and more targeted) shutdowns will probably decrease aggregate demand but less so compared to previous waves (with real activity adjusting better to stricter containment measures). Core inflation in both the Eurozone and the US continues to be driven in large part by catch-up effects underpinning robust aggregate demand (Figures 3 and 4), not just supply-side constraints. Record levels of net disposable household income mean that there is still plenty of spare cash to disproportionately flow into the consumption of goods, especially if the pandemic disruption drags on for longer than expected. This might also delay the rotation of consumption back to services, where price pressures tend to be more short-lived. However, the replacement cycle for durable goods seems to be coming to an end, which would faciliate the adjustment of demand to tighter supply and soften price pressures.

Figure 3: US core inflation (y/y %)



Sources: Refinitiv, Allianz Research

Figure 4: EZ core inflation (y/y %)



Sources: Refinitiv, Allianz Research

The ECB and the Fed still deem rising inflation to be non-structural but acknowledge that it is now lasting longer and has a more uncertain future path than initially expected. For Q3 2021, the US PCE deflator came in at an annualized rate of 5.3% q/q (down from 6.5% in the previous quarter) amid broadening wage pressures, with the cost of employment index rising to a decade high. This raises doubts over whether inflation is still running persistently below the Fed's longer-run 2%-inflation goal, given the accelerating catch-up during the Covid-19 crisis. The PCE level is above target even with a 10-year look-back window (Figure 5). We continue to expect average headline inflation to reach 4.6% y/y in 2021 and 3.6% y/y in 2022 before stabilizing at 2% y/y during 2023. Similarly, in the Eurozone, inflation reached a record high of 4.9% y/y in November. We expect inflation to average 2.6% y/y in 2021 before slowing to 2.5% y/y in 2022 and 1.7% y/y in 2023 (Figures 6 and 7).

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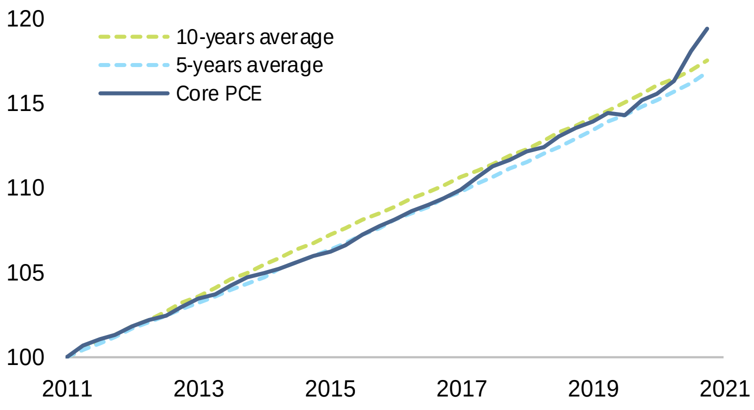
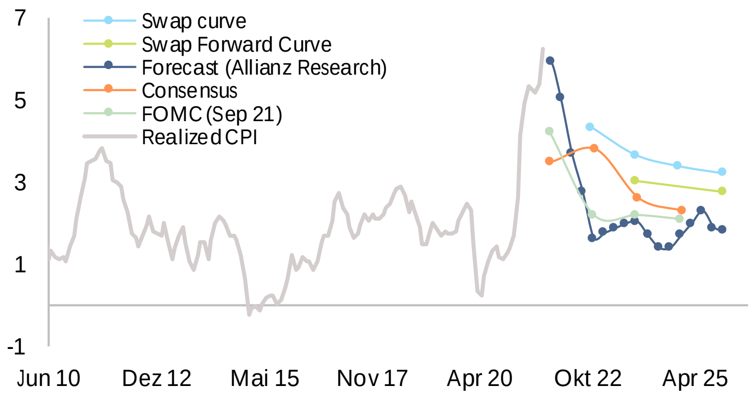
Figure 5: US core PCE deflator (indexed, Q4 2011 = 100)



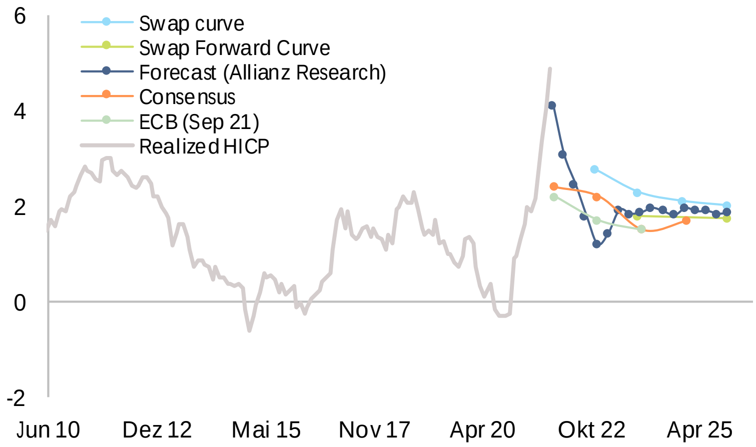
Sources: Refinitiv, Allianz Research

Figure 6: US inflation outlook (y/y %, as of 1 December 2021)



Sources: Refinitiv, Allianz Research

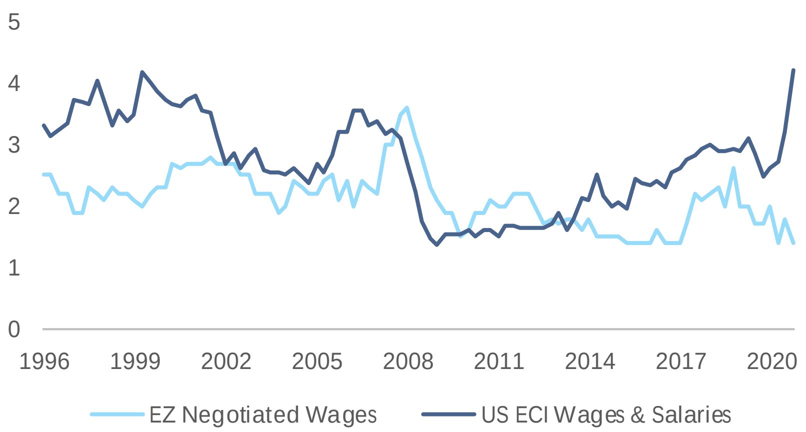
Figure 7: Eurozone inflation outlook (y/y %, as of 1 December 2021)



Sources: Refinitiv, Allianz Research

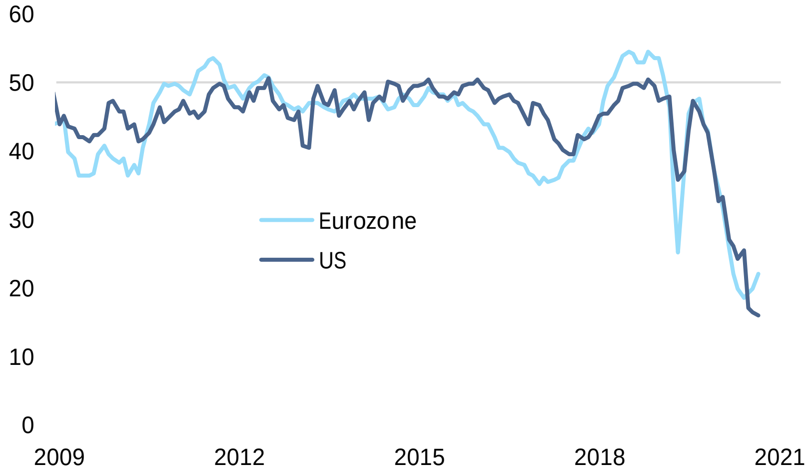
The ECB and the Fed should be ready to act if price pressures broaden and threaten to become self-reinforcing, raising the prospect of an adverse feedback loop between inflation expectations and wages. Supply chains remain clogged, energy prices are still stubbornly high, and parts of the labor market are becoming exceedingly tight, especially in sectors that already experienced labor shortages before the pandemic. However, so far, wage pressures are more pronounced in the US and spotty in the Eurozone (Figures 8-9). In the context of rising uncertainty due to the omicron virus variant, it may well take until mid-2022 to get a better grasp on the stickiness of key inflation drivers, including supply-chain disruptions, elevated energy prices and the healing of the labor market.

Figure 8: Employment costs and wages (y/y %)



Sources: Refinitiv, Allianz Research

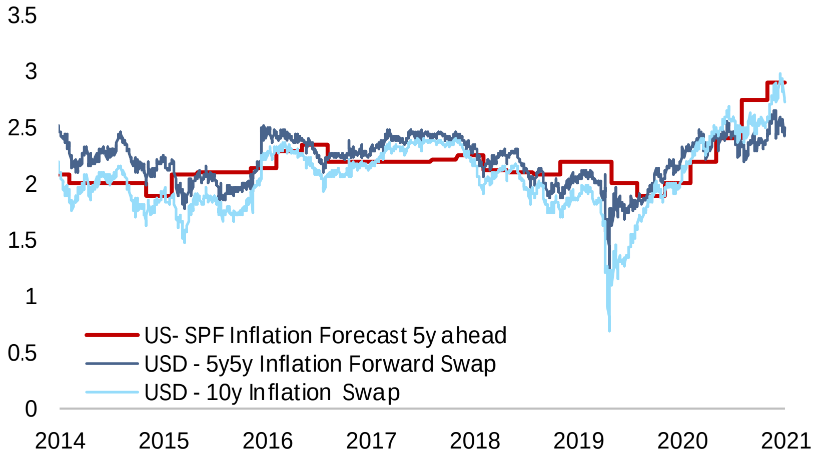
Figure 9: Manufacturing sector–supplier delivery times (indexed)



Sources: Markit, Euler Hermes, Allianz Research

Current inflation expectations imply a slightly more hawkish monetary stance—without a fundamental change in the expected hiking cycle—unless severe virus-related containment measures require continued aggregate demand support. In the fresh round of macroeconomic projections due in December, both the Fed and ECB are expected to forecast higher inflation but lower growth, especially over the near term. This is likely to prepare the ground for a slightly more hawkish monetary stance for now unless adverse confidence effects and potential knock-on effects on growth warrant continued monetary accommodation. Over the longer term, the development in labor markets and its impact on inflation developments (outturn and expectations) as well as the crisis impact on trend growth, will be key aspects of the evolving stance.

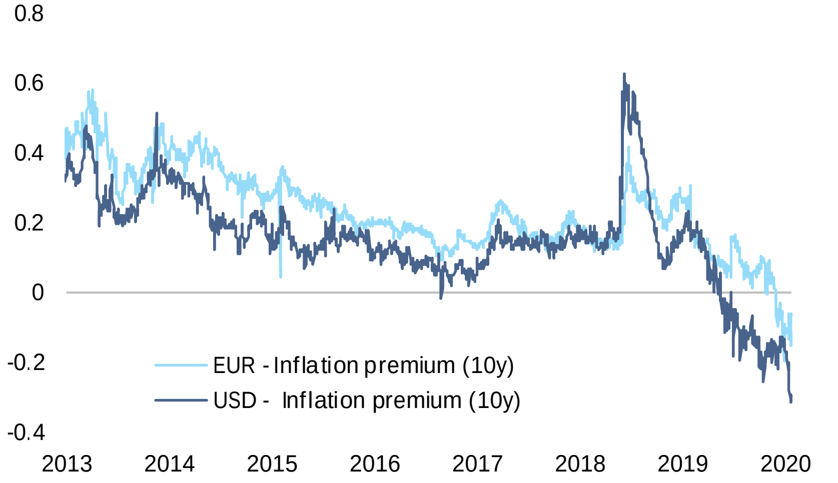
Figure 10: US long-term inflation expectations–swap market vs. professional forecast (in %)



Sources: Refinitiv, Allianz Research

Markets still seem to worry that the Fed and the ECB might be falling behind the curve. Long-term inflation expectations by professional forecasters are now aligned with market-implied breakeven rates, suggesting that current price pressures are already (at least to some extent) embedded in inflation expectations. Long-term implied inflation expectations from US swap markets are poised for permanently higher inflation over 3% in 2024 against a current FOMC projection at 2.1%. In the Eurozone, market implied inflation expectations (2.3%) are also much higher than the current ECB projections (1.5%) in 2024, suggesting continued concerns about the scale and duration of current price pressures and future inflation dynamics (Figure 10). The reconciliation of market expectations and forward guidance could prove bumpy, given the elevated risk of policy mistakes and unwanted side effects, including the impact of differences in the normalization of policy rates and the unwinding of unconventional measures. The continued divergence between the market view and both central banks' forward guidance raises the risk of inflation becoming de-anchored. Thus, stronger employment data and persistently higher inflation over the next quarters could challenge the current stance and justify earlier tightening, especially in the US.

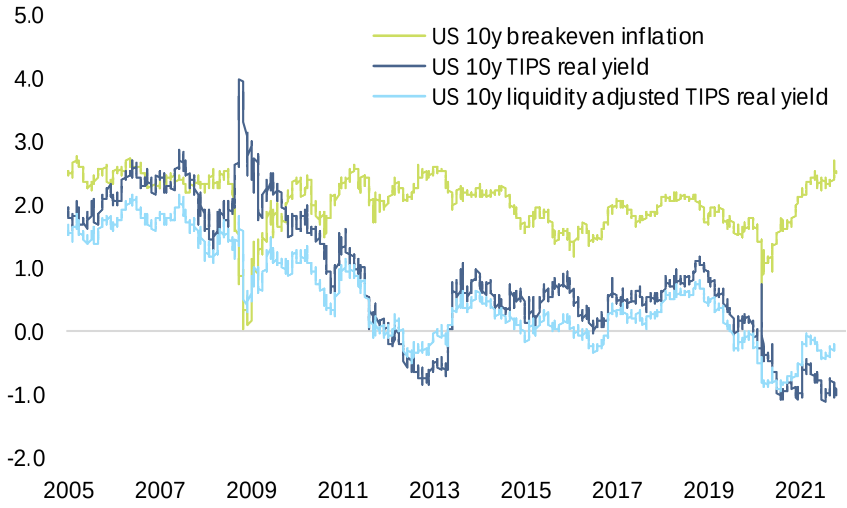
Figure 11: 10-year inflation premium (5y5y forward swap vs 10y inflation swap)



Sources: Refinitiv, Allianz Research

Excessive demand and tight market conditions might artifically upward bias inflation expectations. The inflation premium beyond five years remains (unusually) negative and has decreased (Figure 11). This underlines the uncertainty of the current inflation situation, with investors willing to pay higher prices for inflation protection today than in five years. This backwardating pattern is also reflected in the ongoing inversion of the inflation curve. One should also be very cautious about interpreting inflation breakeven or swaps as pure market expectations. Currently, the demand for inflation protection is so high that the usual liquidity premium over nominal government bonds has turned negative. According to our model for 10-year-TIPS, this distortion overstates implied inflation by 65 bps (Figure 12).

Figure 12: Liquidity-induced distortion of US real yields and breakevens



Sources: Refinitiv, Allianz Research

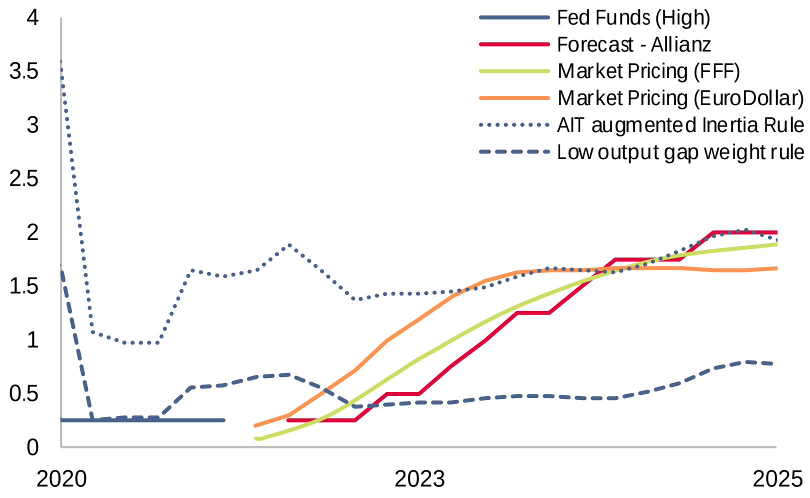
In this context, the ECB and Fed find themselves in unique policy situations. The ECB has been fighting deflationary forces for much of the past decade. Given the limited possibility of central fiscal support for the Eurozone, it acted as the main "stimulus" agent for aggregate demand support via monetary easing. However, current price pressures (which are largely driven by extraordinary effects related to crisis-related reopening dynamics rather than diminishing economic slack) might require a more hawkish stance despite low trend growth–and risk potential market fragmentation (as debt affordability in some vulnerable Eurozone member countries would decline). Meanwhile the Fed has become somewhat of an "inverted ECB", given the current pressure by the US Treasury on withdrawing monetary support to reign in inflationary pressures (before they become endemic).

While the current virus developments have raised the stakes for credible forward guidance, we still expect the tightening cycle to be less aggressive than suggested by market pricing:

- *In the US, the hiking cycle is likely to be shallow and protracted relative to historical standards* (Figure 13). Tapering will conclude between March and June 2022, followed by one hike during the second half of 2022 (with the possibility of a second hike if the FOMC meeting in December signals a more hawkish stance in light of the current virus developments), followed by three successive rate hikes in 2023 before eaching a terminal rate at 2% at the end of the forecast horizon. The real policy rate will remain below the natural rate, suggesting continued easing. Thus, this hiking cycle, although unprecedented in its brevity between easing and tightening, will not end up being a hawkish shift like the tightening cycles in the early 1980s and 2000s. The scale and duration of monetary tightening we envision is somewhat less ambitious than expected by markets. Money markets do not appear to be uncomfortable with the Fed's ambiguity on the timing of rate hikes by decoupling it from tapering and pivoting any decision to achieving the right balance between price stability and full employment (as the twin goals of the Fed's mandate). They continue to price in two rate hikes next year, followed by up to five hikes until 2024.

- *For the Eurozone, the even more shallow hiking cycle suggests little tightening in real terms* (Figure 14). We see the terminal rate at the end of the forecast horizon still substantially below the natural rate. Therefore, the upcoming ECB tightening cycle is just a phasing out of the current crisis mode rather than a clear departure from the accommodative monetary stance that already prevailed before the Covid-19 crisis. We expect a first hike of the deposit rate in September 2023 – a first since summer 2011 and the beginning of the first meaningful hiking cycle since late 2005.

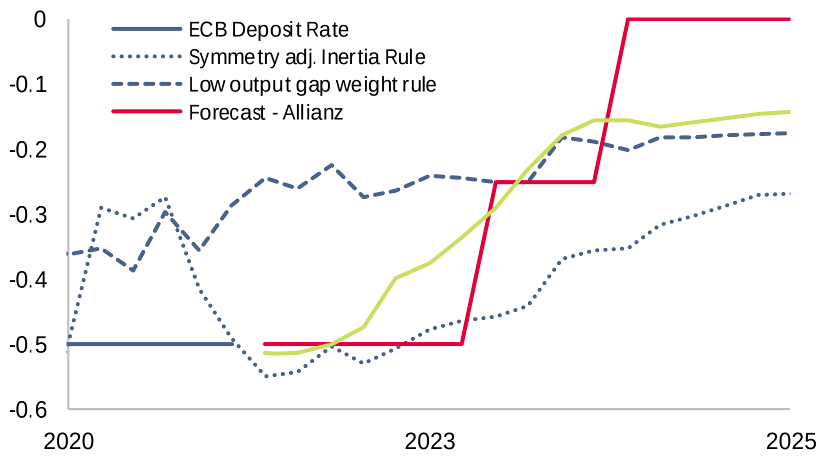
Figure 13: US policy rate outlook (in %, as of 2 December 2021)



Note: AIT=average inflation targeting. The "AIT-augmented inertial (Taylor) rule" and the "low output gap weight rule" are two of the common monetary policy rules used by the U.S. Federal Reserve to assess the appropriate monetary stance. For more information, see [Monetary Principles and Practice](#).

Sources: Refinitiv, Allianz Research

Figure 14: Eurozone policy rate outlook (in %, as of 2 December 2021)



Note: For more information on the monetary policy rules, see Figure 16. For the Eurosystem, we have accounted for the recently amended symmetric interpretation of the price target suggesting that the ECB would tolerate temporary inflation overshoots (rather than being historically bound to keep inflation close to but not above 2%).

Sources: Refinitiv, Allianz Research

In addition to the rate decision, the characteristics of phasing out unconventional policies will crucially influence the term premium and long-term rates, shaping consumption and investment decisions, especially in the US where tapering is already underway. At the short end of the yield curve, the market has positioned itself for an early lift-off. At the long end, the dampening effect of bond purchases prevails. This leads to a particular shape of the yield curve where the "belly" gets much of the pressure, i.e., there is an unequal shift in the yield curve with 5-year yields rising more than long- and short-term yields. In addition, the Fed's messaging on the possibility of earlier rate hikes has underpinned the yield curve flattening bias via ongoing upward pressure on the short end.

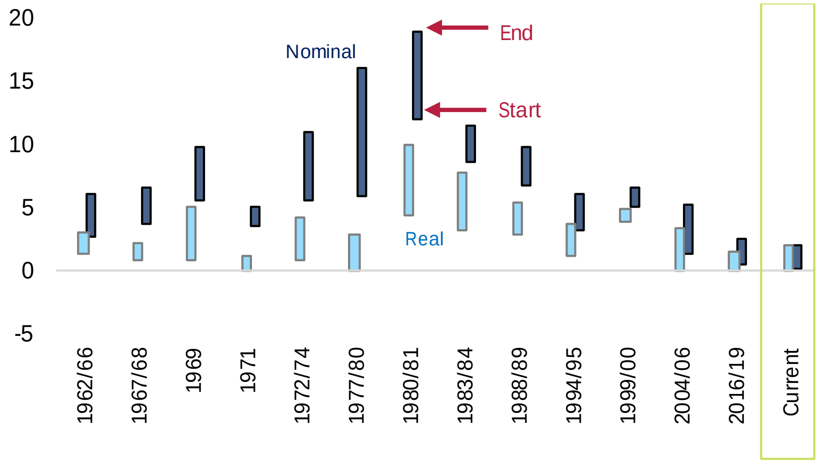
In the US, the expected pace of tapering is higher compared to past episodes. Consistent with our call in the September quarterly scenario[1], the Fed commenced tapering last week at an expected pace of USD15bn per month (USD10bn of Treasuries and USD5bn of mortgage-backed securities (MBS)), which ends the net expansion of the Fed's balance sheet in during the first half of next year, with the flexibility of tapering to be adjusted depending on changes in the economic outlook. In his recent testimony to the Senate Banking Committee earlier this week (30 November), Fed Chair Powell indicated that the FOMC will discuss accelerating the announced pace of tapering at its next meeting in December. He acknowledged that the strengthening economy and very high inflationary pressures would warrant scaling back monetary accommodation earlier than previously announced and ending asset purchases a few months early. For the Eurozone, following the expiration of the crisis-related pandemic emergency purchase program (PEPP) in March 2022, we expect the ECB to announce a post-PEPP cushion to top up the EUR20bn in purchases under the asset purchase program until the end of 2022. APP tapering will kick off in January 2023 and be concluded within six months.

The expanded central bank balance sheet will have long-term legacy effects. The stock impact of asset purchases will remain for a long time after the conclusion of asset purchases, with the focus shifting from net purchases to reinvestment policy. Managing associated excess liquidity will remain a key element of monetary policy for the Fed and the ECB (and in this way, they will continue to operate at the lower bound of the rate band. The longer the phase of full reinvestment, the longer the dampening effect on the yield curve. With full reinvestment, these effects may not wear off for another 20 years (even without new net asset purchases). We estimate that QE has compressed long-term rates by 200bps in the Eurozone and by 130bps in the US. Even though the balance sheet reduction will begin in January 2024, we expect that reinvesting proceeds would reduce long-term yields by 115bps by the end of the forecast horizon. In the Eurozone, reinvestment will continue throughout the forecast period, so we expect the yield compression to be around 135bps (for German Bunds). However, self-imposed limits are likely to constrain the ECB' asset purchases beyond next year due to the potential scarcity of German government bonds. We see several options to boost the room for maneuver, including by raising the issuer limit and expanding the scope of asset purchases while avoiding collateral scarcity for money markets by stepping up the securities lending program.

Finally, the question remains how the ECB and the Fed will emerge from the Covid-19 crisis (including the recent surge of infections related to the omicron variant). We have compared the expected tightening cycle with previous episodes to assess whether there are some permanent effects on monetary policy in the Eurozone and the US (Figures 15-18).

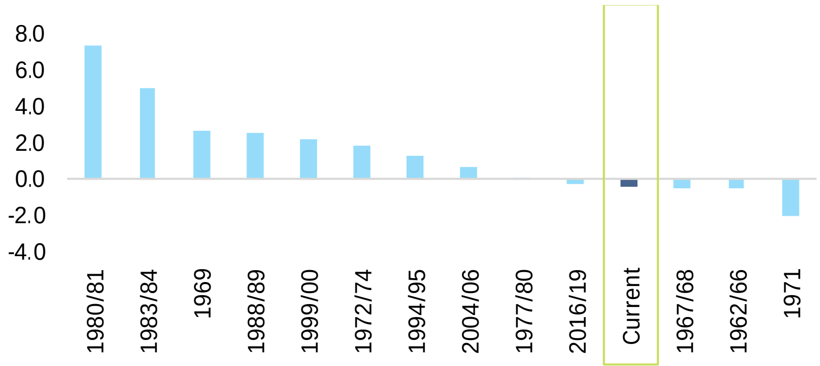
[1] See our report *Global Economy : A Cautious Back to School*.

Figure 15: US–current scenario vs. past US hiking cycles (in pp)



Sources: Refinitiv, Allianz Research

Figure 16: US–deviation of real policy rate from natural rate at the end of the hiking cycle (in pp)



Note: The natural rate was estimated using the approaches by Holston and others (2017), Del Negro and others (2017), and Lubrik and others (2015).
Sources: Refinitiv, Allianz Research

The key takeaways are:

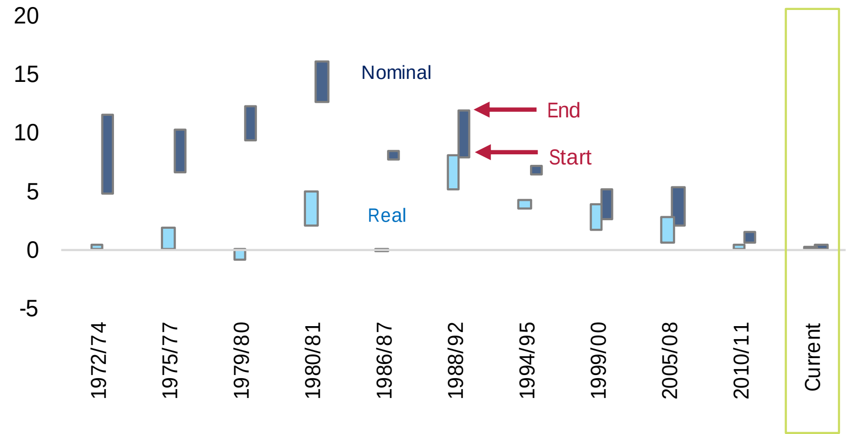
- *As low as it goes.* Both central banks will embark on extraordinary shallow hiking cycles, with terminal rates in 2026 below pre-Covid-19 levels. While the scale of normalization is moderate, in real terms it is somewhat higher compared to previous hiking cycles.

- *It's a long road.* While the sequencing between tapering and rate hikes is short – with only a few months in between the conclusion of tapering in the US and the first rate hike – the expected pace of normalization is slower compared to previous rate cycles. While tapering will occur later in the Eurozone, the cycle is similarly drawn out.

- *Little future policy space.* Given the moderate tightening of monetary policy under the current scenario, the real effective policy rate in the

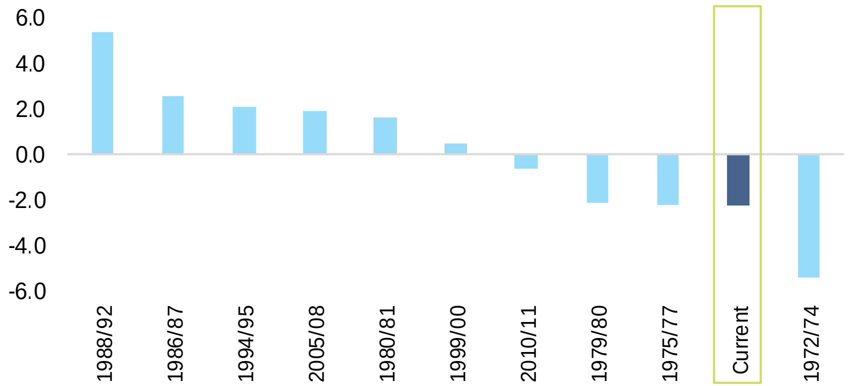
US will be broadly on par with the natural rate of interest. In contrast, in the Eurozone, the ECB will remain significantly below the natural rate, which will significantly limit policy space in the future, given the proximity to the economic lower bound for negative interest rates.

Figure 17: Eurozone–current scenario vs. past US hiking cycles (in pp)



Sources: Refinitiv, Euro Area Business Cycle Network (Fagan and others, 2001), Allianz Research

Figure 18: Eurozone–deviation of real policy rate from natural rate at the end of the hiking cycle (in pp)



Note: The natural rate was estimated using the approach by Holston and others (2017).
Sources: Refinitiv, Euro Area Business Cycle Network (Fagan and others, 2001), Allianz Research

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