

NOT SO HAWKISH AFTER ALL: IS THE ECB PAST THE PEAK OR JUST ON PAUSE?

9 March 2022

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EXECUTIVE SUMMARY

- *The invasion of Ukraine has created a significant negative supply-side shock to the Eurozone. Inflation continues to rise while financial sanctions have effectively shut down non-energy trade with Russia. Consumer confidence has already deteriorated and suggests slowing growth during the latter part of the year.*
- *Given the uncertain outlook, we believe that the ECB will remain in a wait-and-see mode at the March meeting as concerns about slowing growth and tighter financial conditions will outweigh inflation fears. Under current conditions, maintaining as much policy flexibility and optionality as possible will remain essential. The ECB should not pre-commit to either a notably lower pace of asset purchases in Q2 or ending asset purchases this year. We expect that QE will continue throughout 2022, which would push back the first rate hike (which prior to Russia's invasion of Ukraine we expected for December) into Q1 2023.*
- *If the baseline conditions no longer apply, the ECB would need to re-assess its monetary stance at the next policy meeting. We could see a more dovish shift if a shut-off of Russian oil and gas triggers a significant deterioration of the growth outlook and requires further monetary easing. Counter-cyclical fiscal policy would ideally complement aggregate demand support from the ECB and help bring forward expectations of normalization during the recovery.*
- *We expect that stabilizing real rates and higher inflation will still be supportive for corporate earnings growth while long-term nominal rates remain contained by safe haven flows. This should also slow current spread widening, with investment grade corporate spreads reverting back to 120bps by the end of the year.*

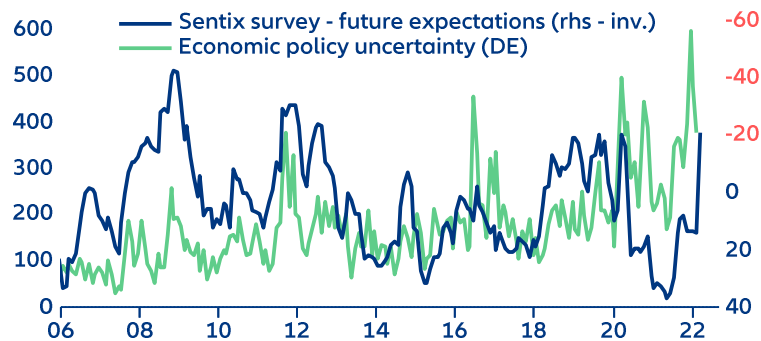
Hawkishness – past the peak or just on pause? Only six weeks ago, the ECB's Governing Council appeared ready to pivot towards a hawkish monetary stance during the second half of the year. However, heightened uncertainty about the economic outlook due to Russia's invasion of Ukraine has added a layer of additional complexity to the question of when and how quickly to tighten monetary policy in the face of a sizeable supply-side shock to the Eurozone economy. The March meeting, which was previously considered a potential turning point for the ECB's monetary stance, could now well prove to become a non-event.

Table 1: Forecast for Eurozone growth and inflation (%)

	ECB		Allianz Research					
	(as of Dec 21)		(as of Jan 22)		"Crisis Escalation"		"Black-out"	
	Real GDP	Inflation	Real GDP	Inflation	Baseline		Downside	
2022	4.2	3.2	3.8	3.8	3	5.3	2.2	6.3
2023	2.9	1.8	2.3	1.8	1.8	2.5	-1.2	4

Sources: ECB, Allianz Research

Figure 1: Economic uncertainty and sentiment
(index points)



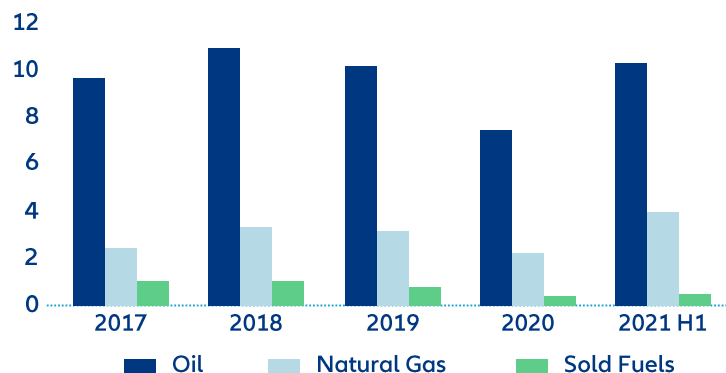
Sources: Refinitiv, Allianz Research

The ECB is increasingly caught between a rock (surging inflation) and a hard place (rising economic risks). On one hand, we expect the ECB to lower its growth forecast this year, given that there will be a negative economic impact from trade and financial sanctions even if Russia de-escalates the current conflict (Table 1). EU consumer confidence has already deteriorated and suggests real growth is bound to slow during the latter part of the year amid record-high policy uncertainty (Figure 1).

On the other hand, higher energy prices as well as continued supply-chain challenges are expected to drive up inflation (which is difficult to resolve via higher interest rates). In February, Eurozone inflation rose 0.7pp to 5.8% y/y, once again setting a record and exceeding consensus expectations (5.6%). While the increase was predominantly driven by higher core and energy inflation, which each added 0.3pp to the headline figure, the upside surprise relative to consensus expectations was due to a stronger-than-expected pick-up in core inflation (2.7% y/y, up from 2.3%), especially for goods. In the coming months, inflation will remain uncomfortably high and even rise further in the short-term – soon crossing the 6% mark - given the sharp increases in energy prices. As a reminder, in December, the ECB forecast that inflation would average 4.1% in Q1 – now we are looking at an average of close to 6%.

The war in Ukraine effects the Eurozone economy via three channels – confidence, trade and above all energy, which can pose significant headwinds to the post-Covid-19 recovery. Europe’s energy dependence on Russia represents the key risk driver to the inflation and growth outlook. Despite the small share of energy products in total imports, Russia accounts for more than one-third of the value of imported natural gas in the Eurozone (Figure 2). And even though gas represents only about 10% of final energy consumption, gas prices have a material impact, which is amplified by the central role of gas in electricity price-setting in Europe. In most countries, gas has become the marginal fuel in the energy sector. We estimate that a 30% increase of energy prices (oil & gas) will increase Eurozone headline inflation by 1pp and reduce growth by 0.5pp after one year.

Figure 2: Share of energy products in total EU imports (%)



Sources: Eurostat, Refinitiv, Allianz Research

We assess the possible economic impact and corresponding implications for the ECB’s monetary stance based on three scenarios¹ (see Figures 3-5):

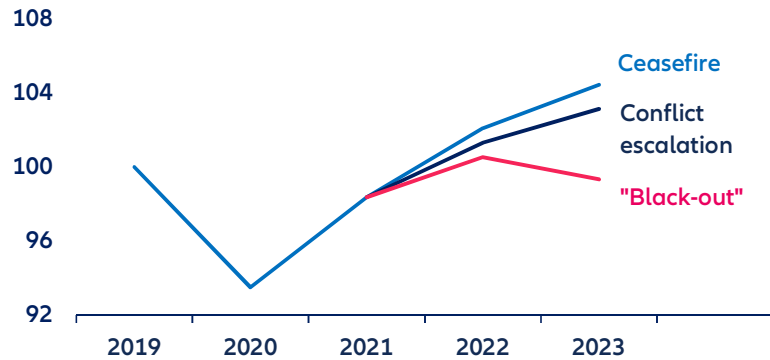
- In our **upside scenario** (“Ceasefire”, 5% probability)², we assume that an uneasy truce allows for a return to the negotiating table in search of a diplomatic solution. As economic sanctions remain largely in place and uncertainty continues to run high, trade disruptions and elevated energy prices will still result in slightly higher inflation and lower growth compared to our forecast prior to the invasion of Ukraine.
- In our **baseline scenario** (“Conflict Escalation”, 55% probability), we assume that the current crisis will continue to escalate, with capital flight intensifying FX pressures and corresponding capital controls (without Russian energy exports being materially affected). Rising energy prices will dampen aggregate demand in Europe (and to a lesser extent in the US) and further push up inflation despite cushioning fiscal policy measures. For the Eurozone, we forecast inflation at 5.3% y/y in 2022 (1pp higher compared to our January

¹ See our report [Russia-Ukraine Crisis: Conflict Escalation](#)

² Note that the scenario probabilities add up to 95%, excluding a 5% tail risk that is not modelled (e.g., military escalation with international involvement).

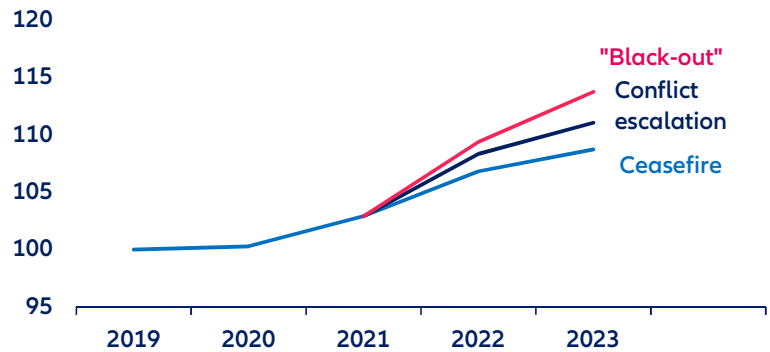
forecast) and at 2.5% y/y for 2023, reflecting higher food and energy inflation as well as higher expected feed-through from elevated producer prices to core goods. Eurozone growth is expected to decelerate to +3.0% in 2022 (a downward correction of 0.8pp) and stabilize at +1.8% (-0.5pp) next year.

Figure 3: Eurozone - Real GDP scenarios
(indexed, 2019=100)



Sources: Refinitiv, Allianz Research

Figure 4: Eurozone - Inflation scenarios
(indexed, 2019=100)

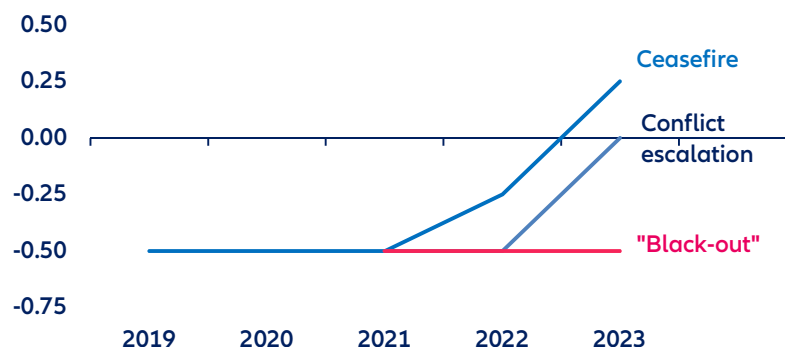


Sources: Refinitiv, Allianz Research

- In our **adverse scenario** ("Black-Out", 35% probability), we assume that the exclusion of energy trade with Russia from sanctions no longer applies (or, with similar effect, Russia decides to reduce its oil and gas to the West). The sharp energy-related supply side shock could see the Eurozone drift towards stagflation, which will then morph into a recession in H2 2022 as aggregate demand adjusts to higher energy prices. Fiscal policy support would be stepped up in this situation but would not prevent rising credit impairments. Inflation would average at 6.3% y/y in 2022 and 4.0% y/y in 2023 while growth would decelerate to +2.2% y/y this year before a contraction sets in next year (-1.2% y/y).

Figure 5: Eurozone - ECB policy rate scenarios

Deposit rate, in %

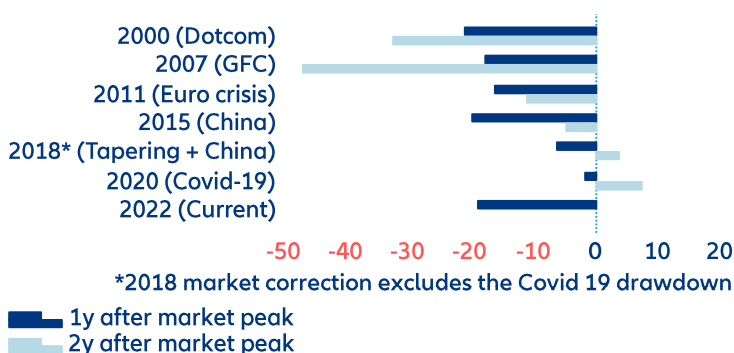


Sources: Refinitiv, Allianz Research

Higher uncertainty has resulted in a significant risk-off correction in global capital markets and rising safe haven flows. Expectations of continued monetary accommodation have reversed the upward trend of higher real rates and kept credit spreads range-bound. Nominal yields for German Bunds (10Y) have dropped and asset swap spreads are at their lowest levels since 2008, pointing to higher safe haven flows. Surging commodity prices (oil, gold) indicate rising uncertainty, amplified by concerns about supply constraints due to increasingly constricting trade sanctions imposed on Russia. At the same time, market expectations have shifted towards a higher probability of stagflation with a rising risk of recession. Real rates have declined on account of rising inflation expectations (and lower growth). Our decomposition of the 10Y Bund yields suggests that the implied short-term rate (as a proxy for expected growth) has declined while inflation expectations have picked up (but without de-anchoring). The recent equity market correction is consistent with past experience during recessions (Figure 6).

Figure 6: European equity market performance during crisis events (%)

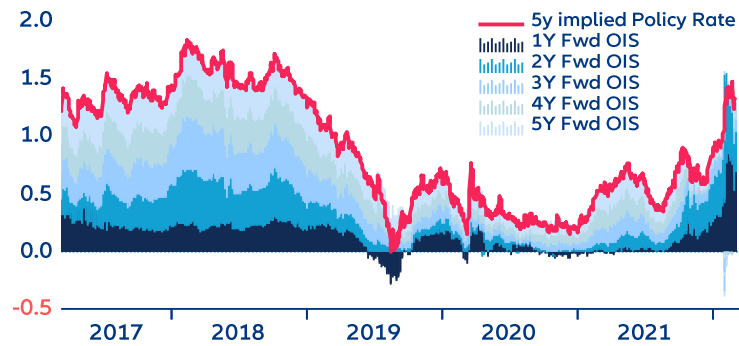
(since 2000)



Sources: Refinitiv, Allianz Research

Money markets are still pricing in some policy normalization, but the implied hiking cycle has become more shallow and short-lived. Over the last month, markets have priced out four rate hikes and now expect five to six hikes of 10bps each with the next 12 months. Interestingly, almost no term structure is emerging in the forward market as the whole hiking cycle is frontloaded within the next 24 months (Figure 7). Looking ahead to the upcoming ECB meetings, a critical factor will be whether further hikes are now priced out and/or whether the hikes move backwards in the term structure. The latter would be a sign of increased uncertainty about the interest rate path without, however, calling the hiking scenario completely into question for now.

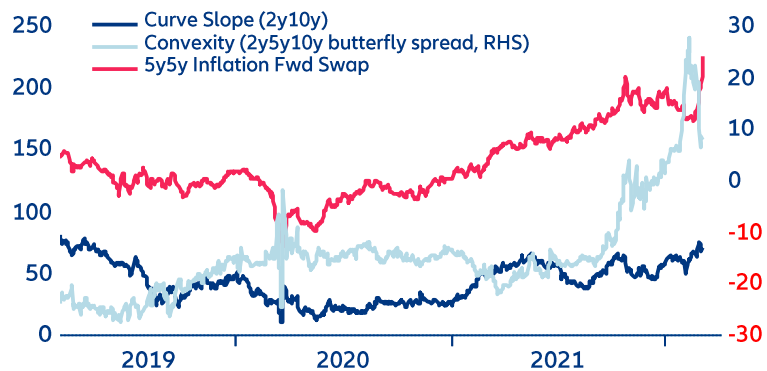
Figure 7: Decomposition of the implied policy rate path
(overnight index swap (OIS) vs. deposit rate)



Sources: Refinitiv, Allianz Research

Bond markets have started painting a gloomier picture. The predominant narrative is shifting away from a quick recovery flanked by monetary policy normalization to an increasing concern that the tipping point where higher input prices (energy) will start to significantly squeeze aggregate demand will soon be reached. This move towards our adverse scenario is shown by the collapse of the 5y versus the long and short end of the EUR swap curve while the slope is increasing due to falling short-term rates (“bull-steepening”, see Figure 8).

Figure 8: German government bond yields (curve steepness and convexity) vs. Eurozone market-based inflation expectations (%)



Sources: Refinitiv, Allianz Research

What does this mean for the ECB's monetary stance? Despite the further expected pick-up in inflation, the ECB will likely prefer to err on the dovish side and opt for a slower normalization pace. Even though Eurozone inflation has risen more than expected, and above-target rates look set to prove stickier than previously anticipated. However, we still see little evidence of second-round effects in Europe as inflation expectations remain largely anchored, and labor market slack should keep upward pressure on wages, and in turn core inflation, in check over the medium term. Thus, the ECB's lift-off conditions are unlikely to be met this year – leaving aside a positive development in Ukraine (with positive knock-on effects on the oil and gas supply to Europe).

Maintaining as much policy flexibility and optionality as possible will remain essential at a time when growth seems to be slowing and effective forward guidance is complicated by volatile capital markets and a difficult external environment. We believe that the ECB will remain in a wait-and-see mode, especially after having been challenged by market expectations on its monetary stance in the face of soaring inflation not too long ago. Under current (baseline) conditions, the ECB is unlikely to pre-commit to either a notably lower pace of asset purchases in Q2 or an end of asset purchases by the end of the year. Nevertheless, PEPP will be retired.

We expect the Governing Council to agree on maintaining a dovish stance as growth concerns and tightening financial conditions will weigh heavier than inflation fears. The ECB will slow its policy normalization plans, with QE continuing throughout 2022 to backstop a more expansive fiscal policy. A first rate hike will take place only in Q1 2023 (previously expected in December).³ In this situation, a soft landing on rates will not derail the economic recovery and overhaul markets. Despite significant negative real interest rates, growth will not be hampered and an asset crash will be avoided (Annex I).

While the March meeting is likely to be a non-event, the next policy meeting might provide an opportunity to reassess the monetary stance if the baseline scenario no longer applies:

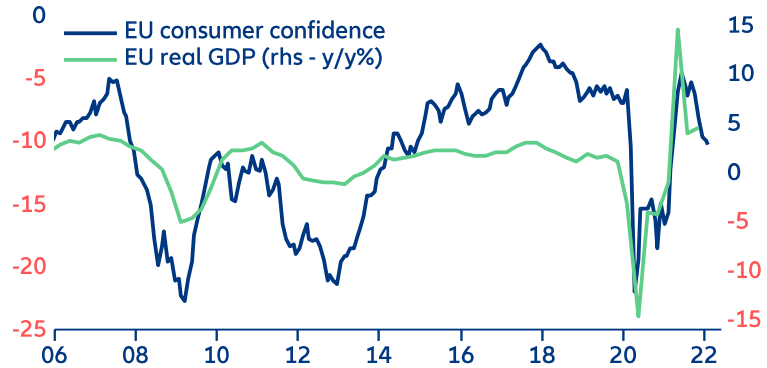
- In our *upside scenario*, the ECB might choose to be preemptive if inflationary pressures become entrenched. The ECB could end its asset purchases in September, which would open the door for a first rate hike in December and two additional increases during the first half of 2023. If the recovery remains on track and labor market dynamics strengthen further, the tapering timing and speed could surprise on the earlier and swifter side.
- In our *adverse scenario*, a surge in energy prices would not only trigger a much higher inflation overshoot but also morph into a recession. In this situation, the ECB would shelve its policy normalization plans altogether and provide general aggregate demand support to effectively counter a significant contraction of economic activity and mitigate financial stability risks.

³ Note that safe haven flows have been strong, which has contributed to a steepening of the curve and reduces the effectiveness of forward guidance if the ECB were to hike soon.

The following factors could trigger a more dovish monetary stance in the context of our adverse scenario:

- *Deteriorating economic prospects.* The ECB will be sure to keep a close eye on the economic recovery momentum. Any sign of a marked deterioration in consumer sentiment would justify a further delay in the ECB's policy normalization plans (Figure 9).

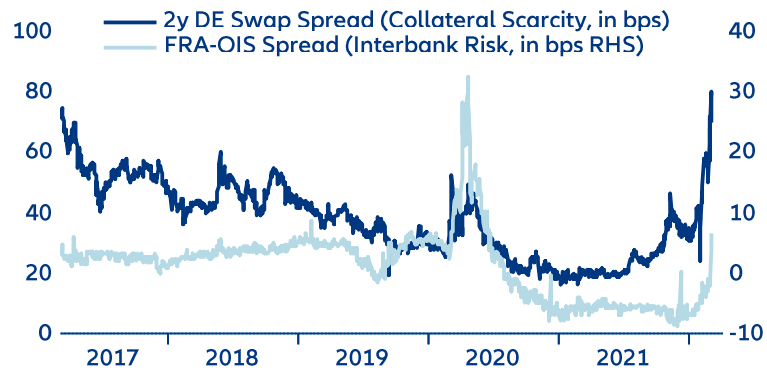
Figure 9: EU consumer confidence (lhs) vs. EU real GDP (rhs) (y/y, %)



Sources: Refinitiv, Allianz Research

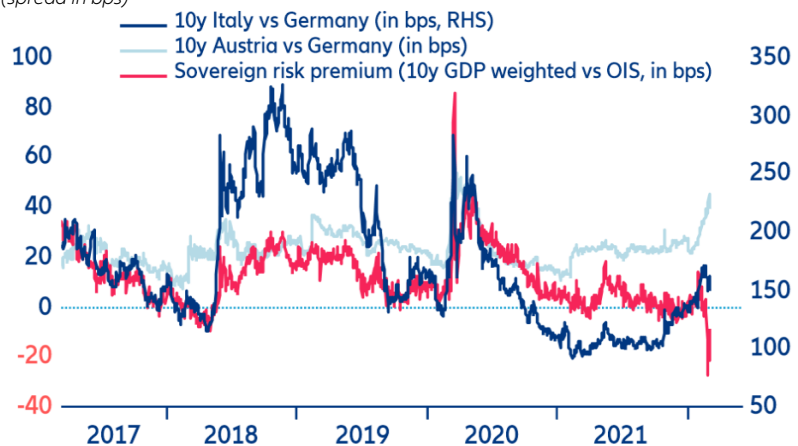
- *Tightening of financing conditions.* The recent market volatility has exposed liquidity and funding risks. Despite high excess liquidity, the FRA-OIS, a proxy for the stress in the interbank market, has recently risen significantly. While we are still far away from the systemic stress levels of previous crisis, the dynamic of the increase is alarming. The funding stress also shows up in the asset swap spread for German government bonds. These have shot up, especially for short maturities, as strong demand for safe collateral meets scarce supply. In view of its financial stability mandate, the ECB will keep a close eye on this (Figure 10). We see the greatest risks not directly in the interbank market but through spillover effects from satellite activities (leveraged loans, commodity finance, prime broker business).

Figure 10: Liquidity and funding conditions
(spread in bps)



Sources: Refinitiv, Allianz Research

Figure 11: Eurozone sovereign credit spread and risk premium
(spread in bps)



Sources: Refinitiv, Allianz Research. Note: the sovereign risk premium refers to only "AAA"-rated member countries of the Eurozone.

- Market fragmentation.* So far, the attack on Ukraine has led to a surprising convergence of Eurozone sovereign spreads. Core economies with lower internal and external imbalances saw widening spreads (e.g. Austria) against German Bund yields while spreads of more vulnerable countries benefited from the expectation of potentially more debt mutualization in the Eurozone (if the situation were to deteriorate significantly) and higher expectations for an extension of the ECB's asset purchase program. The Eurzone sovereign risk premium (GDP weighted 10y Eurozone yield vs. 10y OIS) reached the most negative value since the run-up to the 2008 global financial crisis. A negative risk premium implies that instead of receiving a risk premium over the risk-free OIS, investors are prepared to pay a safety premium for holding Eurozone sovereign debt. This development shows two things: (i) strong flight to quality and (ii) higher counterparty risk in the swap market as the impact of the attack on Ukraine on the European financial sector is yet uncertain (Figure 11).

However, our upside scenario could lead to a more hawkish monetary stance to prevent higher inflation from becoming embedded in the economy and avert external imbalances:

- *De-anchoring of inflation expectations.* Supply constraints on gas and oil (triggered by the attack on Ukraine), together with persistent supply-chain disruptions, could yet combine to strain confidence in low inflation and could push up long-term inflation expectations. While the ECB would look through negative shocks from higher energy prices—because they are either temporary, or, even when permanent, they imply higher aggregate prices rather than rising inflation—it might nevertheless act to prevent higher inflation from becoming embedded (as workers and firms start raising prices and wages on the assumption that everyone else will be doing so).
- *Broadening of inflationary pressures.* So far, drivers of rising headline inflation have been concentrated in the sectors and goods most affected by higher energy prices and supply-chain disruptions. However, if price pressures become more broad-based (as seen in the US), it would call for a swifter reining in of the ECB’s supportive policy stance.
- *Intensifying wage pressures.* Wage growth has so far been consistent with previous bargaining rounds and current union agreements have been relatively modest, focused on one-off pandemic payments instead of permanent income increases. However, current German wage negotiations could be a harbinger of accelerating wage dynamics if the labor market tightens further and pandemic as well as geopolitical uncertainty abates.
- *Exchange rate and spillover effects.* Rising real rates in the US affect financing conditions in Europe through the exchange rate channel as the euro depreciates and the price of tradable goods increases, raising overall inflation. Even though the semi-elasticity of inflation to the FX rate is small in the Eurozone, this situation would nevertheless put pressure on the ECB to act earlier rather than later.

Annex I: Capital Market Implications

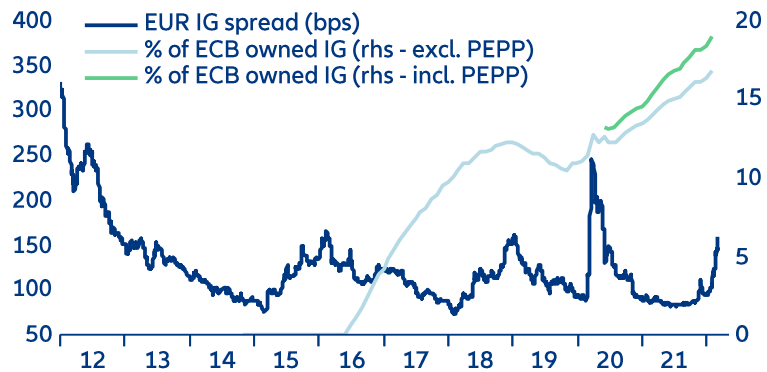
Will the ECB's implicit corporate credit put protection work this time?

We expect that stabilizing real rates and higher inflation will still be supportive for corporate earnings growth while long-term nominal rates remain contained by safe haven flows. This should also slow current spread widening, with investment grade corporate spreads reverting back to 120bps by the end of the year.

The timely and sizeable monetary stimulus in response to Covid-19 kept risky assets on a leash, limiting both credit and equity risk deterioration.

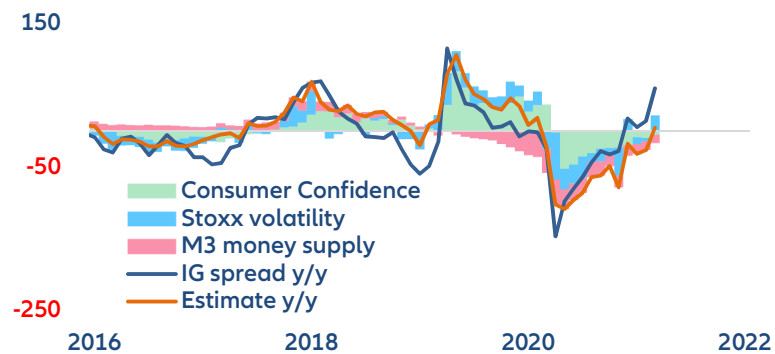
The ECB's additional corporate bond purchases further compressed spreads and suppressed equity market volatility (Figure A1). Our macro-driven spread decomposition framework shows that the combination of accelerating money supply and declining equity volatility managed to compensate and even reverse the credit risk repricing triggered by deteriorating economic sentiment (Figure A2). However, the ECB's direct effect on risk premia has been diminishing over time.

Figure A1: ECB corporate bond ownership



Sources: Refinitiv, Allianz Research

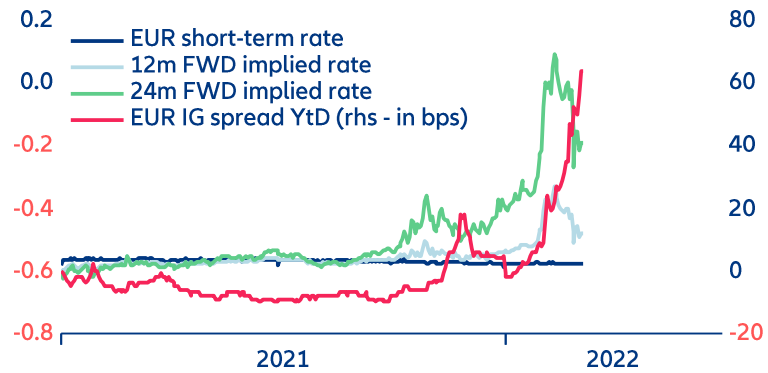
Figure A2: EUR IG corporate spread decomposition (basis points)



Sources: Refinitiv, Allianz Research

However, the rapid repricing of monetary policy expectations in late 2021 and early 2022 weakened the ECB's implicit policy anchor for corporate spreads and synchronized spread movements with the repricing of monetary policy. The hawkish lean led to a rapid repricing by +20bps for EUR investment grade spreads (Figure A3).

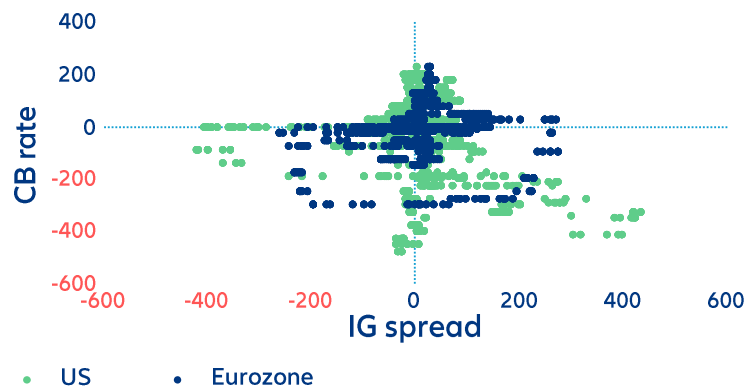
Figure A3: EUR investment grade corporate spreads vs monetary policy expectations (%)



Sources: Refinitiv, Allianz Research

Historically, higher policy rates in Europe tend to be associated with a widening of investment grade corporate spreads. This can be observed in the relatively high concentration of observations in the first quadrant (increasing rates + widening spreads) of Figure A4 and the relative emptiness of the second quadrant (increasing rates + compressing spreads). Interestingly, the US corporate market does not exhibit the same pattern, with spread movements in hiking periods being equally distributed between the first and second quadrant.

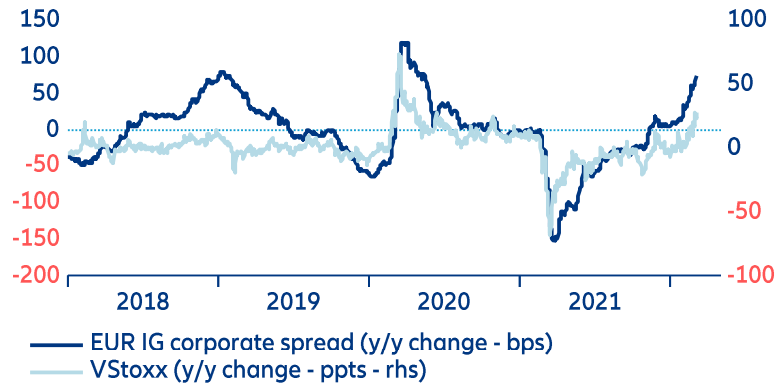
Figure A4: Investment grade corporate spreads vs. central bank (CB) policy rates (y/y change, basis points)



Sources: Refinitiv, Allianz Research

In light of the current market correction, credit risk pricing dynamics are now being mainly driven by equity volatility (Figure A5). This has translated into a +60bps and +160bps year-to-date spread widening for EUR investment grade and high yield, respectively.

Figure A5: EUR investment grade corporate spreads vs. equity volatility



Sources: Refinitiv, Allianz Research

Going forward, we expect the ECB's market-making power to remain strong and to substantially impact market pricing dynamics:

- In the *baseline scenario*, and assuming a "less dovish" ECB, we expect the current corporate spread-widening to slow and even revert as markets keep repricing extended monetary and fiscal policy support. Translating this into numbers, we expect EUR investment grade spreads to peak close to ~160bps but to revert back to 120-130bps by the end of 2022. At the same time, we expect EUR high yield spreads to briefly visit the ~470-480bps level, converging back to 400-420bps towards year-end.
- In the *adverse scenario*, should markets continue tilting towards a stagflation and recessionary scenario, we would expect corporate credit spreads to significantly widen, reaching 260bps and 670bps for EUR investment grade and high yield, respectively. This would mainly be driven by exacerbated equity volatility and deteriorating economic conditions. We would expect a slow reversal from the initial max widening, finishing 2022 with spreads close to 180 bps and 650 bps for investment grade and high-yield corporates, respectively.

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

FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

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