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Amundi ASSET MANAGEMENT

INVESTMENT TALKS

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ECB meeting: larger-than-expected rate hike, with new fragmentation tool outlined

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- ***July meeting***: *The ECB hiked its three key interest rates by 50bp for the first time in more than a decade, **bringing its rates out of negative territory**. The interest rates on the main refinancing operations, the marginal lending facility and the deposit facility will be increased to 0.50%, 0.75%, and 0.00%, respectively, with effect from 27 July.*
- ***A bold move:*** *The move was bolder than markets anticipated and more than the ECB itself had hinted at previously, basically putting a de facto end to forward guidance. **The bolder-than-expected move was aimed at tackling inflation.** The ECB also announced details of its new anti-fragmentation tool, the **Transmission Protection Instrument (TPI)**. This will be a new addition to the ECB's toolkit, one which can be activated to counter **unwarranted** and **disorderly market dynamics** that pose a serious threat to monetary policy transmission across the Eurozone. By safeguarding the transmission mechanism, the TPI will allow the ECB to normalise its monetary policy faster if needed. Purchases under the TPI programme will be carried out if markets become dysfunctional and prices detach from economic fundamentals.*
- ***TPI elegilibility***: *Sovereign bonds will be eligible for TPI purchases, while private sector securities could also be considered, if appropriate. **For sovereign bonds, the conditions for eligibility are strict. The issuer country will be required to pursue sound and sustainable fiscal and macroeconomic policies**, as well as being compliant with the EU's fiscal framework. The country will also be required to comply with the Recovery and Resilience Facility (RRF). Maturities will range from one year to 10 years. The TPI will be activated based on a comprehensive assessment of market and transmission indicators, an evaluation of eligibility criteria and a judgement that the activation of TPI is proportionate to the achievement of the ECB's primary goal. Purchases will be terminated either upon a durable improvement in transmission or based on an assessment that persistent tensions are due to country fundamentals. Sterilisation of purchases was not mentioned explicitily, but they should not have a persistent impact on the ECB's balance sheet. The Outright Monetary Transactions programme (OMT) will remain available for countries that require it.*
- ***Investment implications in fixed income and FX markets***: *The ECB has started a rate normalisation cycle against a very difficult macroeconomic backdrop. **Markets are pricing in an equilibrium rate of 1-2% in the long term.** Given the deteriorating economic and political conditions, markets should target the lower range of 0.75-1.00%. However, the picture is not completely negative. The euro's depreciation could aid the recovery of certain sectors such as tourism, as well as boosting exports. **Despite some volatility, we are beginning to see value in the bond market**. Overall, the valuations of euro fixed income assets are becoming attractive, following an unprecedented repricing in H1 2022. The new TPI tool is aimed at preventing financial inequalities among Eurozone countries and should allow homogenous access to financial conditions across the region.*
- ***On the EURUSD exchange rate***, *hawkish expectations over the ECB and the prospects of a resumption of the Nordstream gas flow to Europe have unwound part of the risk premium attached to the EURUSD exchange rate this week. However, neither element will be enough to support a structural rally, in our view. Whenever global growth is at stake, the USD's safe-haven status tends to be the dominant market driver and we expect this to remain the case as long as the Fed stays hawkish. We deem a dovish turn from the Feb as unlikely in the short term and keep a negative asymmetry for the EURUSD in H2 2022.*

What is your take on the July ECB meeting and what could the next steps be?

At its July meeting, the ECB hiked its three key interest rates by 50bp for the first time in more than a decade, bringing its rates out of negative territory. Hence, the interest rates on the main refinancing operations, the marginal lending facility and the deposit facility will be increased to

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"The TPI is a new addition to the ECB's toolkit, one which can be activated to counter unwarranted and disorderly market dynamics that pose a serious threat to monetary policy transmission across the Eurozone."

0.50%, 0.75%, and 0.00%, respectively, with effect from 27 July 2022. The move was bolder than markets anticipated and more than the ECB itself had hinted at previously, basically putting a de facto end to forward guidance. The bolder-than-expected move was aimed at tackling inflation.

What is your view on the announcement of the new anti-fragmentation tool called TPI?
The 50bp rate hike was only possible if the ECB was also prepared to fight the financial fragmentation that monetary normalisation could generate. It is therefore essential to understand what the ECB intends to do with this new programme.

The TPI will be a new addition to the ECB's toolkit, one which can be activated to counter **unwarranted** and **disorderly** market dynamics that pose a serious threat to monetary policy transmission across the Eurozone. Maturities will range from one year to 10 years (like the SMP), and won't be restricted ex-ante. **By safeguarding the transmission mechanism, the TPI will allow the ECB to normalise its monetary policy faster if needed**. It is important to understand that purchases under the TPI programme will be carried out only if markets become dysfunctional and prices detatch from economic fundamentals. This means that **the ECB will be reactive and not pre-emptive**.

This programme has some similarities with the SMP programme set up at the beginning of the sovereign debt crisis in 2010 (see box). Sovereign bonds will be eligible for TPI purchases, while private sector securities may also be considered, if appropriate (as with the SMP). That said, **the implementation of the TPI is subject to stricter conditionality**. For sovereign bonds, the issuer country will be required to pursue sound and sustainable fiscal and macroeconomic policies, as well as being compliant with the EU fiscal framework. Countries will also be required to comply with the Recovery and Resilience Facility (RRF). Since it has no democratic legitimacy to constrain fiscal policy, the ECB will make its interventions conditional on compliance with commitments made within a legal framework and negotiated with the European Commission. Thus, there will be no moral hazard. Interestingly, the ECB also refers to an analysis on debt sustainability, which will take into account the analysis of the IMF and the ESM. These conditions may foreshadow the upcoming fiscal framework that is currently being negotiated between EU member states.

The TPI will be activated based on a comprehensive assessment of market and transmission indicators, an evaluation of eligibility criteria and a judgement that the activation of TPI is proportionate to the achievement of the ECB's primary goal. Purchases will be terminated either upon a durable improvement in transmission or based on an assessment that persistent tensions are due to country fundamentals.

BOX: ECB's Securities Markets Programme (SMP)

10 May 2010 - 6 Sep 2012 (replaced by OMT)

Primary goal	Restore financial market liquidity
Purchases totalled	€218bn, half of which was Italian bonds
Announcement	The ECB did not announce key features of the SMP during its announcement (securities targeted, amount, duration)
Target bonds	Bonds with maturities of two to 10 years, with both public and private securities eligible
Impact on monetary policy	Designed to have no impact on monetary policy
Sterilisation	Asset purchases were fully sterilised (no impact on CB liquidity); banks that received cash in exchange for securities had to engage in weekly liquidity-absorbing operations and keep the cash in fixed-term deposits

Source: Amundi Institute.

"This programme does not protect against market tensions that may arise in the coming weeks or months."

In short, this means that the TPI will not be activated if the ECB judges that it is primarily domestic economic policy developments that are causing spreads to rise. In the end, the ECB's Governing Council alone will be responsible for deciding whether the conditions are met. In practice, this means that no country will have a veto.

That said, the bar is probably quite high for the TPI to be activated. Therefore, this programme will not protect against market tensions that may arise in the coming weeks or months. The ECB probably hopes that the announcement of the TPI will be sufficient to anchor expectations, and that it will not have to be implemented (as was the case with the OMT). But we believe that in the current environment, sooner or later markets will want to test the ECB's commitment to fighting financial fragmentation. The OMT is still available for countries that require it (with very strict conditionality).

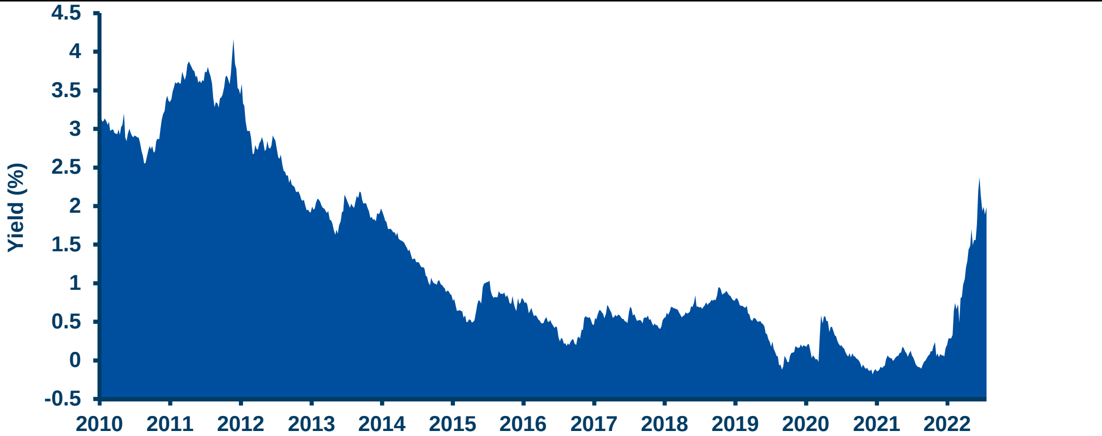
Surprisingly, the ECB has not detailed the sterilisation operations. Sterilisation of purchases was not mentioned explicitly, only implicitly as bond purchases should not have a persistent impact on the ECB's balance sheet. **The ECB will have to specify the modalities that would allow it to absorb the liquidity created through its purchases**. It is possible that it will decide to innovate in this area by opening the door to the sale of assets that are on its balance sheet and not under pressure. The ECB may face technical problems with sterilisation. Without sterilisation, the TPI would not be compatible with further monetary normalisation.

What is your view on euro fixed income in light of the recent ECB move? What is currently priced in by the market and what are your expectations?

"Despite volatility, value has been restored in Euro fixed income markets after the great repricing in H1 2022."

The ECB has just started a rate normalisation cycle against a very difficult macroeconomic backdrop. This first hike is larger than most participants were expecting and larger than the rate normalisation path signalled by the ECB at its previous meeting. This decision shows an updated macro reassessment by the ECB, with inflation at unprecedented levels, i.e., 8.6% in June. In addition, price momentum is expected to stay strong amid the Russia-Ukraine war and its fallout on energy affordability. Inflation is already affecting confidence and the leeway of private agents across the Eurozone. For individuals, disposable incomes are being squeezed and for corporates, the higher input costs and elevated uncertainties are reducing investment activity. **In this context, markets are showing decent expectations despite the vague ECB guidance. They are currently pricing in an equilibrium rate of 1-2% in the long term.** Given the deteriorating economic and political outlook, markets should target the lower range, i.e., 0.75-1.00%. However, the picture is not completely negative. The euro's depreciation against the dollar could aid the recovery of certain sectors such as tourism, and help it gain market share thanks to exports. This final point hinges on the ability of the Eurozone and its corporates to maintain production capabilities. Despite some volatility, we are beginning to see value in the bond market. **Overall, the valuations of euro fixed income assets are becoming attractive again, following an unprecedented repricing in H1 2022.** The unexpected 50bp hike did not have a specific impact on credit markets, which remained stable across segments and sectors after Christine Lagarde's speech. Moves on Italy-related issuers owe more to the Italian situation than to today's announcement.

Euro aggregate yield repricing



Source: Amundi Institute, Bloomberg. Data is as of 21 July 2022.

Do you think that the TPI will be successful in avoiding fragmentation in the government bond market?

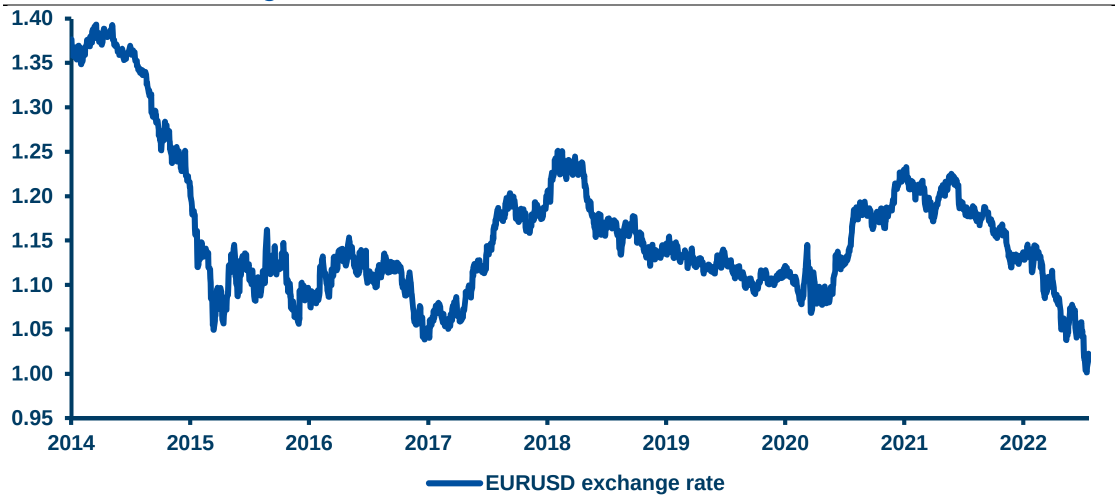
In its previous communication, the ECB surprised with its strong commitment and weak technical details related to the implementation of its anti-fragmentation tool, the TPI. This week's ECB bank lending survey pointed to a significant tightening in credit conditions. The new anti-fragmentation tool announced by the ECB is aimed at preventing financial inequalities across Eurozone countries and ensuring effective monetary policy transmission. The TPI is a new tool allowing the ECB to enhance its flexibility. While the reinvestments of the pandemic emergency purchase programme (PEPP) remain "the first line of defence to counter risks to the transmission mechanism related to the pandemic", the new tool will be "activated to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area". Focused on sovereign debt, this tool can be activated upon a Governing Council decision, bearing in mind some conditionality related to a country's compliance with the European framework. **Being unanimously adopted, the TPI seems sufficiently powerful and discretionary to fulfil its anti-fragmentation role.**

"The correlation between monetary policies and exchange rates dropped significantly in Q2 2022, with most hawkish surprises failing to push up currencies lately; the ECB should make no exception on this front."

Could the recent ECB move support the euro's rebound against the dollar?

Hawkish expectations over the ECB and the prospects of a resumption of Nordstream gas flow to Europe have unwound part of the risk premium attached to the EURUSD exchange rate this week. However, neither element will be enough to support a structural rally from current levels, in our view. The **correlation between monetary policies and exchange rates dropped significantly in Q2 2022, with most hawkish surprises failing to push up currencies lately. The ECB should make no exception on this front and worsening domestic conditions should prevent a quick catch-up relative to peers.** We see the Eurozone's loss of productivity (as measured by the CPI-PPI differential) as unprecedented and we expect the currency to absorb part of the shock. Moreover, whenever global growth is at stake, the USD's safe-haven status tends to be the dominant market driver and we expect this to remain the case as long as the Fed stays hawkish. We deem a dovish turn from the Fed as unlikely in the short term and keep a negative asymmetry for the EURUSD in H2 2022.

Euro-dollar exchange rate



Source: Amundi Institute, Bloomberg. Data is as of 21 July 2022.

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Definitions

- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **PEPP:** Pandemic emergency purchase programme.

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