Wide Angle Shot: Monetary policy on "new" conventional paths in 2022/23?

Raiffeisen RESEARCH

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Inflationary pressure should ease in the US in 2022, not so inside the euro area. The more stubborn inflation remains, the more central banks have to take their inflation fighting mandate seriously. We see autumn 2022 as decisive here because long-term effects in price trends will become more visible here. This could also impact on ECB's monetary policy going forward. Contrary to ECB the Fed already sees a different medium-term inflation trend around the corner.

Inflation from "temporary" to long-term global trend

In 2021, COVID-19 was still in the foreground for politics and society, but solid inflationary upside pressure has gained in relevance. For markets and central banks, inflation risks are increasingly becoming the potential (long-term) game changer. A good year ago, almost all major central banks still used the term **"transitory"**. But by the **middle of 2021**, the **Fed** already adopted a **more cautious approach**. The ECB, on the other hand, stubbornly stuck to its "temporary" assessment until Q4 2021. In September, this stance was still reflected in a HICP projection for 2022 of lowish 1.7% and meagre 1.6% for 2023. Since autumn 2021, the Fed has dropped the vocabulary of "transitory". Especially since the very last meeting of the Federal Open Market Committee (FOMC) in 2021 mid-December, fighting inflation has been the primary goal of US monetary policy. This is despite the fact that the Fed, unlike the ECB, has a dual mandate (price stability plus full employment). That said, the Fed's latest medium- and long-term projections show no sign of temporary price pressures. References to a global low-inflation environment driven by long-term global trends are also less and less to be found in statements by Fed officials.

Inflation forecasts major central banks (Dec 2021)

	2021	2022	2023	2024
Federal Reserve	5.3	2.6	2.3	2.1
European Central Bank	2.6	3.2	1.8	1.8

Fed, ECB, RBI/Raiffeisen Research

Fed: Priority for fighting inflation

After inflation topping 5% on average in 2021, the Fed forecasts inflation to gradually approach the central bank target of 2% in 2022 (+2.6%) and 2023 (+2.3%) through 2024 (+2.1%) — but from upside. Many market players rather expect inflation above 3% in the US in 2022. The outlook of **4 (!) years** of **inflation hovering above** the **inflation target** prompted the Fed to act. And it did so earlier than skeptics had thought. Fed Chairman Powell's communication is crystal clear nowadays: the **increased inflation** is a **threat** to the goal of **full employment**. This means that the monetary policy course for 2022 is currently set for rapid normalization on all fronts. COVID-19-related emergency measures, such as the extensive fourth Quantitative Easing from March 2020 and the

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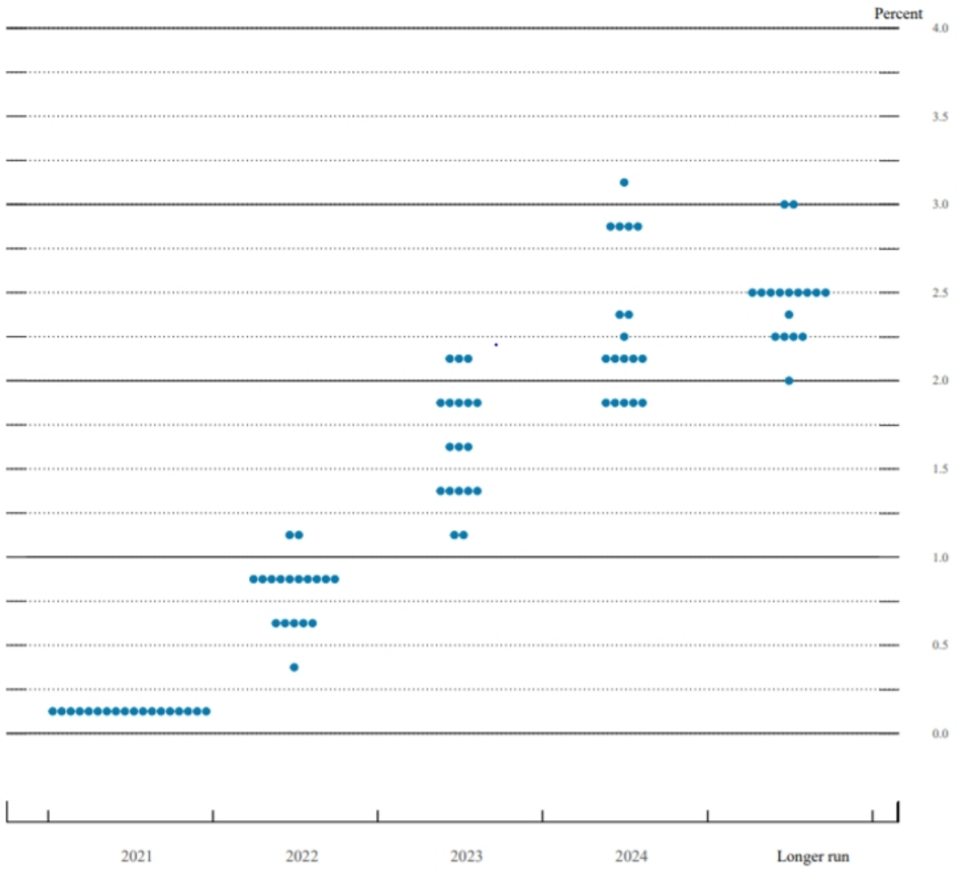
return to zero interest rates, are to be ended as quickly as possible. If USD 120 bn of bond purchases were still on the Fed's asset purchase agenda every month until October 2021, the last net purchases will probably take place in March 2022. Then interest rate hikes are looming. Currently, FOMC members expect three rate hikes in 2022. We see potential for four steps and these may well go beyond small steps of 25 basis points in H2 2022.

FOMC Member Projections for the Federal Funds Rate



Fed, RBI/Raiffeisen Research

Financial markets more cautious since FOMC minutes

Initially, markets reacted in a **measured way** to the **Fed's U-turn**. Initial interest rate hikes are often not poison for (stock) markets. For some time established stock markets have continued their record chase, US yields have remained stable. Only the publication of the last FOMC minutes in Jan 2022 caused more market shifts due to **talk of (swift) balance sheet contraction** by the US Fed soon after initial rate hikes. A termination of full reinvestment of maturing bonds on Fed's balance sheet could take place as early as H2 2022. This holds true although in the past such tightening came much later after initial hikes and was discussed for longer. This time around there was still no mention of such a move at the press conference after the FOMC meeting mid-December 2021.

Such a tightening would be a significant change for financial markets. On the one hand, **liquidity** would again **be withdrawn** from the financial sector, and on the other hand, in view of the rapid changes in the US Federal Reserve's wording, it is clear that **central bank action** is evidently **becoming more short-term oriented** and **data-driven**. Ideas of a longer-term market steering and expectation management as a central component of unconventional monetary policy ("forward guidance") are losing importance. In fact, this is a return to normality. Given the complexity of central banking it is appropriate to maintain such flexibility. Particularly since inflation drivers that already posed upside risks to price developments in 2021 currently point to no material relief on this front in 2022.

Ultimately, **Fed's behavior** is also **rational** from a **broader market perspective**, as with timely intervention in times of mounting inflation risks, fixed-income investors trust it to **succeed in fighting inflation.** Thus, **increases** in **long-term yields** — central to debt sustainability — should be **manageable** in the medium- to long-term. Moreover, inflation rates of more than 4-5% have historically been met with poor performance in equity markets.

US administration cautious on interest rate hikes - rise in yields not to be overestimated

However, interest rate risks at the long end should not be overrated in the USA for other reasons either. **USTs** still carry the **most attractive medium-** and **longer-term risk/ return ratios among global "safe assets"**. Even 10-year Greek government bonds (no safe asset!) yield meager 1.6%, less than USTs of the same maturity (1.85%), in light of the substantial dampening effects of the ECB on long-term European interest rates. For euro-based investors, US Treasuries are currently even yielding a positive currency-hedged return.

Interestingly, **no negative "noise"** about **Fed's change** of **monetary policy course** have been heard from the **Biden administration**. Treasury Secretary Janet Yellen — in the dovish camp as a Fed decision-maker — welcomed rate hikes six months ago as a signal for recovery and inflation fighting. But as finance minister, she has a vested interest in keeping long-term capital market interest rates lowish — while consistently fighting inflation. Another political background is also essential here: In Nov 2022, mid-term elections (Senate, House of Representatives) will take place. The Biden administration would be at a clear disadvantage if inflation remains stubbornly high. Traditionally, elevated price pressure is a burden on Democratic voters.

Fed: Full employment as a control variable for interest rate hikes - bond sales in the 2nd half of 2022?

Which **factors** will **shape** the **pace of the Fed's exit from expansionary monetary policy** going forward? According to the FOMC's assessment, full employment should be reached in the course of 2022 and maintained in 2023 and 2024. The targeted and estimated unemployment rate of 3.5% by the end of 2024 expresses this. If the employment rates of disadvantaged social strata and ethnic groups (e.g. focus on blacks and Hispanics) can also increase, then fighting inflation will be given absolute priority in the trade-off. This is because high inflation in the longer term endangers employment. A wage-price spiral would weaken the labour market and the purchasing power of workers.

ECB: Still with completely different monetary policy communication

Contrary to the Fed, **ECB** has **communicated** a **much less activist monetary policy stance** for **2022**. Similar to the Fed, COVID-19 risks to the economy are not taking prominent role in its monetary outlook argumentation. But unlike the Fed, **ECB still sees** rather **below-average price growth** in the **medium to longer term** inside the euro area. It may have set a first drumbeat with its HICP forecast revision from 1.7% to 3.2% for 2022 in December, but that is not yet enough for it to quickly exit from its ultra expansionary monetary policy. The **inflation projections** for **2023** and **2024** are still a touch below the 2% target at 1.8% each. Christine Lagarde has also made it clear so far that the ECB's medium-term target has not yet been reached: "1.8 % is not 2.0 %!"; a quote from 16.12.2021 in response to the question: "At 1.8%, the ECB's inflation target is as good as met, isn't it?"

Broad spectrum of opinions in the Governing Council, ECB wording becomes more cautious and multi-layered

However, the **spectrum of opinions** is currently **extremely broad** within the **ECB Governing Council** when it comes to the inflation outlook. This can be seen in the various statements. There are voices that are already talking about a key rate hike before the end of QE. Others are calling for more flexibility in reduced bond-buying, and others do want to stick with the status quo for as long as possible. Heterogeneity across many dimensions inside the euro area makes it difficult to communicate as clearly as at the Fed: "[...] unlike to raise interest rates in 2022, but tentative what data will tell us!" said Christine Lagarde in December 2021, clearly intentionally ambiguous.

A few days after the ECB Governing Council meeting in December, relevant **statements** by **ECB officials** have been issued, which, depending on how they are interpreted, partly contradict ECB's pre-commitment for 2022 (and beyond?). "We are well aware of the uncertainty in our inflation forecasts. There is an upside risk," said Isabel Schnabel. "We should take a risk management approach so that we can react quickly if there are signs that inflation is persistently above our two per cent target." Opinions could not be much further apart on the ECB's governing council. The moderate Slovak central bank chief summarised that if ECB's inflation forecasts for 2023 and 2024 do not hold, "the ECB will have to act". There is a "not small risk" of such err, the Slovak central banker said.

Euro area: Raiffeisen Research inflation forecasts

HCPI (% yoy, averages)	2020	2021	2022f	2023f
Euro area	0.3	2.6	3.6	1.6
Core inflation (excl. food & energy)	0.7	1.5	2.3	1.9**

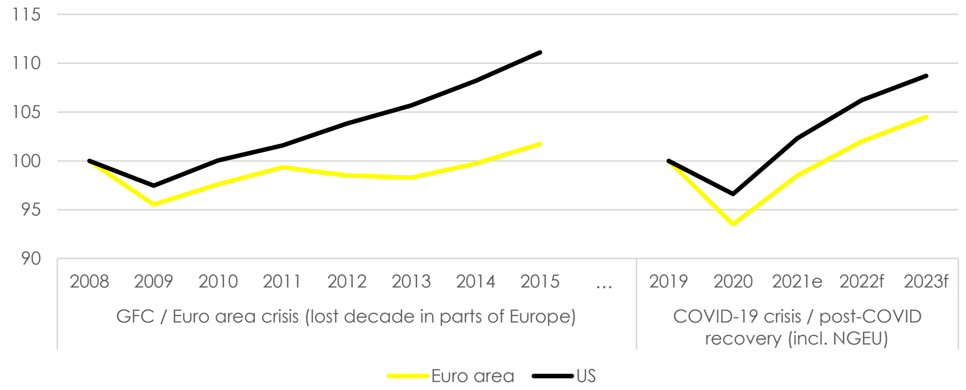
Eurostat, RBI/Raiffeisen Research

*** Year-end value 2.0%*

To what extent does the upward pressure on prices diminish?

The ECB will now closely analyse, especially at the beginning of 2022, how much base effectds will ease the up-pressure on the Harmonised Consumer Price Increase inside the euro area in Jan. Dampening effects of more than one percentage point must be clearly noticeable from Germany. But due to the stubbornness of energy and commodity prices, inflationary impulses are likely to continue to emanate from this important price segment. Further statistical relief would then only be likely in H2 2022. A **decisive factor** for the **ECB's monetary policy stance** will be the **level from which the HICP inflation rate enters months of autumn**. If "inflation remains more stubbornly above target than thought" (ECB chief economist Lane January 7, 2022), then a new ECB HICP forecast for 2023 will be due in September. But even if the ECB does not raise its inflation forecasts until the December 2022 Council meeting, financial market could demand a clear positioning late autumn 2022. Moreover, there could be an increasing number of voices calling for decisive monetary policy reactions from the ECB as early as late 2022, no later than 2023. In this respect, the ECB will probably have to come clean in 2022 about its position on QE, an end to negative interest rates and the primacy of price stability.

Euro area: Expansion closer to US business cycle than in the last decade



Eurostat, Consensus Economics, RBI/Raiffeisen Research

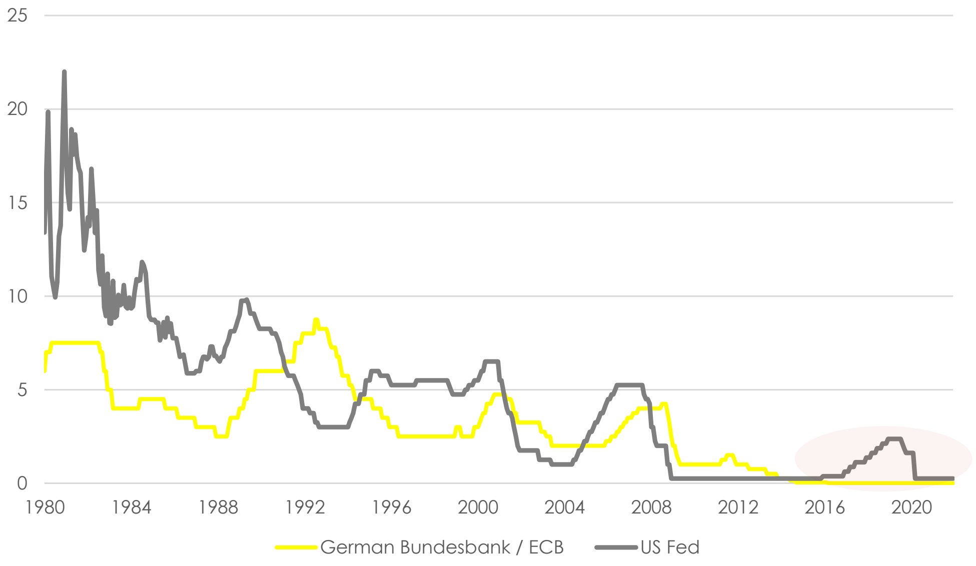
** Real GDP, Index (2008=100 & 2019=100)*

ECB rate hikes on the horizon

We think that **this time around ECB** will **not be able to afford** such a **pronounced monetary policy divergence** from the Fed like seen in the **last decade**. This time, price and economic developments in the euro area should be determined by less specific trends as in the 2010s (deleveraging, euro crisis, internal devaluations in the euro area) or in the context of ECB's "permanent crisis policy", while in the long run price and interest rate trends have a cross-country and global component.

All in all, for the **first time in a long time** we see **measured ECB rate hikes around the corner**, i.e. within a standard forecast horizon of 12 to 18 months. This can also be expressed in a very long-term correlation of key interest rates and monetary policy changes at the Fed and ECB (Bundesbank before) at 0.7 compared to a value closer to 0 in the last decade.

Long-term key rate trends US & Europe (euro area)



BIS, Refinitiv, RBI/Raiffeisen Research

ECB continues to be dominant on the bond market

Nevertheless, we are **neither worried** about the s**ustainability of government debt** in the **euro area, nor about** possible **drastic jumps in yields** for government securities in the euro area. In contrast to the Fed, ECB is not yet thinking about reducing its securities holdings at all. At the December 2021 meeting **ECB did it extend** the **reinvestment phase** of **maturing bonds** until the **end of 2024**. This means that the central bank will continue to push down the long-term interest rates on core European bond markets and German Bunds for a long time, resulting in lowish yields across European government bond markets. And yet ECB should not close its mind to the option — if necessary — of ending the APP programme and adjusting the deposit rate for the first time before the end of 2022 to deliver bolder signals - if needed. Analogous to the Fed, ECB could be forced to show more focus on fighting inflation. Moreover, only moderately rising long-term government bond yields in the euro area should make such a step feasible through an interplay of reinvestments and successful inflation fighting. In view of the protracted ECB interest-rate-dampening reinvestment activity, inflation rates will in all likelihood remain above the government bond issuance yields for most euro area countries for the time being.

Trend-setting 2nd half of 2022

All in all, the **second half of 2022** could turn out to be **really fascinating** for financial market investors in terms of **monetary policy re-orientation**. The crucial question will be possibly **how quickly Fed** and **ECB** are **willing** and **able** to **return to a monetary policy** with **fewer unconventional elements** and significantly less steering of market expectations. Surprises at the Fed and the ECB could partially influence each other. But one should certainly take into account one or two twitches on the financial markets before and after individual interest rate meetings. In this context, we find the statement of the French central bank governor highly interesting, clearly stating that ECB inflation forecasts do not represent a "blind certainty", "[...] should inflation prove to be more persistent, we undoubtedly have the determination and the ability to quickly adjust our monetary policy".

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