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Pain threshold hit already?

ECB post-meeting comment

RaboResearch
Global Economics & Markets
mr.rabobank.com

Bas van Geffen, CFA
Senior Macro Strategist
+31 30 712 1046

Elwin de Groot
Head of Macro Strategy
+31 30 712 1322

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Summary

- In an emergency meeting, the ECB strengthened its commitment to contain Eurozone spreads
- However, the statement leaves much uncertainty over how powerful the ECB's intervention will actually be. We expect more clarity in July.
- The vague statement may contain spreads for now, as the market will not want to try the ECB's hand ahead of the formalisation of any instrument.
- However, once an anti-fragmentation tool is known and markets will know its limitations, that arguably gives traders a new target to aim for.
- The market reception of the instrument will dictate whether this means more or fewer hikes.

Policy decisions

- PEPP flexibility has been invoked, allowing the ECB to reinvest maturing bonds across time and asset classes in order to preserve the transmission of monetary policy
- The Council has mandated the relevant committees to accelerate the completion of the design of a new anti-fragmentation instrument.

Well, well, well. That did not take long at all. In our post-meeting comment last week, we noted that the omission of any concrete anti-fragmentation instrument would only invite traders to test the ECB's pain threshold. It appears that a nerve was struck already, as the ECB decided in an ad-hoc meeting to start using the flexibility of PEPP reinvestments and to accelerate the development of an anti-fragmentation tool.

Forced into a corner?

Activating the flexibility of the PEPP programme may have been all that the ECB originally intended to do today. However, as market expectations built, that would have likely underwhelmed. Yet, an anti-fragmentation strategy of instrument wasn't ready yet, so the ECB added *"we'll get back to you"*. We expect to hear more in the regular July meeting.

If the Bloomberg coverage of this ad hoc meeting is any reliable guidance, it feels to us like the ECB never intended today's meeting to be so crucial or in-focus. The first headlines noted that there would be a Council meeting to *"discuss market conditions"*, and whether to invoke the flexibility that has been embedded in the PEPP reinvestments for some time now. Originally, it wasn't even certain whether this would be followed by a statement.

Nonetheless, markets rejoiced, and Eurozone spreads tightened significantly. These market expectations may have forced the ECB to divulge a bit more detail than they had originally planned. After all, the option to reinvest maturing bonds under the PEPP had already been communicated to the markets in previous policy statements, and so a subsequent Bloomberg article noted that *"ECB officials are discussing a broader strategy to protect the integrity of the EZ as a well as whether to use reinvestments of their PEPP flexibly as a first defence"*. In other words, the

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Council may have felt forced to deviate from last week's strategy of ambiguity. In the statement after this ad hoc meeting, the ECB added that it has *"mandate[d] the relevant Eurosystem Committees [...] to accelerate the completion of the design of a new anti-fragmentation instrument"*. Similar language has historically been used to give strong guidance that a formal announcement should be expected in a following Council meeting.

Anti-fragmentation tool: reusing old blueprints?

As we have noted in the past, the ECB has proven to be creative when it comes to designing new instruments. And so it's folly to try to predict the exact format. If we were to hazard a guess, we would look back at the ECB's Securities Markets Programme as a possible blueprint: targeted, conditional purchases that are sterilized to avoid interference with the broader policy stance.

The ECB is arguably facing a bigger challenge trying to contain fragmentation risk than before. Not because the risks are greater this time, but because this time the fragmentation risk requires a *different* policy stance than the inflation risks. And, separately, the ECB is trying to balance the functioning of its monetary policy transmission with a return to 'market discipline', i.e., the Bank doesn't want to take all pressure off European governments.

If we look back at the various instruments that the ECB has deployed since the global financial crisis, we believe that the Securities Markets Programme (SMP) ticks most of the boxes. The SMP was launched in May 2010 and sought to address the *"severe tensions in certain market segments which had been hampering the monetary policy transmission mechanism"*. In practise, this entailed ECB purchases of bonds issued by the southern member states and Ireland. However, the crucial difference with the Asset Purchase Programme was that these purchases were sterilized: the ECB conducted offsetting liquidity draining operations of similar size as the asset purchases, to ensure that the overall stance of monetary policy was not being affected.[1]

Of course, not all design elements of the SMP need to be copied exactly. For example, the SMP focused particularly on shorter tenors. The average maturity of the ECB's SMP portfolio has only exceeded 5 years once (Ireland in 2013). This of course does not need to be the case with a new iteration of this instrument.

In fact, while we believe the SMP may be a good blueprint, the ECB staff has proven to come up with creative ideas. For example, each series of TLTROs came with different terms and conditions to align the instrument with the ECB's current needs. In other words, while this is our best guess at this juncture, it would not surprise us if Lagarde unveils a completely different instrument.

Whatever design the ECB chooses, we believe that there will be a clear conditionality. Particularly, it is likely that any tool will only be used actively after existing options have been exhausted. We're mainly looking at the flexible PEPP reinvestments, which are now being called the "first line of defense" by several Council members. Any new instrument will probably only come into play if the ECB exhausts the capacity it has under these PEPP reinvestments.

Will it contain spreads?

We believe that the ECB has bought some time with today's announcement. However, once the details are known, the market may test the instruments' weak spots. The design and its reception by the market will therefore also be crucial for our policy rate expectations going forward.

To us, it seems like a risky bet to test the ECB's resolve at this juncture. After all, the ECB Committees will present the Council with several policy options at a future meeting, most likely in

[1] See https://www.ecb.europa.eu/press/pr/date/2010/html/pr100510.en.html

July. If the market decides to test the ECB's tolerance prior to the unveiling of any measures, that will undoubtedly force the Council to opt for a stronger instrument. Essentially, this is like playing a game without knowing how the rules will change. On the other hand, once the modalities are known, the market will be able to assess its potential limitations, and this may invite new pressure – if there are any gaps. We believe this is another reason why the ECB is taking its time in designing the instrument, rather than hastily introducing something concrete today.

Does this (also) imply fewer (or more) rate hikes?

Today's emergency meeting had the side effect of markets paring back their expectations for a greater than 25bp rate hike in July. While we agree that the anti-fragmentation tool is of importance for the ECB's rate path, we believe that the markets' reception of the instrument will be a crucial determinant for the medium-term policy path, particularly the odds of an October hike.

As the ECB's emergency meeting follows on the heels of a meeting where inflation concerns basically trumped all other issues, be that the risk of a recession or possible fragmentation (as highlighted above), one could easily be tempted to think that the ECB's not just jerking one of its knees, but may actually pull back its other leg as well. In other words, could the ECB also dial back its ambitions for its hiking cycle? The fact that the market today is paring back the odds of a 50bp hike in July, and to a lesser extent for the September meeting as well may suggest so.

From the perspective that the market may have been a bit overenthusiastic about the hiking trajectory this is understandable, but fundamentally we are not convinced that more 'spread control' by definition leads to fewer rate hikes.

One reason is political. The other is the potential risk that any form of spread control is going to be interpreted as a signal for conventional monetary policy. They ECB may have good reasons to keep these separated! We would argue that any new instrument that aims to control spreads will require sufficient buy-in from the hawks in the Council. With concerns about inflation still the dominant force, we may actually see those hawks only supporting such a tool when they get sufficient guarantees that the decision is not linked to rates policy. In fact, they may demand bigger hikes to remain on the table in order to prevent further weakness in the euro.

Regular readers know that we have a below-consensus view on the ECB rates trajectory, forecasting 100bp of tightening this year but followed by a 'pause', as the economy is hit by a recession. If anything, we would be inclined to argue that –if the spread control strategy or instrument proves to have a stabilising effect on sovereign spreads– the ECB could see room for additional hikes in October or December, before the recession takes hold.

RaboResearch
Global Economics & Markets
mr.rabobank.com

Global Head

Jan Lambregts
+44 20 7664 9669
Jan.Lambregts@Rabobank.com

Macro Strategy

Global

Michael Every
Senior Macro Strategist
Michael.Every@Rabobank.com

Europe

Elwin de Groot
Head Macro Strategy
Eurozone, ECB
+31 30 712 1322
Elwin.de.Groot@Rabobank.com

Stefan Koopman
Senior Macro Strategist
UK, Eurozone
+31 30 712 1328
Stefan.Koopman@Rabobank.com

Teeuwe Mevissen
Senior Macro Strategist
Eurozone
+31 30 712 1509
Teeuwe.Mevissen@Rabobank.com

Bas van Geffen
Senior Macro Strategist
ECB, Eurozone
+31 30 712 1046
Bas.van.Geffen@Rabobank.com

Erik-Jan van Harn
Macro Strategist
Germany, France
+31 6 300 20 936
Erik-Jan.van.Harn@Rabobank.nl

Maartje Wijffelaars
Senior Economist
Italy, Spain, Portugal, Greece
+31 88 721 8329
Maartje.Wijffelaars@Rabobank.nl

Wim Boonstra
Senior Advisor

+31 30 216 2666
Wim.Boonstra@Rabobank.nl

Americas

Philip Marey
Senior Macro Strategist
United States, Fed
+31 30 712 1437
Philip.Marey@Rabobank.com

Christian Lawrence
Senior Cross-Asset Strategist
Canada, Mexico
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Mauricio Une
Senior Macro Strategist
Brazil
+55 11 5503 7347
Mauricio.Une@Rabobank.com

Gabriel Santos
Macro Strategist
Brazil
+55 11 5503 7288
Gabriel.Santos@Rabobank.com

FX Strategy

Jane Foley
Head FX Strategy
G10 FX
+44 20 7809 4776
Jane.Foley@Rabobank.com

Christian Lawrence
Senior Cross-Asset Strategist
LatAm FX
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Rates Strategy

Richard McGuire
Head Rates Strategy
+44 20 7664 9730
Richard.McGuire@Rabobank.com

Lyn Graham-Taylor
Senior Rates Strategist
+44 20 7664 9732
Lyn.Graham-Taylor@Rabobank.com

Credit Strategy & Regulation

Matt Cairns
Head Credit Strategy & Regulation
Covered Bonds, SSAs
+44 20 7664 9502
Matt.Cairns@Rabobank.com

Bas van Zanden
Senior Analyst
Pension funds, Regulation
+31 30 712 1869
Bas.van.Zanden@Rabobank.com

Paul van der Westhuizen
Senior Analyst
Financials
+31 88 721 7374
Paul.van.der.Westhuizen@Rabobank.com

Cas Bonsema
Senior Analyst
ABS, Covered Bonds
+31 6 127 66 642
Cas.Bonsema@Rabobank.com

Agri Commodity Markets

Carlos Mera
Head of ACMR
+44 20 7664 9512
Carlos.Mera@Rabobank.com

Michael Magdovitz
Senior Commodity Analyst
+44 20 7664 9969
Michael.Magdovitz@Rabobank.com

Client coverage

Wholesale Corporate Clients

Martijn Sorber	Global Head	+31 30 712 3578	Martijn.Sorber@Rabobank.com
Hans Deusing	Europe	+31 30 216 9045	Hans.Deusing@Rabobank.com
Neil Williamson	North America	+1 212 808 6966	Neil.Williamson@Rabobank.com
Adam Vanderstelt	Australia, New Zealand	+61 2 8115 3102	Adam.Vanderstelt@rabobank.com
Ethan Sheng	Asia	+852 2103 2688	Ethan.Sheng@Rabobank.com
Ricardo Rosa	Brazil	+55 11 5503 7150	Ricardo.Rosa@Rabobank.com

Financial Institutions

Short-term Interest Rates

Marcel de Bever	Global Head	+31 30 216 9740	Marcel.de.Bever@Rabobank.com

Bonds & Interest Rate Derivatives

Henk Rozendaal	Global Head Fixed Income	+31 30 216 9423	Henk.Rozendaal@Rabobank.com

Solutions

Sjoerd van Peer	Global Head	+31 30 216 9072	Sjoerd.van.Peer@Rabobank.com

Relationship Management

Rogier Everwijn	Global Head	+31 30 712 2440	Rogier.Everwijn@Rabobank.com
Rob Eilering	Banks	+31 30 712 2162	Rob.Eilering@Rabobank.com
Petra Schuchard	Insurers		Petra.Schuchard@Rabobank.com
Duurt Jan van Dijk	Asset Managers	+31 30 712 2389	DuurtJan.van.Dijk@Rabobank.com
Javier Alvarez de Eerens	MDB	+31 30 712 1015	Javier.Alvarez@Rabobank.com
Christel Kleinhaarhuis	Fintech		Christel.Klein.Haarhuis@Rabobank.com

Capital Markets

Herald Top	Global Head	+31 30 216 9501	Herald.Top@Rabobank.com
Christopher Hartofilis	Capital Markets USA	+1 212 808 6890	Christopher.Hartofilis@Rabobank.com
Ian Baggott	Capital Markets Asia	+852 2103 2629	Ian.Baggott@Rabobank.com
Willem Kröner	Global Head ECM	+31 30 712 4783	Willem.Kroner@Rabobank.com
Harman Dhami	DCM Syndicate	+44 20 7664 9738	Harman.Dhami@Rabobank.com
Crispijn Kooijmans	DCM FIs & SSAs	+31 30 216 9028	Crispijn.Kooijmans@Rabobank.com
Bjorn Alink	DCM Securitisation & Covered Bonds	+31 30 216 9393	Bjorn.Alink@Rabobank.com
Othmar ter Waarbeek	DCM Corporate Bonds	+31 30 216 9022	Othmar.ter.Waarbeek@Rabobank.com
Joris Reijnders	DCM Corporate Loans	+31 30 216 9510	Joris.Reijnders@Rabobank.com
Brian Percival	DCM Leveraged Finance	+44 20 7809 3156	Brian.Percival@Rabobank.com

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