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ECB AND EURO GOVERNMENT BONDS - UPDATE

HAWKISH PIVOT LIKELY MEAN THE END OF NEGATIVE YIELDS

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SUMMARY

› Last week's European Central Bank (ECB) meeting, clearly points it in a more hawkish direction. At its March policy meeting, we expect the ECB to announce the reduction of its net asset purchases from EUR40bn per month in Q2 to EUR20bn in Q3, with the whole asset purchase programme (APP) to be wound up by September at the latest.

› Regarding policy rates, we now expect the ECB to bring its deposit rate back up to zero in two 25 bps rises in December 2022 and March 2023, before marking a pause. Looking ahead, core inflation that looks like staying higher for longer would point to a higher terminal rate than is being priced in by the market (at close to 0.60% on a five-year horizon).

› The end of quantitative easing, coupled with market participants' likely underestimation of the scope of the ECB's hiking cycle, is leading us to revise up our forecasts for the 10-year German Bund yield to 0.2% at end-June and to 0.4% (from 0.0%) at year's end.

› The bond market reacted sharply to the 3 February ECB meeting, with the 10-year Italian sovereign bond (BTP) spread vs. the Bund shooting up by 21 bps to 160 bps in the following days (up to 7 February). The widening in peripheral bond spreads could slow the ECB's policy normalisation, but is unlikely to derail it in our view.

› Our simulations of the sensitivity of Italy's debt-to-GDP ratio to movements in rates show the 'danger zone' for the 10-year BTP spread versus the Bund to be around 250 bps—still some distance away from current levels.

› Although, we cannot rule out the risk that BTP spread levels reach dangerous levels, our main expectation is for the 10-year spread to settle between 150 and 200 bps this year as Italy's growth trajectory is likely to remain robust and planned structural reforms are on track. As such, we are revising up our year-end spread forecast from 130 to 160 bps.

The hawkish revenge

Last week's European Central Bank (ECB) meeting marked a clear hawkish shift. The press release following the meeting was a copy-paste version of the December one, but **the tone of the press conference was considerably more hawkish than in December**. There was abundant evidence that the ECB's concerns about inflation are rising following recent upside surprises, with ECB president Christine Lagarde stressing that **concern over inflation numbers within the ECB's Governing Council was "unanimous"**. She also mentioned that **inflation was now "much closer to its inflation target" and she refused to rule out rate hikes in 2022** as "the situation has changed". Crucially, Lagarde made it clear that **the 'exit sequencing' from policy accommodation would not change** (meaning that the ECB will end net asset purchases first, and then hike its policy rates), but she suggested the timing of the exit could be adjusted.

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President Lagarde signalled that quantitative easing (QE) would be recalibrated at the 10 March meeting when the new ECB staff forecasts are set to be released. They will doubtlessly include an upward revision of inflation forecasts on account of the recent and substantial upside surprises. There were also hints that the medium-term outlook, which until now the ECB staff has forecast to be below the ECB's inflation target of 2%, is set to be revised higher.

In March, we expect the ECB to drop the "or lower" rates guidance and **to announce the tapering of monthly net purchases under its asset purchase programme (APP) from EUR40bn in Q2 to EUR20bn in Q3, and to end the APP entirely by September at the latest**.

The end of negative yields

Regarding policy rates, **we now expect the ECB to bring its deposit rate back up to zero in two 25 bps rises in December 2022 and March 2023**, before marking a pause. This is one quarter sooner than we previously anticipated. The risk is that inflation data continue to surprise to the upside and that in response the ECB tapers APP even more rapidly after March and starts hiking its policy rate earlier than expected. However, Lagarde last week stressed that the Governing Council "will not be complacent but they are not going to be rushed into a process", and that "any move will be gradual". **The updated ECB staff outlook next month means there is a real possibility of a first rate hike being announced after the Governing Council meeting of 8 September**, although recent comments suggest that the 15 December meeting is more likely.

Looking ahead, **markets could price in a higher terminal rate** (currently close to 0.60% on a five-year horizon, *see chart 1*) if inflation proves sticky. In short, we think that market participants have gone too far in pricing in over 50 bps of rate hikes in 2022 (with 25 bps hike fully priced in for August on 7 February), but that there is room for a further re-pricing of the terminal rate. German short-term rates have also moved significantly up in the wake of ECB's hawkish pivot. And standing at 0.02% on 7 February, the five-year German government bond yield turned positive for the first time since 2018.

The room for higher pricing of the terminal rate is likely to mean a further rise in the 10-year German Bund yield, in our view. The 40 bps rise in the 10-year Bund yield since the beginning of this year (to 0.23% on 7 February) has been primarily driven by an increase in inflation-linked (ie. real) bond yields--although these are still negative, with the 10-year real Bund yield standing at -1.7% on 7 February (*see chart 2*). While quite elevated (by European standards) long-term market-based inflation expectations have stabilised at close to 1.9% in recent weeks, despite a sharp increase of the oil price. This is likely due to the hawkish turn taken by central banks in the developed world.

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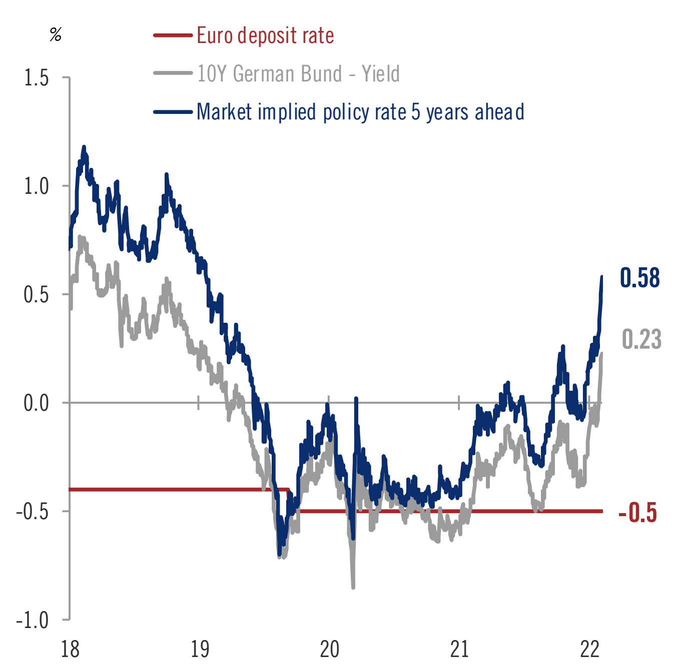
CHART 1: 10-YEAR BUND YIELD AND MARKETS PRICING OF THE POLICY RATE



Source: PWM - AA&MR, Bloomberg, 7 February 2022

CHART 2: GERMAN 10-YEAR GOVERNMENT YIELD (WITH OUR FORECASTS)

Source: PWM - AA&MR, Bloomberg, 7 February.2022

Looking ahead, earlier-than-expected policy normalisation by the ECB is likely to mean further increases in real yields and moderation in inflation expectations. Although markets have already reacted quite abruptly to changed ECB rhetoric, we would expect the nominal 10-year Bund yield to rise even more this year. **The end of QE** (and with it, one of the factors underpinning strong demand for German bonds), **coupled with a potential under-appreciation of the ECB's hiking cycle** (as expressed in a terminal rate of only 0.6%), is **leading us to revise up our forecast for the Bund yield.**

We now expect the 10-year Bund yield to stabilise at around 0.2% in the first half of this year and then to climb further towards 0.4% by the end of the year (against our previous forecast of 0.0%, see Our 2022 scenario for US and German government bonds). In the wake of a robust economic recovery, with inflation accelerating and with fiscal policy loose , **it seems to us that the era of negative yields is drawing to a close (at least for now), and that a new era of volatile bond markets is beginning.**

The end of the ECB's support for the euro periphery

Market participants reacted sharply to the ECB's 3 February policy meeting, **with the 10-year Italian sovereign bond (BTP) spread vs. the Bund shooting up by 21 bps to 160 bps** in the following days (up to 7 February, *see chart 3*). One of the main concerns expressed by this rise in spreads is the likely winding down of QE. We now expect the ECB's monthly purchases of euro government bonds to end in Q3. This means that **from around 125% of net government bond issuance in 2020-21, the ECB's net purchases will decline to zero next year**, bringing us back to the situation prevailing before 2015.

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The widening in peripheral bond spreads could slow the ECB's policy normalisation but it is unlikely to derail it, for several reasons. First, the ECB likely recognises that rate volatility is the price to pay for policy normalisation. Re-pricing has to happen if the central bank is to exit its negative interest rate policy (NIRP) and QE.

Second, the macro and political context has changed dramatically as a result of the pandemic. There are well-flagged risks down the road, including elections in 2023 in Italy and difficult negotiations of euro area fiscal rules this year, but the hope is **that reform of fiscal rules will help stabilise the euro area eventually**.

Third, in absolute terms, bond yields, spreads and average sovereign funding costs remain historically low. The pain threshold for Italian BTPs is not fixed: it depends on broader macroeconomic and financial conditions.

T**he likely end of the support that the ECB has been providing to euro periphery bonds through its monthly asset purchases raises questions about the 'fair-value' of euro sovereign bonds** in the absence of these purchases. But one needs to bear in mind, first, that the ECB holds a large share of government debt outstanding (25% in the case of Italian sovereign debt in November 2021), and, second, that unlike the US Federal Reserve it is probably years away from quantitative tightening (i.e. reducing its balance sheet).

For now, Italy's debt-to-GDP ratio looks sustainable

In our Euro periphery sovereign bonds 2022 outlook, we mentioned that **debt sustainability was key to bond investors**, keeping in mind that Italy's debt-to-GDP ratio reached 155.6% at end-2020. Although we expect Italy's ratio to go down thanks to a robust economic recovery, **the recent sharp widening of euro periphery spreads highlights the sensitivity of the debt-to-GDP ratio to movements in rates**. Indeed, if nominal growth exceeds the nominal cost of funding, countries can run a primary deficit while keeping the debt ratio constant.

The average maturity of the Italian sovereign debt is seven years, and although the seven-year BTP yield has shot up (to 1.42% on 7 February from 0.7% at the end of last year) it is only slightly higher than the average of 1.15% since 2015, and is definitely much lower than the average of 3.9% prevailing between 2006 and 2015 (*see chart 4*). This has cut Italy's net interest payments as a percentage of GDP to a low of 3.1% in 2021.

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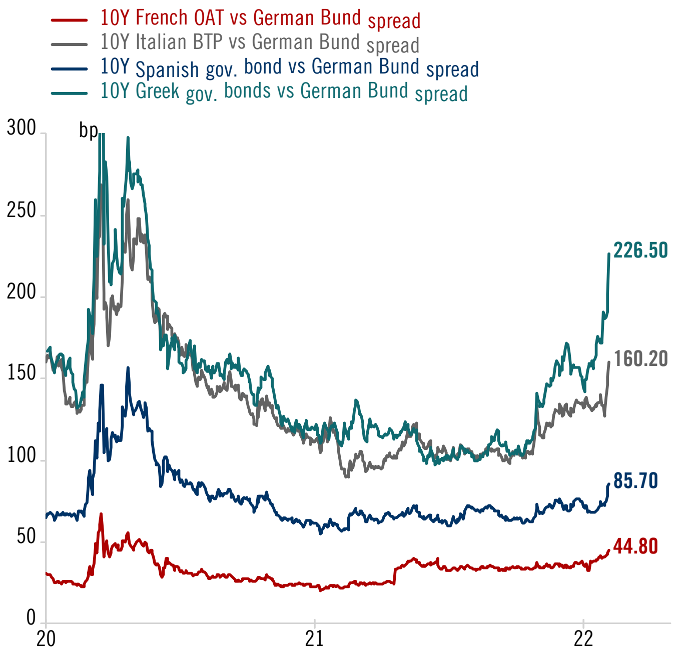
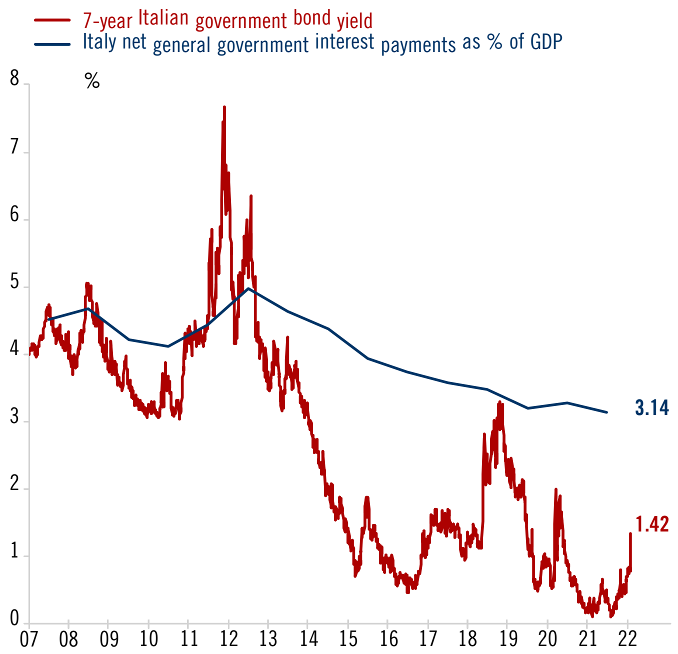
CHART 3: 10-YEAR EURO SOVEREIGN BOND SPREADS VS THE BUND



Source: PWM - AA&MR, Factset, 7 February 2022

CHART 4: ITALIAN GOVERNMENT BOND YIELD AND INTEREST PAYMENTS



Source: PWM - AA&MR, Factset, 7 February 2022

Based on our simulations of debt sustainability (assuming real annual GDP growth of 0.9% in the medium-term), a **permanent 90-100 bps increase in the seven-year BTP yield from 2022 onward would not lead to an explosion in Italy's public debt-to-GDP ratio.** Instead, that ratio would stabilise at persistently higher levels than in our baseline scenario, which assumes a very gradual rise in the seven-year yield to 2.1% and a fall in the debt-to-GDP ratio towards 143% by 2030 (*see chart 5*). In an adverse scenario of a permanent 170 bps increase (implying a seven-year BTP yield of over 3.2%) it would raise Italy's debt ratio to as high as 160% of GDP by 2030.

These calculations show that the seven-year BTP yield has some room to move up before we see a meaningful surge in the effective nominal cost of debt. In terms of the **10-year BTP spread versus the Bund, we see the 'danger zone' as being around 250 bps—still some distance away from current levels** (160 bps on 7 February).

That said, **renewed further divergence in bond yields within the euro area would be a risk to monetary policy transmission, one that the ECB would have to address eventually**. Debt sustainability is not an immediate concern as average funding costs are very low, but one needs to be aware of the risks to market equilibrium posed by re-pricing. For now, the ECB is more likely to stress that pandemic emergency purchase programme (PEPP) **reinvestments "can be adjusted flexibly across time, asset classes and jurisdictions",** even if the programme will terminate in March. **If euro periphery spread widening spun out of control, then we would expect the ECB to set up a new backstop facility** to push back on the kind of policy tightening such widening would imply. However, the ECB's exit sequencing looks essentially set in stone, and the bar for extending its APP purchases while hiking policy rates seems extremely high.

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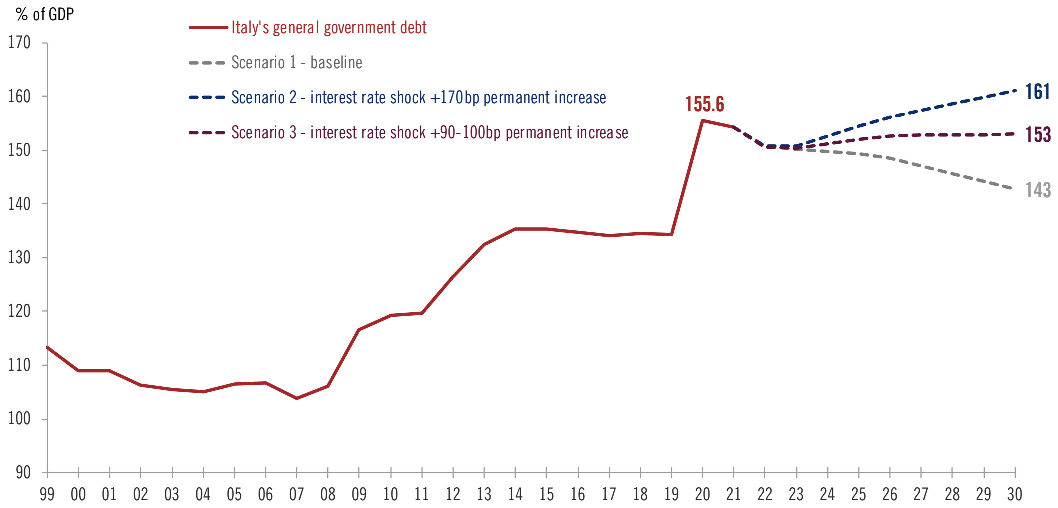
CHART 5: ITALY'S GOVERNMENT DEBT-TO-GDP RATIO, INCLUDINGOUR SCENARIOS



Source: PWM - AA&MR, Refinitiv, own calculations, 2021

Although, we cannot rule out the risk that BTP spreads rise to dangerous levels, our main forecast is that the **10-year BTP spread will settle between 150 and 200 bps this year as Italy's growth trajectory is likely to remain robust and planned structural reforms are on track**. We are therefore revising up **our year-end spread forecast from 130 to 160 bps**. Having said that, the end of this year and the early part of 2023 could be challenging for Italy as general elections and the reintroduction of euro area fiscal rules loom. Volatile times likely lie ahead for BTPs yet again, explaining why **we remain underweight on euro periphery government bonds in general.**

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