March 14, 2022

Special Coverage:

ECB signals an early stimulus withdrawal

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Key takeaways

- With soaring energy prices and geopolitical tensions posing headwinds to growth, the European Central Bank (ECB) announced a steeper reduction of its Quantitative Easing (QE) programme, and retains the “optionality” to adjust the size and pace of the programme.
- The ECB indicated that rate hikes can occur “sometime after” the end of its asset purchase programme and promised to tackle price stability. We believe the central bank remains on course to hike rates by 25bps this year, and that further hikes in 2023 are likely to be limited in size.
- We remain Underweight on European equities due to the region’s geographical proximity to Russia and Ukraine, the slowing growth momentum and shallower hiking cycle compared to the Fed.

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What happened?

- The ECB announced a steeper reduction of the amount of planned monthly net asset purchases under the Asset Purchase Program (APP). It now intends to buy EUR40bln in April, EUR 30bln in May, and EUR 20bln in June. The subsequent purchases are now labelled “data dependent” instead of “open-ended,” with Q3 likely to mark the conclusion of the programme.
- The Governing Council downgraded its GDP estimates on the back of Russia-Ukraine conflicts. Inflation is expected to surge to 5.1% this year due to higher energy prices and lingering supply chain bottlenecks. In light of the uncertainty, the ECB used the words “optionality” and “data dependency” several times, to avoid committing to a defined policy path.
- The initial market response to the ECB policy statement focused on its hawkish aspects such as the revised asset purchase timeline. The press conference also aimed to push back against this interpretation, dismissing the label of an “accelerated” normalisation and referring to it as a simple continuation of its previous stance.
- Last month, the ECB President refused to rule out any interest rate hikes in 2022 and emphasised substantial upside risks to inflation. Indeed, an open-ended Quantitative Easing (QE) programme seemed increasingly awkward in line of rising inflation. The central bank therefore sought to convey credibility, by stating it will do “whatever action is needed” to achieve its policy mandate of price stability. Acknowledging growth risks and economic uncertainty, it clearly highlighted that any policy normalisation will be done one step at a time, adding a more dovish nuance compared to the initial market response.

Market reaction to a balanced ECB announcement

- The EUR/USD rose beyond 1.112 on an intraday basis, before falling to 1.101 levels and down -0.7% on the day upon conclusion of the press conference. German 10-year yield rose 6bps, but Italian spreads spiked 22bps, with European peripheral countries underperforming as they stand to lose the most from a faster end to bond buying programmes. European equities were down 2% at the time of writing, although we needed to highlight that the move came after an exceptional trading session the day before.

Fiscal Policy to provide another backstop

- The ECB meeting affirmed that Europe is on track to normalise its policy, but on a much more gradual path than other central banks. Its geographical proximity to Russia and Ukraine makes it more vulnerable to downside risks in the short term, whereas volatility may remain elevated as events continue to unfold.

- The rise in oil and natural gas prices continue to weigh on European countries, which import approximately 40% of total natural gas from Russia. With international sanctions tightening, many buyers have been seeking alternative supplies even if the prohibition does not apply to them. This has led to higher prices, which could eventually influence consumer spending on discretionary items even if labour markets are in good shape and savings buffers remain elevated. It has also impacted business confidence, with some European fertilizer companies for instance deciding to cut production on the back of higher costs of doing business.

- The EU leader’s summit in Versailles would focus on measures that will strengthen energy security and reduce reliance on a single provider. A faster transition to renewable energy sources has been deemed critical. Defence is another area of focus, after Germany announced a plan to increase its spending budget by as much as EUR 100bln. Sweden has also announced an increase in defense spending to 2% of GDP.

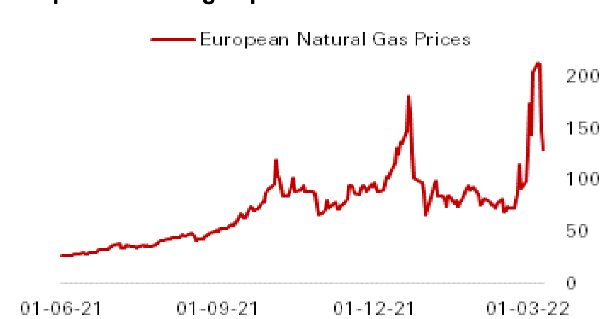
- Prior to the summit, officials involved in its preparation suggested the EU would consider issuing common bonds, in order to finance large-scale investments in energy and defence. Country leaders are also likely to consider other measures to provide relief from energy prices. Increasing measures on the fiscal front can alleviate some of the growth risks and provide an anchor of support to the longer-term European outlook.

Market considerations

- The diversification of energy supplies cannot be done overnight. The US and UK have already banned oil imports from Russia, and although this has not been applied in Europe, we need to factor in the probability that the oil market will remain in deficit this year, as capacity constraints in other oil producing nations cannot fill the gap, whereas additional shale oil investments in the US will take some time to deliver new production and cannot offset the gap from Russia, which controls more than 11% of total oil market supply. We now expect oil prices to average $120 in Q2, before easing somewhat by year end.

- This should support energy stocks which remain cheap despite their recent outperformance. Value stocks should also remain in favour, whereas we advocate a preference for quality and income. We recently downgraded our view to European and reduced cyclicality in favour of defensives. We retain this positioning after the ECB meeting, and reaffirm our underweight view on EUR as slower growth and a relatively gradual path to normalisation will favour the USD instead.

European natural gas prices remain elevated and volatile



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 10 March 2022.

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