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Weekly Macro and Markets View

14 March 2022

Highlights and View

The ECB intends to end QE asset purchases some time in Q3

Inflation hawks are dominating the policy discussion within the ECB, but ending QE quickly risks weakening periphery bond markets and undermining the recovery.

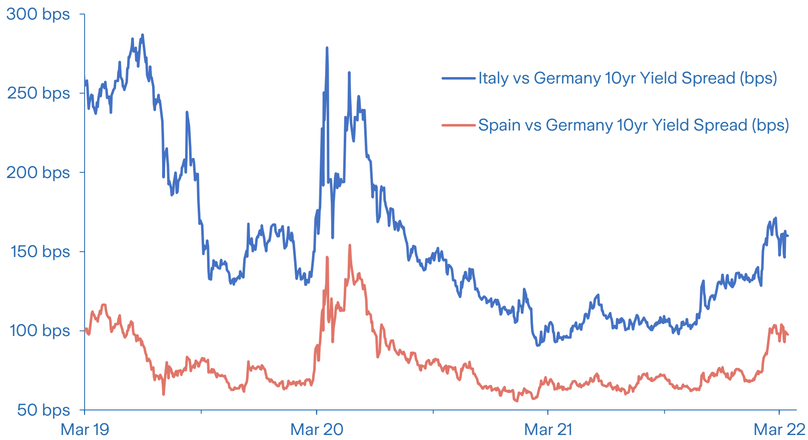
US inflation continues to soar, but signs of fading wage pressure have emerged

Headline inflation reached another four-decade high, but weaker compensation plans and a drop in the quits rate point to a slowdown in wage growth.

Surprisingly hawkish ECB comments and a push higher in US inflation fans market volatility

Market turbulence last week was less about the war as investors pondered the policy response to still surging global inflation and ebbing growth, which we see as the key theme in the weeks ahead.

ECB announces quicker end to QE despite increasing risks to growth



Source: Bloomberg

Last week the ECB announced an acceleration in the pace of tapering of QE asset purchases. Instead of asset purchases of EUR 40bn in Q2, EUR 30bn in Q3 and EUR 20bn in Q4, as indicated in December, the ECB plans to reduce QE quickly over the course of Q2 so as to end completely some time in Q3.

Periphery bond markets reacted negatively to the news, with spreads between Italian and German 10yr government bond yields widening by about 15bps on the day of the announcement last Thursday. Despite the increasing risks to growth from the war in Ukraine, the ECB seems to be more focused on the threat to inflation, though arguably there is little it can do about a commodity price shock in the short term. The risk is that the ECB is making a policy mistake. It may eventually have to reverse course and continue QE for longer than it currently envisages. If the ECB does continue with its accelerated plan to wind down QE, then we could see further upward pressure on periphery bond yield spreads over the coming months. Meanwhile, at the EU summit in Versailles, EU leaders agreed to bolster European defence capabilities and reduce their energy dependency on Russia. However, both objectives are likely to take time, possibly many years, to achieve and it is not clear yet how the extra spending required will be financed.

Bonds

Bond yields snap higher on hawkish ECB announcement

Global bond yields rose last week following the hawkish surprise from the ECB and announcements of stricter sanctions, including a US ban on Russian oil and gas imports. The 10yr Bund yield gained 32bps in the largest weekly move since 2015, now back to its pre-invasion level. Long-term inflation expectations snapped higher, and the 5yr5yr forward Eurozone inflation swap rate is now up over 40bps since end February. Central banks will pay notice as it indicates that long-term inflation expectations are potentially becoming unhinged. Real yields have slipped back and are close to historical lows, also pressuring central banks to act. Yield curve flattening paused last week, but at only 24bps the 2/10 Treasury yield spread indicates growth worries and needs to be closely watched. While we expect the upward trajectory for global bond yields to remain in place, bond market volatility is likely to remain elevated near term, as it reflects the tug of war between rising inflation and policy tightening, on the one hand, and elevated uncertainty and growth risk, on the other.

Credit

Gap down risk remains with flows tumbling

Sentiment remains weak in credit markets as flows tumbled further last week. European high yield has now seen outflows of around 4.8% of assets on a YTD basis. Once outflows exceed certain thresholds implied by cash levels in portfolios, we think the risk of gap downs could rise sharply. In a rather volatile week, US credit spreads ratcheted wider and narrowed the gap with European credit spreads that had been selling off aggressively for some time. While several market participants attributed the move in US credit to heavy supply, we believe it was also somewhat overdue given that the spread gap between the two markets has reached the highest levels since 2013. While Europe is indeed more exposed to the Russia-Ukraine conflict, recent volatility has disrupted several relative relationships with high yield, risk adjusted outperformance being another one. Financials continued to underperform corporates, while credit derivative indices once again outperformed. All in all, it seems choppiness could likely continue in credit with risk-reward appearing more attractive in stocks.

US

Rising inflation weighs on consumer sentiment

Headline CPI inflation hit another 40-year high in February, rising to 7.9% YoY, while Core CPI picked up to 6.4% YoY. Given the surge in commodity prices caused by the war in Ukraine headline inflation is likely to remain elevated in the near term. Rising living costs keep weighing on consumers' minds with the University of Michigan's sentiment index falling to the lowest since 2011, mostly driven by a marked drop in expectations. Small business optimism also receded to the lowest in a year with a significant fall in hiring intentions. At the same time, both actual compensation and compensation plans were lower than a month ago indicating reduced wage pressure, in line with wage data published earlier this month. Finally, the number of job openings ticked down in January with the quits rate falling to 2.8% from its record level reached in November and December. Though it may be too early to see a strong trend this is in line with the above-mentioned data of fading wage pressure, an important factor for the Fed to consider on its way to tightening monetary policy.

North Asia

Conservative candidate Yoon wins the presidential election in South Korea

Though Yoon Suk-yeol of the conservative People's Power Party won South Korea's presidential elections by a slim margin, he may struggle to push through his reform agenda as the Democratic Party has a majority in the National Assembly. Yoon is expected to follow a more hawkish policy versus China and North Korea. In China, aggregate financing came in lower than consensus had expected, mainly reflecting a decrease in household mortgage lending amid slow home sales and a decrease in off-balance sheet lending. Meanwhile, most indicators published in Japan confirm slow economic activity in Q1. The economy is likely to have contracted but is expected to recover in Q2 as new Omicron infections are slowing and labour shortages in the manufacturing sector should wane. The manufacturing and services sector both weakened in the quarterly Business Outlook Survey, but we note that capex plans for the fiscal year starting April 1 remain brisk. Both wages and producer prices rose more than expected in February.

LatAm

Inflation continues accelerating, and core inflation maintains its upward trend

The outlook for inflation remains challenging given the generalized increase in prices and the inflationary external shocks to commodity prices due to the geopolitical crisis in eastern Europe. Furthermore, inertial inflation seems to be building, adding additional inflation pressure. In Brazil, inflation posted 1.01% MoM in February, reaching 10.5% YoY. Core inflation continues to accelerate, gaining 8.41% YoY. In addition, Petrobras announced increased gasoline and diesel prices of 19.2% and 24.9%, respectively. Industrial production disappointed, falling 2.4% MoM in January. In Chile, headline inflation reached 0.3% MoM in February, below market expectation, reaching 7.8% YoY. The negative contribution of tourist packages and airline tickets explained the downside surprise. It should not be read as a turning point for inflation pressures as the CPI ex-volatile components printed 0.7% MoM, climbing to 6.5% YoY. In Mexico, headline inflation accelerated to 7.3% YoY, while core inflation maintained its upward trend, reaching 6.6% YoY, being the most pressing concern.

What to Watch

- The Fed is expected to initiate its tightening cycle with a 25bp rate hike this week and is likely to prepare the ground for further rate hikes at subsequent meetings.
- In the Eurozone, the ZEW survey will be closely watched to assess the war in Ukraine's affect on confidence.
- We believe that Taiwan's CBC will keep policy rates unchanged. China's February economic activity data, Japan's February export and inflation data as well as February export data in Indonesia, Malaysia and Singapore will be in focus. In Australia we will watch Q4 house prices and February labour market data. India's financial markets will be closed on Friday due to the Holi festival.
- In Brazil, the focus will be on the monetary policy meeting at which we expect the BCB to hike the Selic rate by 100bps to 11.75%. In Chile, Q4 2021 GDP will be published, while in Argentina, we expect inflation to have accelerated in February.

Disclaimer and cautionary statement

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