THE ECB'S STEADY HAND

VERY PATIENTLY STAYING THE COURSE

July 23, 2021

Northern Trust
Global Asset Allocation

Wouter Sturkenboom, CFA
Chief Investment Strategist EMEA & APAC
ws65@ntrs.com

Jim McDonald
Chief Investment Strategist
jxm8@ntrs.com

Dan Phillips, CFA
Director, Asset Allocation Strategy
dp61@ntrs.com

Colin Cheesman, CFA
Investment Analyst
cc327@ntrs.com

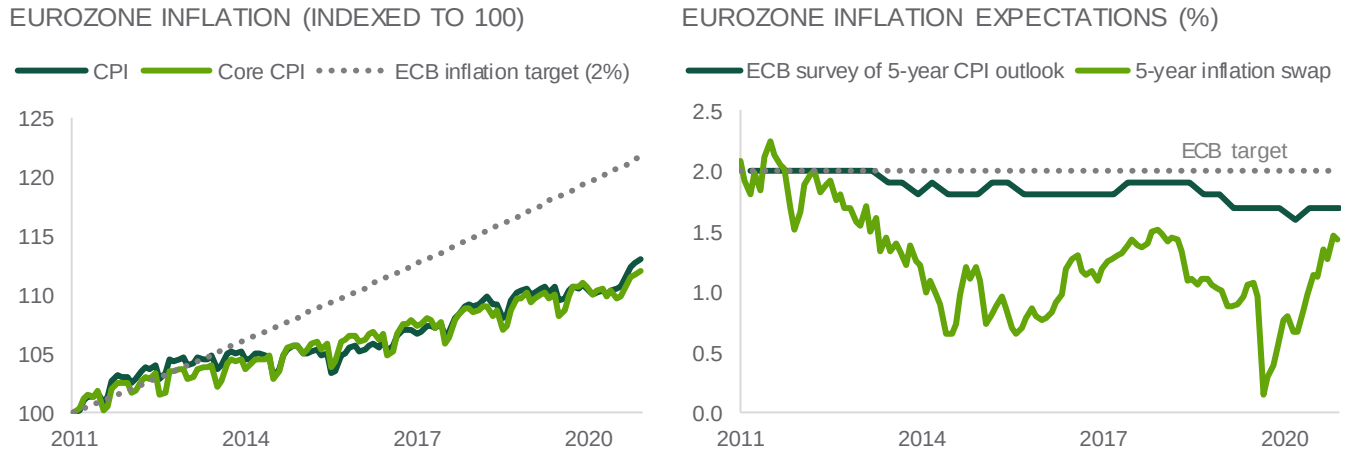
The European Central Bank (ECB) has had a busy month so far. A few weeks ago it concluded its strategy review and changed the definition of its inflation target. This week it followed up with a recalibration of its policy mix. The main takeaway from all of this is that the ECB is going to be very patient before tightening policy.

Strategy review gives the ECB more leeway. The most important outcome of the strategy review was the change in the ECB's inflation target from "close but below 2%" to "symmetric around 2%." Although that may not seem like a big change, it is for an institution built on the hawkish inflation heritage of the Bundesbank. The new approach means both upside and downside deviations from 2% are to be addressed with equal importance, whereas previously upside deviations carried more weight. This aligns the ECB with the Federal Reserve and Bank of Japan among others, and effectively removes a hawkish tilt in its mandate.

An important reason for the ECB to make this change is its flagging credibility. After a decade of falling far short of 2% inflation (as seen in the left-hand chart below, the Consumer Price Index [CPI] has averaged only 1.2% annually) neither the markets nor professional forecasters expect the ECB to succeed in getting inflation sustainably back to 2% (see right-hand chart below). The ECB hopes that increasing its inflation target will change the perception that it is unable to deliver *and* will give it cover to provide more stimulus if needed. In fact, in a best case scenario the two will reinforce each other and turn into a self-fulfilling prophecy. For now, however, that is wishful thinking and the ECB knows it. It has to deliver something tangible first.

EXHIBIT 1: NOT SO FAST

Europe's stuckflation of the past decade endorses a very patient approach to monetary policy.



Source: Northern Trust Asset Management, Refinitiv Datastream. Left: Indexed to 100 on 7/29/2011. Data through 6/30/2021.

A high hurdle. That tangible deliverable was presented on July 22 in the press conference following the Governing Council meeting. ECB President Christine Lagarde laid out that the ECB has decided to change its forward guidance for interest rates in response to the outcome of the strategy review. In effect, the ECB put a very high hurdle in place before it will even consider hiking interest rates. Three criteria need to be met: 1) see inflation reach 2% well before the end of the three-year projection horizon; 2) expect inflation to stay durably above 2% for the rest of the projection horizon; and 3) see inflation stabilizing at 2% over the medium term. Truth be told, it is very hard to foresee these three criteria being met in the next two-to-three years, and maybe even longer. But that is exactly the point. The ECB is using this hurdle to signal it will patiently maintain its current course, conduct monetary policy with a very steady hand and prevent itself from tightening prematurely.

With interest rate changes off the table for even longer, this new forward guidance constitutes a small dovish surprise. More importantly, investors need to learn how this new framework will extend to other parts of the policy mix, most notably the ECB's quantitative easing program. Lagarde made it clear the Pandemic Emergency Purchase Program (PEPP) was not a topic of conversation, calling it premature to even consider slowing the monthly pace of bond purchases. But with the new economic projections due in September and the recovery still going strong, that will change. It will be interesting to see if the ECB uses the new framework as an argument to not only keep the monthly purchases going at the same rate, but also to keep them going after their current March deadline. Our expectation is that it will, but to what extent is hard to estimate.

What it means for investors. A dovish surprise from the ECB and a higher probability for more dovish surprises down the road support our tactical overweight to European equities (also achieved through developed ex-U.S. equities). Combining newfound dovishness with the strong recovery from the COVID-19 recession, continued fiscal stimulus through the NextGenerationEU package and European equities' global growth exposure further supports this tactical viewpoint.

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