Market Bulletin

10 September 2020

ECB: Talking the talk but not walking the walk

The European Central Bank (ECB) made no changes to its key monetary policy instruments at today's meeting. The lack of policy action is much more to do with the reduced effectiveness of the remaining options at its disposal rather than the ECB being comfortable with the current state of the economy. While expectations for growth in 2020 were modestly revised higher, of greater concern is the expectation that inflation will remain low over the medium term. The strength of the euro in recent weeks has also played on the minds of the members of the governing council and makes the ECB's task of generating inflation even more difficult.

Growth outlook mixed and deflation risks receding

Second quarter GDP in the eurozone contracted by 11.8% quarter on quarter, but the economy looks to have rebounded strongly over the summer largely due to Germany's relative success in managing the virus. The ECB lifted its growth estimates for 2020 to minus 8.0%, from minus 8.7%, but with the recent rise in Covid infections across France and Spain in particular, ECB President Christine Lagarde's tone remained circumspect as she highlighted a slowing in the services sector rebound.

The outlook for inflation remains most concerning. Headline inflation for August turned negative for the first time since 2016 and the ECB expects it to remain at similar levels through the rest of the year. The ECB's latest projections show inflation is expected to be just 0.3% in 2020 and still only 1.3% in 2022, but could be as low as 0.7% in 2022 under a more severe scenario for the economy. While still a huge way away from target, the latest forecasts represent an upgrade for 2021 relative to June and Lagarde suggested that the fears of deflation have actually receded over the summer.

EXHIBIT 1: European Central Bank staff macroeconomic projections for the euro area

	Real GDP (y/y)			HICP inflation (y/y)		
Meeting	2020	2021	2022	2020	2021	2022
Jun-20	-8.7%	5.2%	3.3%	0.3%	0.8%	1.3%
Sep-20	-8.0%	5.0%	3.2%	0.3%	1.0%	1.3%
Change	+0.7%	-0.2%	-0.1%	0.0%	+0.2%	0.0%

Source: European Central Bank, J.P. Morgan Asset Management. Data as of 10 September 2020.

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Monitoring the euro

Investor appetite for European assets has risen since the announcement of a EUR 750bn European Recovery fund. European equities (ex-financials) have performed much better in recent months, while the euro has appreciated versus the dollar. The drawback to this is that a stronger euro will typically reduce the cost of imports and reduce the attractiveness of exports, therefore tightening financial conditions and weighing on inflation. With the deposit rate already at -0.5%, the ECB has little room to cut interest rates in order to prevent the euro from strengthening further. While Lagarde acknowledged that the ECB is carefully monitoring the recent strength of the euro and its potential implications on inflation, she reiterated that the ECB doesn’t target exchange rates.

Will average-inflation targeting catch on in Europe?

With the Federal Reserve’s recent change to target an average of 2% inflation over a period of time so as to compensate for long periods of low inflation, pressure may build on the ECB to consider a similar move. Medium-term inflation expectations in the eurozone have drifted lower and at 1.2% are considerably below the ECB’s target. By contrast inflation expectations in the US have steadily risen to above 2% now. The ECB had begun their own review earlier this year but - like the economy - this was put on pause. Until the completion of that review we may not see the ECB reveal more about a change in its target. Even if the governing council did consider a shift towards inflation targeting, it is not clear that this would be perceived credibly by the market. The central bank’s willingness to tolerate higher inflation has never been question, rather it is their ability to do so that is in doubt.

Investment implications

In aggregate the tone of today’s meeting was less dovish than investors may have been expecting. Little was said around the prospect for further easing, and the absence of a significant attempt to “talk down” the level of the euro likely explains the rise in the value of the euro versus the US dollar post the announcement. German Bund yields nudged higher, with European equities showing little reaction. While today the ECB chose to focus on talking about achieving their goals, pressure is likely to build on the governing council to “walk the walk” at a meeting later this year by delivering further policy stimulus.

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