A late Italian Strike?

99 – 12 July 2021

Key points

- The European Central Bank's (ECB) strategy review, seemingly aligning its official stance with Mario Draghi's public views at the end of his tenure, provides the intellectual underpinning for prolonged stimulus at a time when the propagation of the Delta variant rekindles downside risks to the ongoing recovery. Still, ambiguity abounds.

While covid-related uncertainty is not going away, policy-makers' resolve to provide stimulus as long as necessary remains crucial. Indeed, the latest news-flow on the pandemic front is concerning again. Even in the UK where the vaccination rate of the population is among the highest, tension on segments of the healthcare system is re-emerging as the Delta variant continues to propagate at a very fast clip. Some restriction resumption is already underway in Portugal, parts of Spain and the Netherlands, even if we remain very far from the levels of stringency still seen only 2 months ago.

Beyond their current support, central banks can also provide reassurance to the market and to fiscal authorities by tweaking their long-term strategy. As widely expected, the ECB moved last week to a symmetric definition of price stability: 2% in the medium term, with deviations above and below "equally undesirable". Inflation overshooting is now explicitly endorsed. This is putting the ECB's official stance in line with what Mario Draghi had been saying repeatedly in the last 2 years of his tenure.

We are not sure however that Mario Draghi would be fully satisfied with the strategy review. There remains a gap between the Fed, for which overshooting should be "aimed for" in consideration with past sub-par inflation, and the ECB, for which it would be a mere possible outcome, while he might see "better taking into account" house prices as a concession to the hawks. The conclusions of the strategy review were adopted unanimously because in practice, the big and divisive decisions still lay ahead.

We also continue our exploration of the "technical factors" behind the surprising relapse in US long-term yields. The US Treasury's cash management may have played a significant role recently: as its ballooning account at the New York Fed is being emptied, liquidity rises while debt issuance needs fall. While the level of the Treasury General Account is still above its historical average, debt issuance should re-start at a faster clip once the "debt ceiling" is extended again at the end of this month.

Negative Delta

There is nothing we would like more than being able to stop depressing our readers with the latest news from the pandemic front, but we need to take **a hard look at the "delta variant".** The equation there is pretty simple: this variant is more transmissible than the historical version of the virus, vaccines are less efficient after only one dose, which calls for a steep acceleration in vaccinations to protect as many people as possible with two doses. **We can continue to look at the UK for general lessons on how to deal with the variant,** and the news flow from there is not uniformly good, to say the least.

Let's start with the good news however: vaccines do make a big difference in curbing the number of severe cases. In Exhibit 1, we compare the actual number of people hospitalized in the UK with Covid with a simple model based on the number of declared new cases (smoothed over 7 days) with a lag of 14 days (we checked that this lag fits the data better than the contemporaneous relationship or a 7-day lag). Since the beginning of May, the model has been increasingly overstating the number of hospitalizations. For 6 July, the equation predicted 7,600 hospitalized people, when in reality the figure stood at 2,400. We re-estimated the same model, this time adding the percentage of the population with two doses of the vaccine, also lagged by 14 days to take into account the time it takes for the inoculations to fully boost immunity. Historically, the model has been fitting the actual data much better (see Exhibit 2) and has significantly reduced the deviation observed since May in the initial version (the second model predicts 4,000 hospitalizations on July 6). The elasticity is close to 100: each percentage point of the population fully vaccinated reduces the number of people in hospital by 100.

Exhibit 1 – without vaccines it would be very bad…

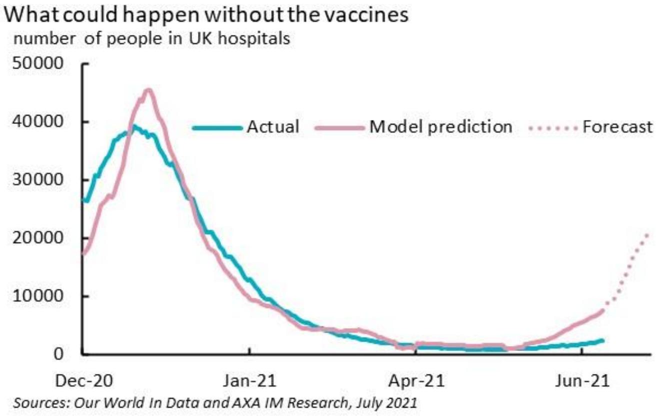
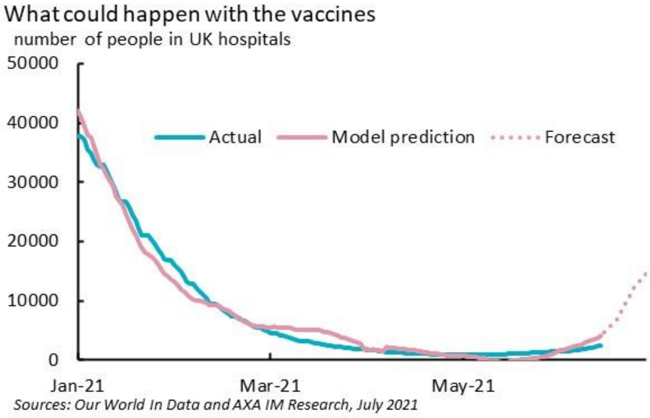


Exhibit 2 - … but even with them it could be tough



Still, even in the UK the vaccination rate of the population is likely to be too low to completely eradicate the pandemic pressure on healthcare. Vaccines are efficient but they are not perfect. According to Public Health England, two doses of vaccine provide a protection of 96% against hospitalization with the Delta variant (79% against the symptomatic forms). As long as the virus circulates, an incompressible fraction of the population will be at risk even with a completely successful vaccination campaign. But the crucial issue is that even in the UK, only half of the population is fully vaccinated (50.2% on 6 July), which leaves space for a significant rise in the number of severe cases.

Since we have a lag of 14 days in our equations between the number of cases and hospitalizations, we can forecast two weeks ahead on the basis of the latest data on virus circulation, which has accelerated massively (27k cases/day in the 7 days to 8 July, against 12k/days in the 7 days to 24 June). Without the vaccines, this would be consistent with nearly 22k people in hospital in two weeks, but a still substantial 14k at the current vaccination rate.

True, attitude to risk may be different now. Most unvaccinated people now developing the disease are young. Even if their case is severe enough to warrant a stay in hospital, their probability to draw on scarce life support capacity is comparatively lower (the death-to-hospitalization ratio is currently a fourth of what it was at the beginning of the year). Our second model still overstates the number of people in hospital. This may reflect the fact that, thanks to lower severity of the cases among vaccinated and younger people, the "turnover" is higher than during the previous waves (patients stay for a shorter time).

For now, the British government intends to proceed as scheduled with a removal of most of the remaining sanitary restrictions next week. An implicit calculation might be that the healthcare system is structurally under less stress in the summer than in the winter, so this seasonal pattern would warrant an "acceptable level of hospitalization" now, to balance against the economic – and political – risk of deferring once again the full termination of restrictions. If the vaccination programme continues at a brisk pace, by the time winter starts and non-covid pressure on healthcare capacity rises again, the Delta variant could have become easier to manage. Yet, this approach can be considered as a "gamble". Tension is already re-emerging in some segments of the British healthcare systems with several hospitals last week announcing they had reached maximum capacity and postponing non-covid related procedures once again. Continental European countries may not follow the British example. Some restriction resumption is already underway in Portugal, parts of Spain and the Netherlands. While the UK is still markedly ahead in terms of variant circulation, continental countries are still less advanced on vaccination (40% of the population are covered with two doses in Germany, 35% in France). All this creates of course a downward risk to the full materialization of the steep acceleration in GDP in Q3 which is now widely expected, even if extreme scenarios such as a return to full lockdown look far-fetched at this juncture.

Over the last few weeks, "surprise indices" had been much stronger in Europe than in the US, pointing to a welcome (if incomplete) catch-up on this side of the pond. This may be halted now, with **probably a growing North/South divergence in Europe given the risks to the tourism season**. Foreign arrivals to Spain reached only 2.7mn in May 2021 (last available data), less than a quarter of the level seen in May 2019. A steep catch-up was expected for the summer months. It is now in jeopardy. **Economic pressure may force an acceleration on decisions around linking access to certain activities to vaccinal status**. Generational fairness issue made this politically very cumbersome but opening vaccinations irrespective of age can now make this easier. This could be a powerful accelerant of the vaccination process, which ultimately is the best, if imperfect, form of protection again the pandemic.

Weak consensus

While covid-related uncertainty is not going away, policy-makers' resolve to provide stimulus as long as necessary remains crucial. This has been both the Fed's and the ECB's pledge since the beginning of the crisis. Beyond their current support, central banks can also provide reassurance to the market and to fiscal authorities by tweaking their long-term strategy. This is what the Fed did last year with their shift towards Flexible Average Inflation Targeting (FAIT). The ECB took more time as it was working towards its "strategy review". Its conclusions came out last week, and our assessment is that **although "inflation overshooting" is now explicitly contemplated on the European side as well, there remains a significant "strategic gap" between the two central banks**.

The fact that the ECB's Governing Council was able to come to a decision in July already – instead of the widely expected September – sends a positive message on the level of consensus at the Governing Council and Christine Lagarde specified the text had been accepted unanimously. However, **ambiguity about the implications for future policy decisions of the new strategic thinking was probably the price to pay for this consensus.**

As widely expected, the ECB moved to a symmetric definition of price stability: 2% in the medium term, with deviations above and below "*equally undesirable".* This is finally putting the ECB's official stance in line with what Christine Lagarde's predecessor had been saying repeatedly in the last 2 years of his tenure. Actually, there isn't any better proof of Mario Draghi's magic than his ability to say with a straight face – and to be believed by the market - that the ECB's definition of price stability was symmetric when *"below but close to 2%"* precisely meant the opposite.

Yet, this shift to a symmetric approach now enshrined in the ECB's policy scripture takes a very different form from the US. Indeed, according to the ECB's statement last week, a situation when policy rates are close to the lower bound *"may also imply a transitory period in which inflation is moderately above target"*. This is less forceful than the Fed's language, in which overshooting, in consideration of past sub-par inflation, is explicitly what monetary policy should *aim* for. In a nutshell, where the Fed would actively pursue an inflation rate transitorily above its target, for the ECB overshooting would only be a *possible outcome*. Failure to overshoot would normally imply accommodation for longer/more accommodation for the Fed. In the ECB's formulation, the Governing Council will still have to make a decision about its policy stance if and when inflation overshoots. **The difference between "possibility" and "intention" is that forward guidance is thus less strong.** This helps explain why even "ueber hawks" supported the new wording: in truth, it does not commit the Governing Council to anything.

Another source of compromise can be found in the **fact the ECB will take into account owner-occupied housing costs in the measure of consumer price inflation.** Eurostat won't be in position to provide complete data on this before several years, but the central bank will use preliminary data in the meantime to "complement its analysis". This will align their practice on the Fed's – US inflation numbers take on board imputed rents. If the solution is merely to raise the weight of the "rent" component of the price index to proxy housing costs for owners (which is basically the US approach), this change could move core inflation by up to 0.2%. Such a move would add to inflation volatility: in "good times" inflation would be generally higher, and lower in "bad times" when the housing market is in the doldrums. In theory, this could make monetary policy more volatile also. As for the current "policy-relevant horizon", given the trend in house prices amid persistently low interest rates, on the margin this will help reach 2% inflation, and potentially exceed it. This is probably a concession to the hawks against their acceptance of "exploring the possibility" of overshooting.

Given past performance, and the current cyclical gap between the US and the Euro area**, it is the ECB which is facing the heaviest credibility burden on achieving 2% inflation. However, it is also the least forceful when it comes to overshooting**. We can probably see this as a manifestation of the ECB's more conservative culture than the Fed's, even if in the practice of its policy action, as seen last year, it has been recently broadly as responsive to emergencies as its US counterpart.

The ECB also unveiled its climate change strategy. The biggest move there is going to be the introduction of a "climate change risk" in the ECB's collateral framework. The wording is vague here but if that means modulating the haircuts according to the carbon footprint, or on the ratings thresholds for eligibility, the ECB could set the tone for the entire European financial system's pricing of the carbon risk. Now, the ECB made it plain that they – just like the other asset owners – are dependent on the availability of non-financial disclosures by debt issuers and the final definition and enforcement of the EU regulations. Implementation of these new collateral rules will thus probably have to wait until 2023-2024. As much as changing the ECB's "plumbing" can help the fight against climate change, **we remain disappointed that the central bank did not take the opportunity of its strategy review to elaborate on how higher carbon prices could affect its monetary stance**. True, the review makes it plain that the impact of climate change will be explicitly considered in the ECB's forecasts, but the real issue is how it could change the central bank's reaction function: in plain English, would the ECB hike policy rates if the cause of a lasting overshooting above 2% is a rise in carbon prices? Since the decarbonization of the European economy will require a massive investment effort, higher rates would not necessarily help. On this issue, the statement is silent. Another major decision which will need to be made later…

Finally, statements are often as interesting for what they do *not* mention as for what they actually talk about. **The word "fiscal" does not appear once in the review**. The need for cooperation between the fiscal and monetary arms of economic policy was in our view one of the breakthroughs of the last 18 months. This does not infringe on the ECB's independence – what matters if that the central bank remains free of its own decisions – but can mutually enhance the efficiency of the stimulus for both actors. Habitual readers of Macrocast may remember that we are in favour of "fiscal forward guidance, providing visibility on the future fiscal stance - conditional on the pace of improvement of the economy - to the market and the central bank, complementing monetary policy forward guidance. This should go both ways and a high level of ex ante information sharing – giving governments a fair idea of how the ECB would react to the cycle - would be an asset. It seems however that on this, also, the ECB has chosen to be silent.

Schnabel pre-empting the future debate with the Bundesbank

Given the vagueness of what the strategy review entails for the monetary stance ahead, we will be looking for clues in the rest of ECB-speak. **We think Isabel Schnabel's latest speech, delivered before the review was unveiled, provides some potential guidance**. She offered a thorough assessment of the plausible inflation trajectory in the Euro area. What we found interesting is not so much that she defended the ECB's forecast baseline of an "inflation hump" followed by another dip significantly below 2% - the opposite would have been very surprising – but more her conclusion that **even if inflation ultimately surprised on the upside, this would not be bad news for the ECB, which would remain patient**. In this discussion and keeping in mind the stark differences in terms of capacity utilization across the Atlantic, she is to some extent echoing Janet Yellen and Paul Krugman, who rebuked Summers' criticism of Biden's stimulus precisely on the ground that exiting, at last, from the pre-pandemic low inflation trap would make monetary policy easier, not more complicated. **She offered a more elaborate defence of "overshooting" than the strategy review, presenting it as a major tool to re-anchor inflation back to 2% after years of sub-par delivery.**

At first glance, the long list she drew of forces which could trigger an inflation upside could be seen as a hawkish message. Schnabel starts with the possibility that firms prolong the inflation spike due to the temporary demand/supply imbalance upon reopening by trying to recoup some of their profit compression from last year through a faster-than-usual transmission of the rise in input costs to final prices. Such price transfer would be easier to implement in the context of households spending fast their saving overhang. More persistent than expected demand/supply imbalance would be another channel through which inflation would exceed the ECB's central scenario. Schnabel mentions the possibility that the fiscal multipliers of the Next Generation funds could be higher than expected. Finally, second-round effects transiting through the labour market could also prolong the spike. While the high level of slack in the Euro area is not supportive of a wage acceleration, Schnabel highlights the possibility that some of the structural effects of the pandemic – e.g., accelerated digitalization – could result in a skills mismatch, pushing the wages of those with the scarce abilities significantly higher, bringing aggregate wages along.

However, Schnabel would actually welcome the materialization of these upside risks to inflation as an opportunity to exit from the "low growth, low inflation" regime which prevailed before the pandemic. A low inflation regime tends to be self-perpetuating, as households and corporates re-assess their inflation outlook according to the recent developments. The current "spike", by reminding economic agents that consumer prices can sometimes rise faster, could engineer a welcome rebound in expectations. Her view seems to be that, while there is a "fair" chance consumer prices will rise faster than in the ECB's current baseline, the risks of an uncontrollable price spiral are very limited. We agree with this point, given our belief that ultimately 1970s type inflation cannot be engineered without the specific institutional features of the time, in particular a very rigid labour market with powerful unions.

Schnabel's nationality makes her speech particularly interesting. **We are tempted to read it as an *ex ante* justification of the continuation of a very accommodative stance in a looming debate with Bundesbank President Jens Weidmann**. This impression was confirmed in a less technical interview given to the Frankfuerter Allgemeine Zeitung by Isabel Schnabel after the release of the strategy review which was a clear attempt to "sell" the review's conclusions to the German public opinion.

In practice, **the ECB's strategy review, complemented by Schnabel's latest statements, provides a rationale for beefing up the ECB's "ordinary" quantitative easing programme once Pandemic Emergency Purchase Programme (PEPP) is terminated.** However, the calibration of the upgrade will undoubtedly be a source of intense debate at the Governing Council by the end of this year. Given the internal tensions and the concessions offered to the "hawks", it is still quite clear to us that the "net stimulus" next year will be smaller, with as a corollary a significant change in supply and demand conditions on the European bond market.

More about “technicals”

Concerns over the pace of the further reopening in the world economy found their way to the equity market last week, but there is no firm direction yet (the S&P still ended the week slightly up). The resurgence of covid-related stress may explain part of the recent decline in US yields following the usual search for a safe haven, but the correction of the bond market started before concerns with the Delta variant emerged.

The recent decline in long term US yields (losing another 7 basis points last week to reach 1.35% despite a late rebound on Friday) does not seem to reflect a belief in a more dovish Fed for longer. Exhibit 3 presents the market’s timing of the Fed lift off. The change in the Federal Open Market Committee (FOMC) “dot plot” has been duly taken on board, investors bringing forward the first hike by a few months since June - now expected for February 2023. We explored in Macrocast three weeks ago the role of some technical factors – in particular US banks recycling plentiful deposits into US government securities. Another one deserves attention: the gyrations in liquidity brought about by the US government’s cash management.

The Treasury’s account at the New York Fed (the TGA) had massively exceeded its historical average in 2020 as the US administration was accumulating cash to pay for its massive stimulus. Expenditure has been lower than expected as the recovery is taking place at a faster pace. For example, we calculated 3 weeks ago that thanks to lower unemployment and the decision by half the states to terminate the federal top-up to unemployment benefits early, the US government has saved USD 150bn relative to its initial forecasts. Despite these savings, as can be seen on exhibit 4, the TGA is now being emptied, as a result of an institutional constraint: as we are getting close to the end of the latest extension of the debt ceiling (31 July), “preloading” issuance to beef up the cash reserves would be considered as a circumvention of the debt limit rules.

Exhibit 3 – Expectations of Fed hike brought forward

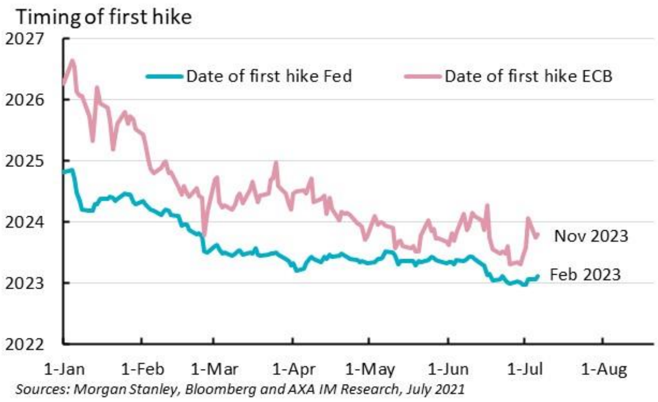
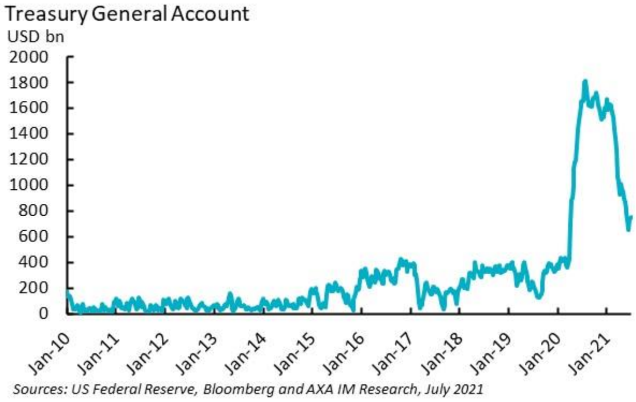
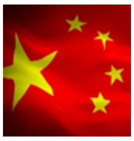


Exhibit 4 – US government cash management



The effect on the market of the TGA being emptied is twofold: first, there is more liquidity being released – as the Treasury drawing on the TGA ends up as more bank reserves at the Fed - and second there is much less need for government debt issuance, both conspiring to keep bond yields low, even if the Fed tries to “mop up” liquidity on the money market with reverse repos. It’s difficult to predict exactly when this will stop, but logically, once the debt ceiling is extended again this summer, this race to the bottom of the TGA will stop. This is another reason to take the current fall in yields as a pinch of salt.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• Yields slumped to a 1.25% low from 1.43%, before rebounding to 1.34%, broadly reflecting lower BEI • FOMC minutes: Fed would signal "well in advance" notice on tapering, review over coming "months" • Weekly consumer confidence posted biggest two-week decline since December, to early April level • JOLTS survey maintained all time high at 9.2m (May) • ISM non-mfg index slipped to 60.1 from 64.0 (Jun), elevated but constrained by supply-chain issues	• CPI inflation (Jun) should dip after 5.0% in May, but consensus sees this as a close call expecting 4.9% • Fed Chair Powell delivers semi-annual testimony to Congress – expect no new developments • Retail sales (Jun) expected to rise ex autos, after a fall last month. To set stage for Q2 GDP • Philly and Empire State Fed surveys (Jul) for signs of easing in supply constraints • President Biden to meet Chancellor Merkel
	• ECB adopted a 2% symmetric inflation target, will take into account owner occupied housing costs, and provided a working agenda to green its monetary policy • EC revised up EA 2021/22 GDP growth to 4.8% and 4.5%	• EC to unveil its strategy "Fit for 55" with details on ETS revision and proposal on CBAM • After disappointing prints in Germany and France, EA IP should moderate, with negative impact from supply shortages • Watch variant developments/ policy measures
	• GDP +0.8% (May), below consensus. Manu and construction affected by supply-chain issues, services dipped on lower retail activity • Virus cases rise to 32k, highest since Jan. Hospitalisations up to 450, from >3k in Jan. • RICS house price survey highest since 1988 • Services PMI revised higher to 62.4 (Jun)	• BoE's Saunders speech on "inflation outlook". He could be new most hawkish member • CPI inflation (Jun), consensus for modest lift to 2.2% (from 2.1%), but we expect bigger rise • Labour market release (May/Jun), unemployment expected stable at 4.7% • BoE Financial Stability Report
	• Tokyo returns under the state of emergency until Aug 22 • June Service PMI stands at 48 vs 46.5 prev, below 50 for the 15th month in a row • Bank lending declined to 1.4%yoy from 2.9%	• The BoJ holds its monetary policy meeting but we do not expect any changes on tools or communication. Details about climate financing program should be unveiled • July IPSOS Primary consumer sentiment index
	• State Council calls for a RRR cut to support SMEs and alleviate downward pressure in the economy	• The PBoC may deliver the RRR cut as soon as next week if June activity data disappoints expectations
	• CB in Malaysia (1.75%), Poland (0.10%), Peru (0.25%) kept policy rates unchanged • Higher oil prices will further weigh on CPI metrics and oil import bills for EM oil importers (Asia ex Malaysia, Turkey etc), while oil producers (GCC, Russia, African oil producers) should benefit through better CA and fiscal positions	• Central banks expected on hold in Turkey (19%), Korea (0.50%). A first hike possible in Chile (25bp from 0.50%) • Inflation reports for June in Poland, Czech, Romania, India • Singapore Q2 2021 GDP release – qoq contraction likely but strong yoy rebound

Upcoming events		
	US :	Tue: CPI (Jun); Wed: PPI (Jun); Wed: Beige book; Thu: Philly Fed index (Jun); Industrial production (Jun); Fri: Retail sales (Jun), Mich consumer confidence (Jul)
	Euro Area:	ECOFIN meeting; Final HICP (Jun); Wed: Euro area IP (May); Fri: Car registrations in Italy, Germany and France (Jun);
	UK:	Tue: Retail sales (Jun), BoE Financial stability Report; Wed: CPI (Jun); Thu: unemployment rate (May), employment figures (Jun), Fri: car registration (Jun)
	Japan:	Mon: Machinery orders (May); Wed: Reuters Tankan survey (Jul), Final IP (May); Fri: BoJ meeting, IPSOS PSCI (Jul)
	China:	Mon: Bank lending (May); Tue: Trade figures (June); GDP growth (Q2), Retail sales (Jun), IP (Jun), unemployment rate; Fri: IPSOS PSCI (Jul)

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Tour Majunga – La Défense 9 – 6 place de la Pyramide 92800 Puteaux – France
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