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TRANSCRIPT

ECB, FOMC, Find Out What it Means to Me

Featuring:

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Adam Bass (0:00):

This is MSCI Perspectives, your source for insights for global investors and access to research and expertise from across the investment industry. I'm your host Adam Bass, and today is June 16th, 2022. Would you be at all surprised if I told you inflation was a global concern. Probably not. We've all felt its pinch and central banks around the world have taken action to address rising inflation, though with mixed results. That was going to be the topic of today's episode, specifically the European Central Bank doing an about-face and ending a negative interest rate policy that's been in place since June, 2014.

Adam Bass:

But on Wednesday, as we are recording, the ECB held an emergency meeting to address another side effect of inflation; rising bond spreads across the eurozone. And that coupled with the Fed's announcement that it was raising the Fed fund rate by 75 basis points, that's the highest in 30 years. Well, that changed the focus of the episode somewhat. So I hope you'll bear with us for what turned out to be an interesting fire drill, but a fire drill nonetheless. So let's start with the ECB. What happened? Why are bond spreads important? And what does it mean for the ECBs interest rate normalization that it announced earlier this year, in fact, just a few weeks ago? For starters, let's turn to our first guest and friend of the pod.

Andy Sparks (1:40):

My name is Andy Sparks. I work in the MSCI research solutions group with a particular focus on fixed income and multi-asset class solutions. The ECB has 19 different countries that they need to be very cognizant of, and they need to be particularly sensitive to how ECB policies may have a differential impact on different countries. And so the keyword lately has been fragmentation. And as the markets have begun to anticipate scaling back of the ECBs asset purchase program, we've seen different markets react differently. So we've seen yields on Italian government go up, bonds going up quite a bit more than on German government bonds.

Andy Sparks:

So for example, since the beginning of February, the spread between those two countries has widened 110 basis points. And it's not isolated to just Italy, it's affecting other countries as well, including Spain, which has seen its government yields go up 70 basis points in the 10 year government bond sector versus German bonds. And so as the ECB scales back its bond purchases and tapers its programs, the market concern is that countries

with a higher debt burden will face a disproportionate increase in yields, which in turn could make it even tougher for these countries to pay back debt.

Andy Sparks:

And I think in the back of a lot of people's minds, it does stir memories among market participants of the Greek sovereign bond crisis from 10 years ago, which posed some real existential threats to the stability of the eurozone. And we're nowhere close to the level now that spreads were back then, but ECB policy makers do seem to be very focused on acting against the potential for fragmentation. So the ECB has this huge portfolio of government as well as corporate bonds that they've purchased in their asset purchase programs over the past few years. And these bonds are maturing. And the question is, what to do with the principle on that?

Andy Sparks:

So the ECB has basically said that they want to be very flexible in how those redemptions are reinvested back into the portfolio. And effectively, they're saying that they want to reduce uneven effects from a general pullback of monetary stimulus. And so the idea that they want to avoid having differential effects. And I suspect what they will do with the fragmentation policy is they'll put concrete detail on that general statement of avoiding differential effects across countries.

Adam Bass (4:35):

So the ECB in its effort to fight inflation has announced that it's going to end the era of negative interest rates and also left the door open for flexibility in the future. At the same time, bond rate spreads among eurozone constituents are widening, something that raising rates clearly doesn't help. So my question was, how can the ECB fight both of these trends at the same time?

Andy Sparks:

It's really tough because fundamentally, the ECB cannot control the debt level of countries. And it's really from the core origin of the eurozone itself. There were 19 distinct countries that are allowed to have different fiscal policies, but they have a common monetary policy, and reconciling those two different classes of policies is very difficult. And so there are and were rules about how large government deficits can be relative to GDP among members at the eurozone. But these rules at times of market stress have been sometimes suspended.

Andy Sparks:

And so some might argue that the ECB has caught between a rock and a hard place here. I definitely don't want to be alarmist. I don't want to say this is going to be another sort of Greek crisis that we experienced 10 years ago. But I think there is a little bit of concern that a bad situation could worsen.

Adam Bass:

During the Greek crisis, then head of the ECB, Mario Draghi, famously said that the central bank would do, "Whatever it takes to keep the eurozone intact."

Andy Sparks:

Just this week, prominent member of the ECB's executive board said there is no limit to the support that the ECB will provide to the euro. And these anti fragmentation tools might be an example of that. So the ECB is still very much saying that they are going to be very supportive.

Adam Bass:

There's a fly in the ointment here, though. Things are different than they were 10 years ago, and that could affect what the ECB is actually able to do to help with today's crisis.

Andy Sparks:

If you roll back 10 years ago to the time of the Greek crisis, 10, 11 years ago, inflation in the eurozone was very low. And so you might argue that the ECB had a lot of dry powder that they could deploy if needed, because they had the nice situation where if anything, inflation was too low, below their 2% inflation target. Whereas this time, we're in a very different situation, of course, inflation is extremely high. It's much higher than 2%.

Adam Bass (7:34):

For a bit more on the inflation picture, enter our second guest.

Thomas Verbraken:

I'm Thomas Verbraken. I'm based in the Budapest office. I'm part of the risk management solutions research team. Inflation, both in the US and Europe, is now above 8%, which is really high, I would say. US inflation seems to be rather driven by high demand. We also see a very tight labor market in the US. Whereas in Europe, the labor market is weaker and also household consumption is not yet back at levels we saw before the pandemic. So where US inflation is more driven by high demand, I would say European inflation is rather driven by supply side shocks like the higher energy and food prices.

Adam Bass:

Energy and food shocks that stem from Russia's war in Ukraine.

Thomas Verbraken:

When you look in the eurozone at the spread between headline inflation and core inflation, so when you take out energy and food, well, that spread is still high. So we see a spread of 4% between those two inflation numbers. But the question is how much will these higher energy and food prices trickle to other segments of the economy. And then of course, the question on everyone's mind is, how will these higher prices, the high inflation, disruptions of the Russia-Ukraine war, how will they impact economic growth?

Thomas Verbraken:

Because there is the risk that these higher energy prices will trickle through to the other segments, like the services industry, for example. So these are all reasons to normalize monetary policy and go away from the loose monetary policy we've seen in the past decade.

Andy Sparks (9:30):

There are a lot of similarities between the Fed's challenge and the ECBs challenge. And now just moving down a level, the practical realities is there are differences. And I'd say a lot of the lowered economic forecasts we've seen for growth this year, of course, has been related to the Russian invasion of Ukraine and the spike up in energy prices. And the US is a major energy producer. We're largely self-sufficient from an energy perspective, and that is not true for much of the eurozone. And so the US is not dependent on Russian energy imports, a lot of the eurozone is. And so just from a growth perspective, that helps out the US versus the eurozone. And because of that, the US may have greater ability to take aggressive action in reducing inflation than the eurozone.

Andy Sparks:

And so the US has already begun raising rates. The US has already announced when they're going to actually start allowing the balance sheet to contract. So that's happening in real time now. Whereas for the ECB, that has not yet happened. I would also add one other thing about the European version of quantitative easing compared to the US version is that the European asset purchase programs have played a very major role in the European corporate bond market, the investment grade market in this case. So they're a very, very significant player and that's been true for multiple years now.

Andy Sparks:

Whereas the US announced a corporate bond purchase program in the early days of the COVID crisis. But that was the example of words being just as strong as actions, because they never really had to purchase very much. But they got it across that they were willing to, which provided a lot of calm to the US corporate bond market.

But the European market, the explicit purchases by the ECB has been very large. And so another contrast between the eurozone and the US is actually the corporate sector. And over the past few months, as governments have begun talking more and more about removing monetary stimulus, just as we've seen in the sovereign government bond market in Europe, we've seen spread widening of some of the countries with higher debt burdens, such as Italy and Spain, as we've seen their yields go up more than, say, in stronger credit countries such as Germany.

Andy Sparks:

We've also seen that in corporate credit spreads, the eurozone spreads have widened more than in the US markets. And so that's another constraint if you want to call it that the ECB may be facing.

Adam Bass (12:39):

Yet another challenge for the eurozone is the euro's weakening position against the US dollar. At the time of this recording, the euro was nearly at parody.

Andy Sparks:

FX rates are affected by inflation, but they're also affected by just the level of yields. And if you look at real yields and those are driven at the longer end of the curve from inflation protected securities, in the US, those are known as tips, those yields have gone up very significantly in the US. Those real yields are after inflation adjusted yield. So this has been a terrible environment and a terrible year for bonds. And the one bright side you might say, it's really the other side of the coin, is that there has been this repricing, which has made real yields on bonds higher, and it's actually made them more attractive as investment vehicles.

Andy Sparks:

And so, one possible explanation for the relative strength of the dollar has to do with real yields have gone up quite a bit. And that may make US investments more attractive than, say, eurozone investments.

Adam Bass:

So bear with me. I'm about to use a word, it feels like we've been using a lot this year. And to be honest, I'm beginning to feel a little bit like chicken little claiming the sky is falling, but here it goes; stagflation. Andy, are we there yet?

Andy Sparks:

The concern is that we may be getting closer to a potential stagflation opportunity, which is a very bad one for capital market investors. And a lot of investment strategies that became popular over the past 20 years or so may not work as well going forward. The question is, are we in a new paradigm or not?

Adam Bass:

I know what Andy's getting at here. MSCI has been doing a lot of research lately around how stocks and bonds behaved in the 1970s and early '80s, the last time we went through such a high inflationary environment. Back then, a negative shock in the equities market was usually concurrent with a negative shock in the bond market. Something known as positive return correlation. But then something happened.

Andy Sparks:

We enjoyed this period roughly starting around the year 2000, where that return co-relation was actually negative, which meant that in a multi-asset portfolio, combining bonds and stocks, that there was a tendency when there was a big selloff in equities that bonds, particularly US treasuries, would rally. And so bonds began to develop more and more of a reputation as a diversifier, as in an anchor in multi-asset portfolio. So it's the anchor that when the equity market was going through bad times and sailing through stormy waters, that the bond market would help stabilize portfolio returns.

Andy Sparks:

And I think there's a very big concern that with much higher inflation now, that that bond-equity correlation, that negative correlation may be weakening and potentially even turning positive. So this is an example of how a change in a relationship like that could affect many strategies that have been popularized over the past 20 years, including strategies such as risk parity.

Adam Bass (16:19):

The next logical question for investors, of course, is how do I manage through this? What are the options? That's where scenario analysis comes in. So Thomas, take it away.

Thomas Verbraken:

Well, in times of this high uncertainty, it is important to be prepared for everything, right? You want to plan for the worst, you want to hope for the best. And scenario analysis is an instrument or a tool that investors can really use to play out a variety of different outcomes and see how that would impact their portfolios. And I think in this environment where there's so many uncertainty about inflation, about growth, about central bank

policy, it's important to take into account that things can go different ways and understand how that would impact your portfolios.

Thomas Verbraken:

We're having a couple of narratives in mind that we're working on. And they really make assumptions on the inflation outlook on growth and on central bank policy. And we always try to have a range from optimistic scenarios to more pessimistic scenarios. And most optimistic is the soft landing, knowing which inflation would subside and economic growth can be strong. That's probably a scenario that not many people still believe in, especially in the eurozone. We have a scenario where we have sustained inflationary pressure, but the ECB is reluctant to very decisively high grade. So the base is not fast enough. The monetary tightening is not fast enough.

Thomas Verbraken:

And they might not do that because of fears for slowing growth. So that's one scenario which focuses more on the high inflationary environment. Then we have one scenario where we're focusing on slowing growth, and that's a scenario where the ECB actually acts quite decisively, hikes rates pretty aggressively, really can put a stop to the high inflation, but causes a short term recession in the eurozone. And then the last scenario, that's the one you often hear about is the stagflation scenario where we do combine that high inflationary environment with the weaker growth outlook. And that's, of course, a scenario that's rather pessimistic and that I think many market participants or many investors want to avoid.

Adam Bass:

Can you give us a peek into some of the results, some of the implications for markets under these four scenarios?

Thomas Verbraken:

Of course. I can give a broad picture. Like in the soft landing, it would be good for equities. Normally, rates and inflation expectations would come down relative to current levels and the euro would regain some loss territory against the dollar. It's the most optimistic scenario. Then we have the sustained inflationary pressure scenario where equities would slightly lose inflation expectations and long term rates would go up and the euro would weaken against the dollar. Equities would also lose in the slowing growth scenario, but their inflation expectations would come down.

Thomas Verbraken:

And then in the stagflation scenario, that would really take the biggest hit on diversified portfolio of equities and bonds that we usually model. And in that one, equities would drop significantly, especially because those

longer term implications of the stagflation scenario. Normally, rates and inflation expectations would go up and the euro would also lose against the dollar. So again, as I highlighted before, the stagflation scenario would take the biggest toll on a diversified portfolio of equities and bonds.

Adam Bass (20:26):

And right on queue, there was that 75 basis point interest rate rise I mentioned, as well as chairman Powell's press conference that followed the announcement. So how did markets react?

Andy Sparks:

So the markets have responded very favorably since the press conference, and both the bond market and the equity market have rallied. So I think they took comfort in several things. So the actual 75 basis point increase, I think that was largely expected, but he talked about whether a 75 basis point rate increase going forward should be common or not. And he said no. But he also said that they want to be particularly transparent in this uncertain environment. And so he wants the Fed to be very, very transparent about the Fed's reaction function. And so he actually said, for the next meeting, he said that the Fed is currently thinking about a 50 basis point increase or a 75 basis point increase. But he also said at the same time that don't think 75 basis points will become common.

Andy Sparks:

And so the market very well may have been interpreting that as favorable, that the Fed is not panicking and is not talking about very aggressive rate hikes. He also stated that he thought that over the past six months, as we all know, the financial markets have traded off, and he actually viewed that favorably. He said that he feels that that is healthy. If you look at the bond market, we have seen this huge selloff, this huge increase in yields and with real rates going up very significantly. And so to the extent that the Fed believes that that selloff was partly what they were driving at, it may mean that some market participants may interpret that as further selloffs may be less likely. So I actually think the market may have responded positively to that statement as well, that the Fed feels that the general tightening of financial conditions has been healthy.

Adam Bass:

What about going forward? What are the indicators the Fed will be watching?

Andy Sparks:

Chairman Powell and the Fed are looking very closely at data right now. The Fed has lots of models, but he really emphasized they are going to be looking extremely closely at inflation data, actual realized inflation data. And he talked about what may have been some of the factors that had driven rates to extremely low or low levels over the past 20 years. And he talked about demographic, an aging population. He talked about

globalization. And he also talked about technology. So I think in his mind, all of these factors helped to push rates lower. So it's debatable, going forward, how strong of a role they will play, but you also have a new set of factors. So he definitely called out the invasion, the Ukraine-Russia war. He called out COVID lockdowns. He called out generally higher energy prices.

Andy Sparks:

And so these are some of the battling things. So I think in his mind, the latter set of variables, let's call supply shocks, and he posed the question, "Do we think those are going to be long term or short term?" Previously, those types of things tended to be short term. He's not pulling out his crystal ball and trying to predict what will happen. But I think he genuinely was trying to let market participants understand the types of things that the Fed is looking at. But he said that in terms of what the Fed is focusing on, again, he repeated time and again, he talked about, they want to see inflation coming down.

Andy Sparks:

So they thought that the inflation data that was released last week was, we caught them by surprise. And they're trying to understand why they were caught by surprise. As of a week and a half ago... Actually, as of a week ago, a lot of the Fed guidance was for 50 basis points today, but solely because of that data that was released at the end of last week, they basically have modified their views.

Adam Bass:

One of the statements that stood out to me was him specifically saying, "We're not going to be model driven." And I hadn't realized it at the time, but now listening to you, I'm wondering, is the driver behind that, could that be some of this humbling that's going on with the Fed that you mentioned?

Andy Sparks:

I think so. Yes. I think that being caught by surprise, like they were with the release of last week's inflation data, that is a little humbling. And there are these potential regime shifts that probably in the back of the Fed's mind, they are mulling over. He also, more so than in the past, he was talking about variables outside of the Fed's control. And he particularly called out commodity prices more so than in the past. He called out commodity prices is something those are largely determined globally, and it's a bit outside of the Fed's control.

Andy Sparks:

And so at the last press conference he had in March, he seemed more certain that the focusing on monetary policy could achieve the goal of lowering inflation and effectively engineering a soft landing. And this issue of soft landing came up several times during the press conference. And he basically said it's not going to be easy. And also last press conference in March, he talked about potential positive labor market supply trends. So he

talked about the labor force participation rate maybe going up, which would help labor supply, would help growth, but it would also keep wages low and therefore inflation little on the lower side. But he didn't mention that this time around.

Andy Sparks:

So my general takeaway is that, just reading between the lines perhaps, I think it's quite possible he's thinking a soft landing is harder to achieve than the last time he met the press. But he also said there are pathways towards this soft landing. And so he definitely thinks that is a distinct possibility.

Adam Bass (28:18):

At this point, you may be asking yourself, "Wait a second. Weren't we talking about Europe?" And we were. You're right. We're about to head back there. Though, to be fair, we won't really be leaving the Fed too far behind. As I asked Andy, how might this 75 basis point move affect what the ECB does next?

Andy Sparks:

These central bankers pay a lot of attention to each other. And by being more aggressive like that, it gives the ECB perhaps a little more cover, if you want to call it that, for pursuing a little more of an aggressive monetary policy. In general, the ECB's monetary policy, they've not been as aggressive as the Fed has been over the past few months. Not even really close because they do have 19 different economies and some have much softer economies than others. Some have a much higher debt burden level. And by enacting stricter monetary policy by pulling back and reducing asset purchases, that has the potential to affect different countries in different ways.

Adam Bass:

That's all for this week. Our thanks to Andy, Thomas, and to all of you, not only for listening, but for sticking with us as this story of ours took shape in what was pretty much real time. Next up on Perspectives, how does a company or an investor go about determining their carbon footprint? Now, this is an important question because before you can figure out where you're going, you have to figure out where you are. Consider that your deep thought for the day. Until then, I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

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