ECB guidance to take centre stage next week, CBR set to hike rates

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Markets faced renewed fears of sharply rising inflation last week, with questions arising on whether monetary policy normalisation should start sooner. Hawks at the Bank of England spoke up after June inflation jumped by 2.5% YoY, with Michael Saunders stating that inflation could double up if pressures continue to build. In the US, CPI inflation surging to 5.4% YoY led to mixed commentary from the Federal Reserve, with Chair Powell maintaining a dovish tone at this week's testimony while St. Louis President James Bullard pledged for earlier normalisation. Despite comments from Fed hawks, most policymakers highlighted the transitory nature of the inflation surges, while the gap in unemployment warrants a prolonged stimulus via interest rates. However, the wind is blowing towards lively tapering discussions, as inflation expectations hinge on the balance.

The ECB takes centre stage next week, with a revamped strategy review setting the tone for a persistently more dovish course of action in the months to come, while the CBR is set to hike rates further amid a light data calendar.

Calendar

Monday – 19/07

"Freedom Day" (as some British politicians have called it), will likely arrive on Monday as most of the Covid restrictions will be lifted in England. However, just three days before England plans to drop all remaining social distancing rules, government minister Lucy Frazer told Sky News the UK holds out the prospect of restoring some restrictions amid a surge in new cases, making markets second-guess how likely it is Monday's reopening will be irreversible.

Tuesday – 20/07

Japan's CPI print from June will be released at 00:30 BST and is expected to have increased to 0.2% up from May's negative 0.1%. The pickup is likely driven by energy prices and non-fresh food, as well as a weaker yen. **Then, at 02:30 BST, the People's Bank of China releases its 1Y and 5Y loan prime rates.** The 1Y - the reference rate for bank loans to companies - is set to remain steady at 3.85% this month, while the 5Y - the reference rate for mortgages - is expected to remain at 4.65% in July.

Wednesday – 21/07

Australian retail sales at 02:30 BST will be the highlight of the Australian data calendar this week. Sales are set to have fallen by -0.6% in June, down from May's 0.4% increase. This follows the latest restrictions in Sydney, with data showing that Australia's largest city is now one of the most locked down cities globally, despite measures being lighter than throughout earlier lockdowns.

Thursday – 22/07

The European Central Bank concludes its policy meeting on Thursday, with the policy statement expected at 12:45 BST and the press conference following next at 13:30 BST. While the meeting isn't expected to hold much news for policy at the moment, in-depth details on the implementation of the new ECB strategy review is set to capture investors´ attention along with what purchases will look like over the summer.

How the ECB plans to achieve its new symmetric 2% target and tackle climate change will be the main questions at sight, with a major credibility test hanging in the balance for the ECB. A preview is included below. **Also at 13:30 BST, markets will turn to US jobless claims** after this week's print showed claims remain on a downward trajectory that should reach pre-pandemic levels by the end of the summer when expanded benefits ebb.

The operational course of action following the new guidelines will mark the route for European assets including the **euro** looking ahead.

As the start of the ECB press conference coincides with the jobless claims data release, it may be difficult to navigate through FX markets around then, especially if the jobless claims deviate significantly from the recent trend.

Friday – 23/07

Friday's agenda starts with UK retail sales from June at 07:00 BST and is expected to show a significant month-on-month improvement after May's retail sales unexpectedly dipped following a record drop in food sales. The decline in food sales likely reflected the shift toward eating as the weather improved and restrictions around hospitality were gradually eased. June's reading is set to reflect the consumer-led recovery. **At 09:00 BST, the euro area comes out with flash composite purchasing managers' index figures.** These are expected to climb further in July, as June marked some further easing of restrictions in various eurozone countries, especially in the services sector. **Similar figures are then scheduled for release in the UK**, where the consensus foresees a print of 62.5 for the composite reading compared to last month's 62.2. This will provide markets with an idea of how the final stages of easing restrictions have impacted sentiment. **The Central Bank of Russia announces its interest rate decision at 11:30 BST on Friday and is set to hike rates by another 75bps to bring the key rate up to 6.25%, as inflation pressures continue to weigh on the ruble.** More on this below.

ECB Preview:

On the way to persistent accommodation

The European Central Bank´s policy meeting on July 22nd will be broadly watched by markets, after ECB President Christine Lagarde set the tone for an eventful discussion last week. The Bank recently launched the results of its strategy review, providing the ECB with a broader space to deliver even more accommodative and flexible monetary policy. At least three major changes were noted in the institution's new rulebook. First, the ECB made a significant twist to the inflation goal, from "close to, but below 2%" to a symmetric 2% inflation commitment over the relevant timeframe of the monetary policy. Second, the ECB set the groundwork for a more representative measure of inflation that accounts for the cost of housing, which could eventually yield a higher level of inflation in the eurozone. Finally, the institution made a strong political vow to promote environment-friendly investment, which is also poised to affect the general inflation outlook on a broader scale.

How does the new inflation target reshape monetary policy?

The ECB's strategy review ratified the interest rate as the centrepiece of the policy setting, while acknowledging the core functions of unconventional tools like asset purchases and forward guidance. Given that policy rates are already at their lower bound, the more significant changes to the current setup should be embodied in the marginal tools.

> "Next week's meeting is meant to be the platform in which the **ECB sheds more light on these new guidelines**, while also discussing what that policy will look like over the rest of the summer."

We expect the Governing Council to update its forward guidance with a realisation that a transitory episode of inflation overshoot might be needed in order to provide a persistent monetary support.

Although the new target is symmetric – which means that both above and below inflation are equally undesirable - the ECB signalled tolerance for temporary inflation overshoots. In practice, the overshooting bias provides the ECB with a stronger mandate: it calls for action in the presence of underperforming inflation while demanding a softer need for adjustment when the economy overheats. This also sets a higher bar for hawks within the Governing Council, whose patience will now be tested by the institutionalised more dovish approach.

QE stimulus is also put under a microscope as the ECB is expected to provide a clearer path ahead regarding asset purchases. As PEPP faces its end in March 2022 while persistent monetary accommodation is still needed, questions arise around the QE agenda further ahead. The ECB can operationalise its revamped approach via asset purchases under multiple recipes.

The Bank could either extend the duration and size of PEPP, or replace the programme at maturity with a stronger APP agenda to maintain favourable financing conditions. The policy review effectively recognises the importance of sovereign bond yields and spreads within euro-area bond markets to the ECB´s mandate, which means that ample flexibility would remain a core component in the policy setting. We believe a feasible path forward would be to signal the replacement of PEPP in March with an upsized APP programme between €30bn and €40bn monthly purchases afterward – up from €20bn currently-, to be appeased as economic conditions allow. A front-loaded QE strategy not only would allow for a faster convergence to the inflation goal, but will provide stronger credibility of the new ECB strategy.

5Y5Y Inflation Swaps: The ECB has consistently failed in anchoring inflation expectations around 2% in recent history.

Are changes to the inflation measure trivial for the policy setting?

Even as ascertaining the appropriateness of the current inflation measure, the Harmonised Consumer Price Index (HICP), the ECB reckoned that owner-occupied housing costs (OOH) should be present in a more representative inflation gauge. Relative to its international peers, the euro-area HICP underscores the weight of living costs even as the rate of home ownership is high, 50% on average. In comparison, rented accommodation costs account for a 6.5% of the HICP. Therefore, including OOH weights to the ECB´s preferred inflation measure, would assure a more accurate and comparable metric. Estimates for the augmented HICP considering housing indicate that the observed inflation could be some 10-30 basis points higher than current headline figures. Moreover, housing inflation should align more accurately with the cyclical properties of overall inflation and output.

"These methodological changes are far from trivial in terms of policy implications, as a potentially higher level of inflation could limit the stimulus delivered by the ECB to achieve the upwardly revised inflation target."

It isn´t easy though; the inclusion of OOH poses significant methodological challenges regarding the data harmonization across countries, frequency and timeliness. In the presence of such complexities, implications for policy are not straightforward and will require a few years to fully develop.

Neutrality in green policies?

The ECB pulled a major political string by committing to incorporate climate change considerations into its policy framework. While this principle has become a cornerstone in European institutional policies, the adoption by the ECB as a key component of monetary policy has no neutral effects on pricing. It´s not only about promoting green practices "in line with its obligations under the EU Treaties"; it also matters for market dynamics and eventually for price stability.

> "The upcoming meeting should pinpoint the specific policy implications on this new area."

The strategic review already revealed that environment considerations should reshape policy from the very analysis of the economy and financial markets, to the actual design of the QE and the collateral framework of the ECB. Aside from the practical details, the main takeaway for investors is that the green mandate should solidify the dynamics in which lots of capital chase relatively few assets, driving up market prices and keeping yields low. As such, tackling the climate change will not only be beneficial for the environment, but should help the ECB to deliver on its mandate.

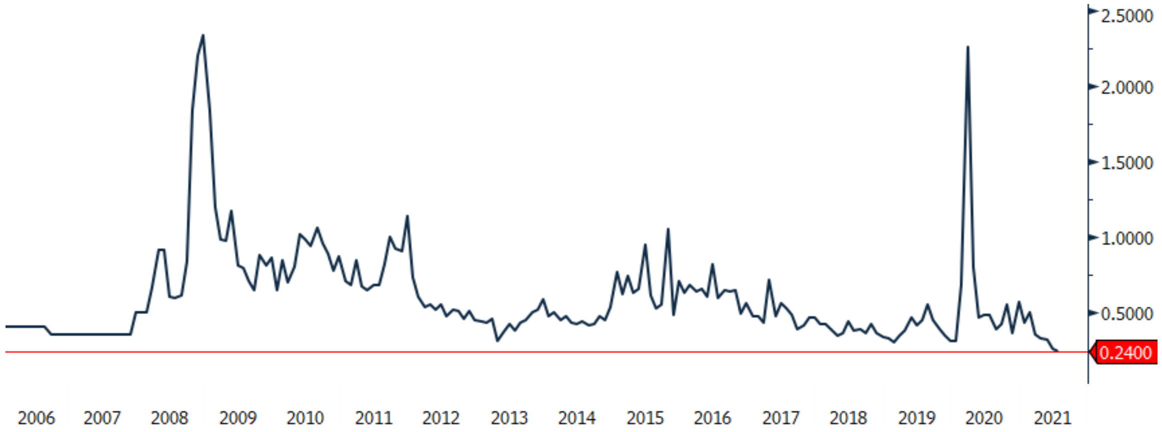
ECB credibility test

By warning investors about an impactful meeting ahead, the ECB has set up a major credibility test for itself. The task for Lagarde is relatively easier under the light of diverging central banks like the Fed and the Bank of England, which are already discussing the tightening agenda. But the goal isn´t simple at all. The ECB has consistently failed to drive prices and inflation expectations towards the aim over the last decade, even though substantial policy accommodation had been put in place.

> "A low volatility environment overall suggests that traders are not too anxious about Lagarde´s further remarks since the policy direction is broadly priced in already."

Demand for euro out-of-the-money options into ECB decision keeps dropping, with one-week 10-delta butterfly falling to record lows. The high bar for surprises carries a low event risk for next ECB meeting, but opportunities are out there should the ECB move towards a significantly more dovish road ahead.

EURUSD one-week 10-delta butterfly indicates no big surprises are expected on next ECB meeting.



CBR Preview:

Central Bank of Russia to speed up the pace of tightening as inflation risks mount

The Central Bank of Russia was one of the first central banks in the EM space to kick start a tightening cycle as inflation risks were mounting, and commentary by CBR Governor Nabiullina paired with the latest surge in inflation give markets all reason to expect another rate hike at Friday's meeting. Since March, the CBR hiked rates by a total of 125bps, with the first move adding 25 basis points, followed by 50bp hikes in April and June respectively.

> Since then, developments pointed to the CBR opting for another aggressive rate hike and an open door to more tightening ahead.

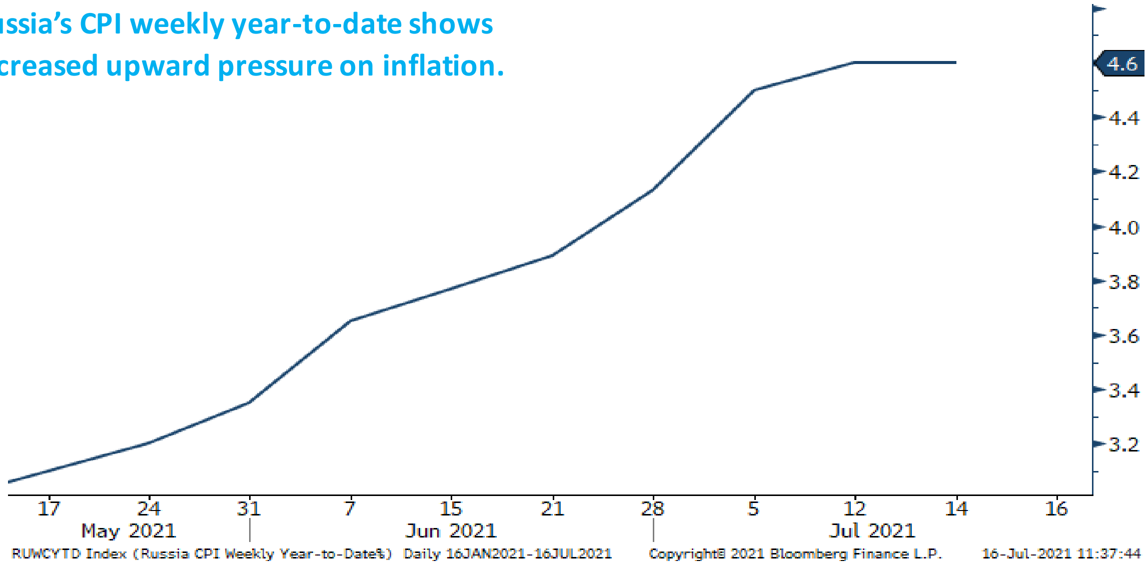
75bp hike expected, but more aggressive hiking not ruled out

At the end of last month, Governor Nabiullina commented on the July decision and stated that the the CBR considers raising the rate by 25-100bps. The hawkish signal came after the consumer price index jumped by more than expected to 6.5% in June, leaving inflation well above the 4% target. The median of forecasts submitted to Bloomberg now foresees a 75bp rate hike to reach a key rate of 6.25%, and we see this as the most likely option, although risks are tilted towards a more aggressive hike.

Below are the main developments that make a rate hike on Friday imminent:

- Escalating tensions with the US on the back of the ransomware attacks linked to Russia have been weighing on the ruble lately. President Joe Biden urges Russian President Vladimir Putin to act against hackers, warning that the US would defend networks considered vital to the economy. Combined with the recent surge in inflation, this could further stoke downward pressure on the ruble.
- Data showed prices for food and fuel have been rising by more than expected in May and June, but weekly indicators point to a further acceleration in July as well. The first five days of July saw weekly CPI stand at 4.5% year-to-date, while the week after showed a print of 4.6%.

Russia's CPI weekly year-to-date shows increased upward pressure on inflation.



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Despite the resurging virus case count in Russia, consumer demand has remained stable and mobility data is little changed compared to before the surge. Additionally, most of the factors contributing to the inflation surge include food and energy price increases as well as shortfalls in supply.

These drivers are highly sensitive to reopening effects, which means the CBR may want to avoid more aggressive tightening than 75bps until more is known about the inflation outlook.

"A 75bp rate hike should continue to support the ruble while any upward surprises should lead to higher moves."

Markets may be asymmetrically more sensitive to the CBR under-delivering given the current inflationary environment. For this reason, a downward surprise may weigh more for the ruble than a full-point hike surprise.