

LAGARDE'S REAL VISION

The primary focus of the ECB remains on fostering a sustainable recovery. The current policy stance fits with that. And so does a strong euro.

Efforts to hype up September's ECB meeting as a make or break for the euro have come to nothing. President Lagarde's press conference showed the pragmatists remain in control. She outlined a consistent vision of how policy ought to evolve going forward, brushing off the most recent decline in Eurozone inflation rates and repeated questions about the appreciation of the euro. Both might appear to be a nightmare from a price stability focused ECB. But in reality, neither represent any new threat to the medium-term outlook. That was enough to leave the overall policy footing unchanged, with the governing council — as ever — willing to respond to changing circumstances as needed. Lagarde expressed a clear preference for more asset purchases over rate cuts if more action was needed.



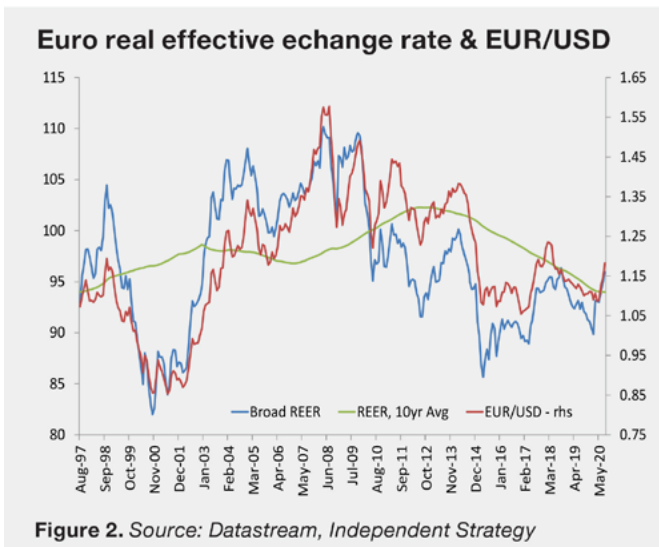
This seems a sensible approach. The governing council should overlook the decline in August inflation and prices over the next few months.

There is plenty of short-term chop weighing on the data. This ranges from the 3% pt. reduction in German VAT, which came into effect at the start of July and will run through to year-end. This has knocked 2% pts. off the German yoy inflation rate (Figure 1). There is also quite a bit of volatility in the individual components as disruptions from Covid work through. Services during the holiday season look particularly vulnerable to downward swings. Energy will remain a persistent drag and earlier increases in food prices should unwind. All together, the headline data should continue to understate the true picture of underlying inflation slightly.

The argument still stands that underlying inflation is still too low, but this is a persistent and largely structural problem that pre-dates Lagarde and Covid. Trying to engineer some kind of euro depreciation won't have any

Disclaimer ARCA FONDI SGR SpA. Via Disciplini 3, 20123, Milano.

La presente pubblicazione è prodotta da Independent Strategy e distribuita da ARCA FONDI SGR. Pur ponendo la massima cura nella predisposizione della presente pubblicazione e considerando affidabili i suoi contenuti, ARCA FONDI SGR non si assume tuttavia alcuna responsabilità in merito all'esattezza, completezza e attualità dei dati e delle informazioni nella stessa contenuti ovvero presenti sulle pubblicazioni utilizzate ai fini della sua predisposizione. Di conseguenza ARCA FONDI SGR declina ogni responsabilità per errori od omissioni. La presente pubblicazione viene a Voi fornita per meri fini di informazione ed illustrazione, non costituendo in nessun caso offerta al pubblico di prodotti finanziari ovvero promozione di servizi e/o attività di investimento né nei confronti di persone residenti in Italia né di persone residenti in altre giurisdizioni, a maggior ragione quando tale offerta e/o promozione non sia autorizzata in tali giurisdizioni e/o sia contra lege se rivolta alle suddette persone. ARCA FONDI SGR non potrà essere ritenuta responsabile, in tutto o in parte, per i danni (inclusi, a titolo meramente esemplificativo, il danno per perdita o mancato guadagno, interruzione dell'attività, perdita di informazioni o altre perdite economiche di qualunque natura) derivanti dall'uso, in qualsiasi forma e per qualsiasi finalità, dei dati e delle informazioni presenti nella presente pubblicazione. La presente pubblicazione è destinata all'utilizzo ed alla consultazione da parte dei collocatori di ARCA FONDI SGR cui viene indirizzata, e, in ogni caso, non si propone di sostituire il giudizio personale dei soggetti a cui si rivolge. ARCA FONDI SGR ha la facoltà di agire in base a/ovvero di servirsi di qualsiasi elemento sopra esposto e/o di qualsiasi informazione a cui tale materiale si ispira ovvero è tratto anche prima che lo stesso venga pubblicato e messo a disposizione della sua clientela. ARCA FONDI SGR può occasionalmente, a proprio insindacabile giudizio, assumere posizioni lunghe o corte con riferimento ai prodotti finanziari eventualmente menzionati nella presente pubblicazione. In nessun caso e per nessuna ragione ARCA FONDI SGR sarà tenuta, nell'ambito dello svolgimento della propria attività di gestione, sia essa individuale o collettiva, ad agire conformemente, in tutto o in parte, alle opinioni riportate nella presente pubblicazione.



effect on that and is really outside the control of the ECB, mandated or otherwise. While local currency strength has contributed to some of the recent weakness in import prices, it's tough to argue that this is a significant driver, or for that matter any driver of the disinflation we've seen. Clearly there are bigger things going on than that, like the collapse of oil prices and the economic shock triggered by efforts to contain the virus.

In the real world, given the demand hit from Covid, this episode of 'too low inflation' should be viewed as a positive contributor to the recovery, not something sinister. It increases the purchasing power of struggling consumers, thus supporting the recovery in demand.

ECB macroeconomic scenarios

	September 2020 Projections								
	Mild Scenario			Baseline			Severe Scenario		
	2020	2021	2022	2020	2021	2022	2020	2021	2022
Real GDP	-7.2	8.9	3.5	-8.0	5.0	3.2	-10.0	0.5	3.4
HICP	0.3	1.2	1.8	0.3	1.0	1.3	0.3	0.7	0.7
Unemployment	8.3	7.8	6.6	8.5	9.5	8.8	8.9	11.4	11.2

	June 2020 Projections								
	Mild Scenario			Baseline			Severe Scenario		
	2020	2021	2022	2020	2021	2022	2020	2021	2022
Real GDP	-5.9	6.8	2.2	-8.7	5.2	3.3	-12.6	3.3	3.8
HICP	0.4	1.1	1.7	0.3	0.8	1.3	0.2	0.4	0.9
Unemployment	8.8	8.5	8	9.8	10.1	9.1	11.3	12.5	11.2

Table 1. Source: ECB, Independent Strategy

The notion that a stronger euro might slow exports and compound manufacturers' woes looks equally flimsy. It's tough to find a recent example of a country that has enjoyed an export boom thanks to a weaker currency, Japan being a comparable example where export volumes were completely static despite a currency depreciation of 25%. And in real terms the euro still looks reasonably priced. The real effective exchange rate is just 2% above its long-term average and substantially below the levels it was trading the last time a strong euro flustered the Governing Council (Figure 2). The main determinant of export growth will be the broader recovery of the global economy. Looking at the US and China that is on track.

We'd also take a positive view of the updated staff macroeconomic projections (Table 1). The baseline scenario saw positive revisions to 2020 growth and unemployment. Although the subsequent rate of recovery in 2021 and 2022 were shaded lower, the shallower trough is far better news. The alternative scenarios also provided some encouragement, with the worst case now looking milder than the declines policy makers were fretting about as the central scenario when the pandemic broke in the spring.

The prompt fiscal response — something the ECB seems very pleased with — alongside the uncharacteristically swift monetary policy reaction has clearly worked well too. This helped to ameliorate that labour market disruption while quick and generous liquidity measures helped avoid any credit crunch, creating a solid base from which to build the European recovery. The stronger euro partly reflects this positive reality, alongside the forward steps that Covid generated in terms of moving the entire euro project forward, specifically the relaxation of fiscal rules and delivery of a mutualised policy response.

Overall, we expect the Governing Council will maintain a pragmatic approach to euro gains and would expect to see further appreciation as the recovery continues. Downside risks for the currency look to stem entirely from any potential setback to the recovery and should not alter the outlook for monetary policy in isolation. In fact, a weaker currency/weaker growth and further policy steps look a more likely combination for euro bears to look for.

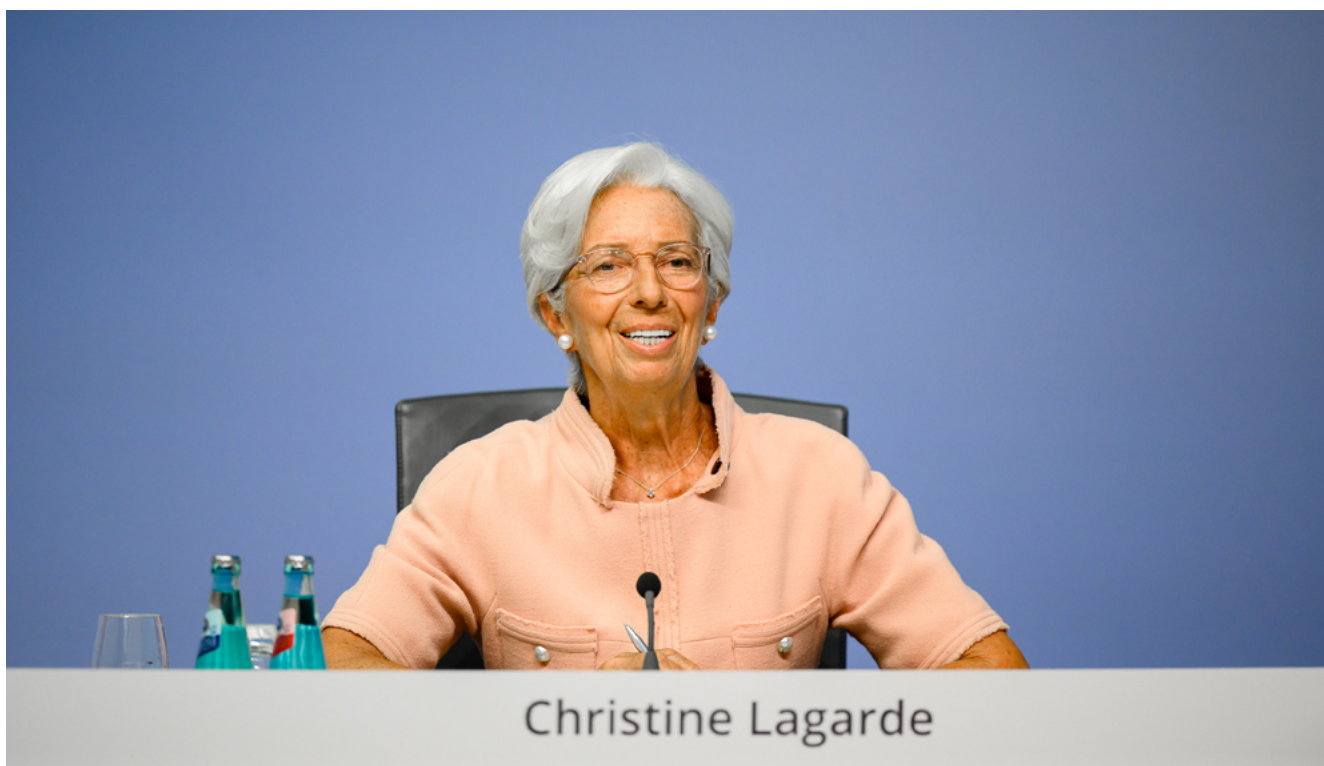


Photo by Sanziana Perju / European Central Bank / <https://www.flickr.com/photos/europeancentralbank/50326360818/in/album-72157715841969527/>

This memorandum is based upon information available to the public. No representation is made that it is accurate or complete. This memorandum is not an offer to buy or sell or a solicitation of an offer to buy or sell the securities mentioned herein. Independent Strategy Limited has no obligation to notify investors when opinions or information in this report change and may disseminate differing views from time to time pertinent to the specific requirements of investors. Independent Strategy Limited is authorised and regulated by the Financial Conduct Authority in the UK. Save for any liability or obligations under the Financial Services and Markets Act 2000, Independent Strategy Limited accepts no liability whatsoever for any direct or consequential loss arising from any use of this memorandum and its contents. It may not be circulated to or used by private investors for any purpose whatsoever, or reproduced, sold, distributed or published by any recipient for any purpose without the written consent of Independent Strategy Limited.