On our radar screen

Sintra's syntax

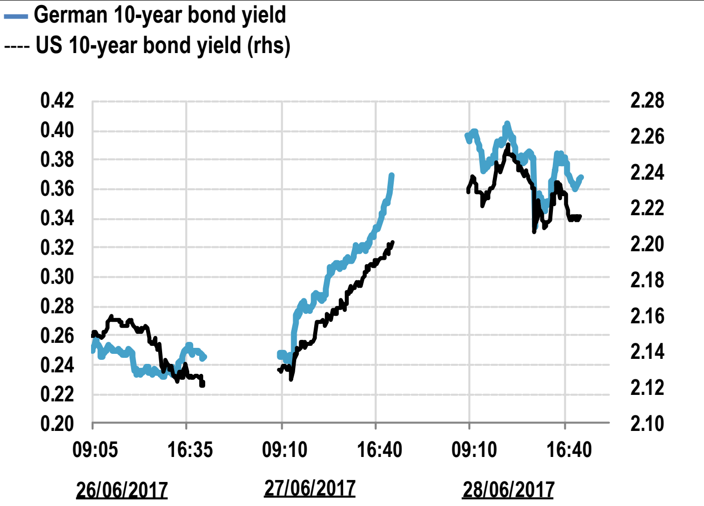
■ The market reaction to the introductory speech of Mario Draghi at the ECB conference in Sintra was strong ■ This reflects a high degree of unease about the prospect of a policy normalisation ■ The upcoming ECB Governing Council meetings (20 July, 7 September) should trigger more market nervousness than has been the case in a long time

Did the ECB have a hunch that the invitation-only annual gathering in Sintra could bring market moving news or was it just a coincidence that this year's event could be followed live via webcast? In any case, compared to last year when the mood was downbeat right after a small majority of British voters had said no to the EU, this year the economic sky looked a lot brighter and the conference brought some market-moving news. It is reminiscent of the Fed's Jackson Hole meeting some years ago when QE was brought to the table.

The market reaction to the introductory speech of Mario Draghi was strong, as illustrated by the accompanying charts with the intraday evolution of bond yields (please note the impact on US yields as well) and the euro against the dollar. The jumps are to some degree understandable. Low volatility offers comfort and better sleep at night but it brings frustration because it implies trading opportunities are scarce. When the stakes are high and things seem to start moving it is key not to miss the opportunity. The sensitivity reflects an attitude of "shoot first and then we'll check what the noise was about". Adopting such a stance is all the easier when the investment horizon or more appropriately trading horizon is very short and the transaction costs are tiny: positions can be closed easily.

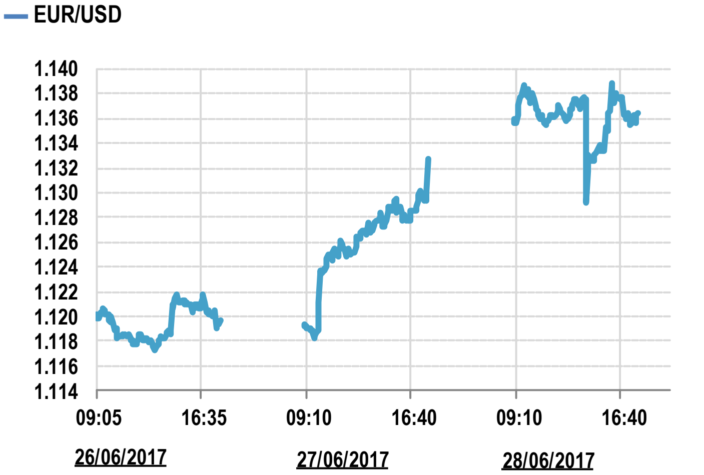
More fundamentally the market swings reflect a high degree of unease because "it" is coming. "It" refers to monetary policy normalization which means scaling back QE by the ECB. These processes are very drawn out: in the US Ben Bernanke first referred to tapering in May 2013, it was implemented in 2014 but we had to wait until December 2015 for the first rate hike and December 2016 for the second. This year the pace has been stepped up with increases in March and June (we expect another one in December). This glacial pace did not stop markets from getting very concerned about it (the taper tantrum of 2013) although subsequently their attitude became quite relaxed. The same could very well happen in the euro area. Investors now realise that the ECB, having been cruising on a QE highway, is likely in the not too distant future to take another road, towards higher rates. Markets are discounting mechanisms so understandably the initial reaction will be big in comparison to the immediate central bank action, because investors will anticipate subsequent moves as well.

Intraday evolution of bond yields



Source: Bloomberg, BNP Paribas

Euro versus dollar



Source: Bloomberg, BNP Paribas

This leaves us with the impression that when a change of policy direction is imminent the thinking becomes binary and nuances don't count. On the contrary, what was intended to be very balanced as a statement ends up being simplified to something rather blunt. We had seen that with Bernanke in May 2013: a statement like *"If we see continued improvement and we have confidence that that's going to be sustained then we could in the next few meetings ... take a step down in our pace of purchases*"[1] would look pretty anodyne to most people but in financial markets it had a big impact. Same thing for Mario Draghi last week who towards the end of his speech said *"As the economy continues to recover, a constant policy stance will become more accommodative, and the central bank can accompany the recovery by adjusting the parameters of its policy instruments – not in order to tighten the policy stance, but to keep it broadly unchanged."*[2]

At first glance the reader might wonder *"why all the fuzz?"* but markets jumped to the message that a constant stance would become more accommodative as the recovery continues, implying a need to tighten to keep the policy stance unchanged. The caveats which followed (market volatility can caused an unwarranted tightening of financial conditions, the need for prudence in the adjustment of the policy parameters) were something falling on deaf ears. The implications are twofold: one, good economic data should fuel the anticipation of change coming from the ECB and two, the upcoming ECB Governing Council monetary policy meetings (20 July, 7 September) should trigger more market nervousness than has been the case in a long time.

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[1] Source: Reuters
[2] Source: ECB, Accompanying the economic recovery, Introductory speech by Mario Draghi at the ECB Forum on Central Banking, Sintra, 27 June 2017