MARKET COMMENTARY

ECB hikes by another 25 bps but puts high hurdles to further hikes

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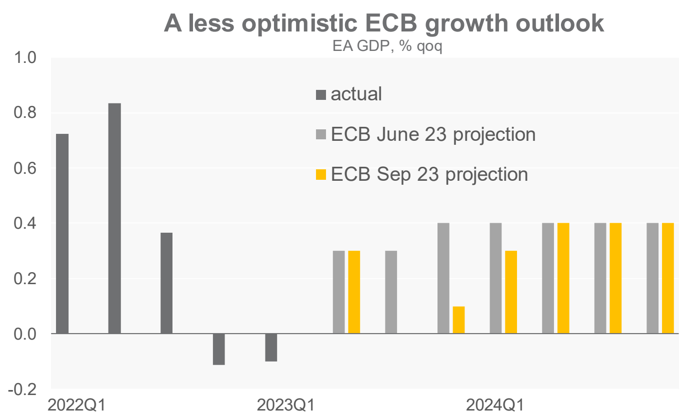
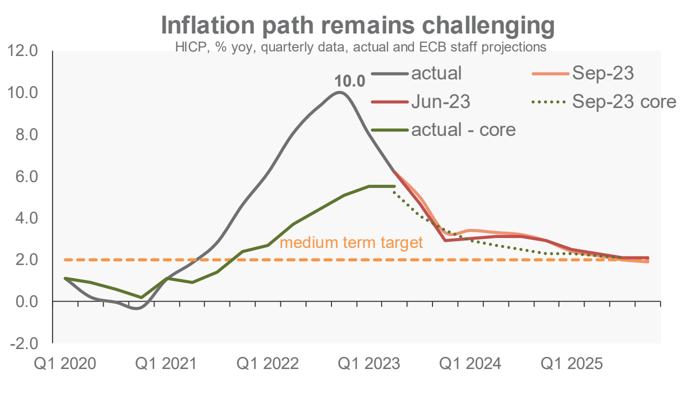
- **At today's meeting the ECB's Governing Council (GC) agreed to raise rates by a further 25 bps. But unlike last time it was backed by a "*solid majority*" and not unanimity.**
- **This was not trivial given weak activity data and the downward revision of the ECB's growth and underlying inflation projections. The key rationale was that especially headline inflation is still seen as "*too high for too long*" and that some indicators of inflation expectations "*increased and need to be monitored closely*".**
- **The GC implied that at current levels rates are sufficient to bring inflation back to target but that this needs "*a sufficiently long duration*". In the Q&A President Lagarde gave the impression that it would need much to trigger another hike and that the focus now shifts towards the duration of the present rate level. She dented speculations about outright bond selling.**
- **All in all, we think that the peak of the hiking cycle is now reached given the still too optimistic growth outlook of the ECB. We see the risk of a policy mistake rising but expect the easing cycle not to start before Q3 2024.**
- **Markets celebrated the dovish hike in a knee-jerk reaction.**

GC decided to lift rates to an all-time high: At today's meeting the GC lifted its key rates by another 25 bps thereby bringing the deposit rate to 4.00% and the repo rate to 4.50%. It continues with APP non-reinvestments and sticks to PEPP reinvestments until year-end 2024. Also, in the Q&A President Lagarde mentioned that the ECB will become compliant with the Paris Agreement by year-end 2023 and that further measures to remain so will be discussed.



Source: Datastream, ECB



Source: Datastream, ECB, GIAM calculations

Growth revised down but return to normal quickly expected: Since the June macro projections activity indicators like the PMIs deteriorated significantly and GDP growth for Q2 has been revised down by 0.2 pp to just 0.1% qoq. However, the fresh ECB forecasts still assume the initial estimate of 0.3% qoq and look only for stagnation but not receding activity in the third quarter of this year. Next year quarterly growth rates are set to return to normal again. The key driver is higher consumption on the back of receding inflation and a good labour market. As a result, the annual growth numbers come down to only 0.7%

in 2023 (from 0.9%) and 1.0% in 2024 (from 1.5%) while 2025 is largely left unchanged at 1.5% (from 1.6%). We deem these projections still too optimistic and look for a downward revision at the next update in December.

Short-term increase of inflation outlook a concern: Disinflation was hampered by increasing oil and gas prices as of late, but measures of core inflation turned. In its new inflation forecasts, the ECB lifted its projections for headline inflation to 5.6% in 2023 (from 5.4%) and 3.2% in 2024 (from 3.0%) but reduced the 2025 expectation slightly to 2.1% (from 2.2%). Quite noteworthy, in the last quarter of the forecast horizon headline inflation is set to be 1.9% yoy at target and underlying inflation with 2.1% yoy "*almost at target*". Hence there is light at the end of the tunnel. It became clear from the press conference that mainly the upward revision of headline inflation for 2023/24 raised concerns by the GC. Moreover, the GC expressed worries about inflation expectations as "*some indicators have increased and need to be monitored closely*."

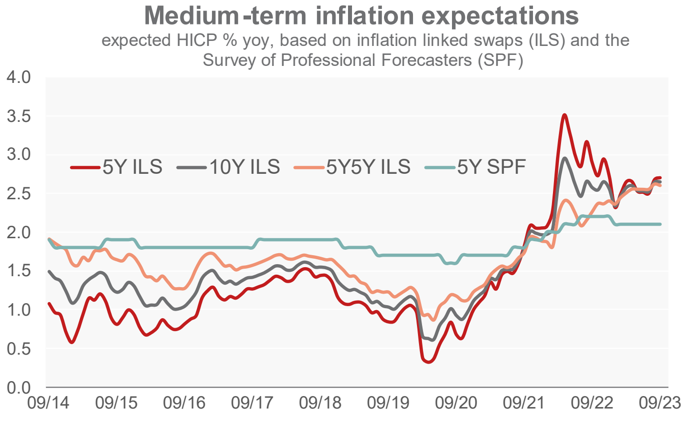
Medium term less need for further tightening: That said, Lagarde also made clear in the Q&A that the transmission of monetary policy was "*extremely rapid*" on its way to lifting financing conditions for firms. Moreover, she sees wage growth plateauing. And in the Q&A it also became clear that the GC is quite concerned about commercial real estate and the non-bank financial system.

A big hurdle for another rate hike: With today's 10th consecutive hike, key rates advanced by cumulatively 450 bps since July 2022. Looking ahead, the ECB signalled that the hurdle for further rate hikes is very high as it stated, "*that the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target".* Mrs. Lagarde characterised this as heavy words. To us, they made clear that the current rate hike was the last one for the time being. She also made clear that the focus now shifts from the level of rates to the duration of rates at the current level. We think that the GC intends to leave rates at current levels until Q3 2024. Furthermore, she reiterated that the key rate is the primary policy tool denting speculations about accelerated tapering.

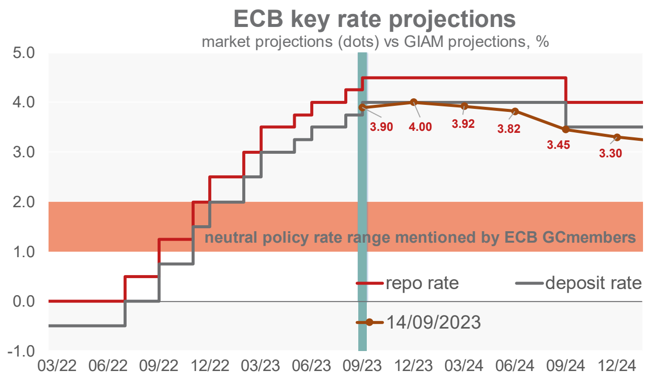
A deal between hawks and doves? Today's decision was met with a "*solid majority*" and no longer with unanimity and only reached after a longer discussion. Against this backdrop, the big hurdle for further rate hikes can also be seen as a compromise between hawks and doves that the hiking cycle is finished now. However, the next milestone will be in December when the ECB updates its macro projections and extends the forecast horizon by one year to 2026. Unlike in the case of upside risks to inflation materializing this should give support to the doves making a further rate hike even less likely.

Risk of policy mistake increases: However, we still deem the ECB's growth outlook as too optimistic. At the same time, the "*extremely rapid*" transmission of monetary policy could harm growth even more and bring inflation on a lower trajectory. This could turn out to be a policy mistake.

Markets celebrated the dovish hike: In a knee-jerk reaction yields receded, especially BTPs, the EUR lost strongly while share prices surged.



Source: Datastream, ECB, GIAM calculations



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