MARKET COMMENTARY

ECB: Lagarde no longer dismisses a 2022 rate hike but hurdles remain high

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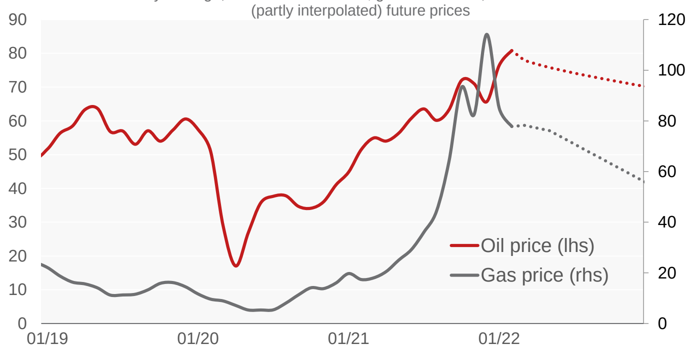
- **As expected, at today's meeting the Governing Council (GC) did not act and just "*confirmed the decisions taken at its monetary policy meeting last December*".**
- **That said, while still defending the transitory inflation view the headache on the back of upside inflation surprises is getting stronger and the policy statement acknowledged that inflation risks are "*tilted to the upside*".**
- **President Lagarde made clear that the March meeting will be pivotal. She refused to reiterate that a 2022 rate hike was "*very unlikely*" and rather stated that this was contingent on the projection. But she also emphasized that QE would be terminated before lifting rates and that the criteria for hiking rates still need to be fulfilled.**
- **We see a first rate hike in 2023. However, the risk that the GC might be forced into a faster reduction of QE purchases and hike rates in 2022 increased significantly.**

Holding course for the time being: As expected, at today's meeting the Governing Council (GC) did not act and just "*confirmed the decisions taken at its monetary policy meeting last December*". However, the ECB finds itself between a rock and a hard place. With the January (flash) headline inflation of 5.1% yoy surprising strongly on the upside and marking a new high the ECB's policy course is increasingly questioned. And indeed, according to President Lagarde there was "*unanimous concern*" about this within the GC.

It's still only energy prices? She continued to emphasize that energy prices are clearly a major driver behind sky-rocketing inflation numbers. In January they contributed 2.7 pp to the headline reading. Inflation will stay higher for longer according to Lagarde but is still seen to decline over the year. Oil and gas futures are still consistent with disinflation from the fourth quarter onwards. However, during the Q&A Lagarde also hinted at the broadness of price increases.

Persistently high energy prices ahead

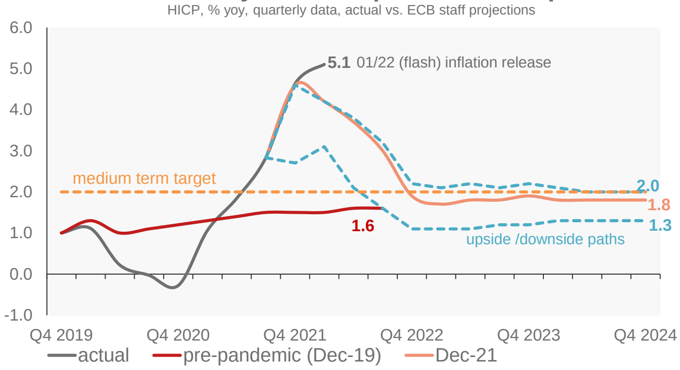
monthly average; oil: EUR/barrel brent, gas: EUR/ Mwh; dotted lines: latest (partly interpolated) future prices



Source: Datastream, GIAM calculations

Risks clearly tilted to upside inflation path

HICP, % yoy, quarterly data, actual vs. ECB staff projections



Source: Datastream, ECB, GIAM calculations

Inflation path will need to be shifted to the upside: At the March meeting the ECB staff will update its macro projections. It is perfectly clear that this will be to the upside. The materialization of geopolitical risks (and the impact on energy prices) related to the Ukraine as well as the outcome from the current wage round will be key. The GC is pretty much aware of the risks stemming from the labour market. "*If price pressures feed through into higher than anticipated wage rises or the economy returns more quickly to full capacity, inflation could turn out to be higher*." And there are indeed looming risks in some economies, for instance in Germany trade unions demand a 5% wage increase for 2022. According to Lagarde there are currently no "*significant wage increases*" yet. Stronger than anticipated wage growth would probably lift the outlook for core inflation(latest annual average are 1.9%, 1.7% and 1.8% for 2022-24) towards 2% and trigger policy action.

Financing conditions already tighter: That said, financing conditions have already tightened somewhat over the past months (see table below). Inflation expectations have broadly recovered towards normal and stabilized. Looking ahead, Fed policy tightening will likely contribute to further tightening of financing conditions in the euro area.

The ECB's Financing Conditions Dashboard

z-scores of respective variables with values > 0 indicating better than average financial conditions, < 0 the reverse; own calculations, latest data on lending rate estimated, BLS data monthly interpolated

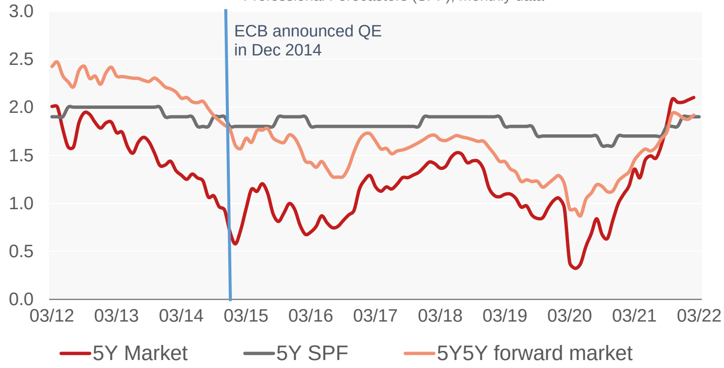
	2021	Q3 2021	Q4 2021	Dec-21	Jan-22	Feb-22
Gov. bond spread (GDP weighted)	1.45	1.46	1.48	1.51	1.37	1.40
Term premium (10Y-1Y OIS)	1.01	1.14	0.75	0.82	0.38	0.21
BLS credit standards	-0.64	0.00	0.23	0.27	0.30	0.33
BLS credit demand	-0.30	0.52	0.02	-0.08	-0.10	-0.12
High Yield spread	1.02	1.15	0.78	0.67	0.75	0.49
Lending rate	1.39	1.43	1.32	1.24	#NV	#NV
unweighted mean	**0.65**	**0.95**	**0.76**	**0.74**	**#NV**	**#NV**
~ ex Lending rate	0.51	0.85	0.65	0.64	0.54	0.46

last update: 03/02/2022

Source: Datastream, GIAM calculations

Euro area inflation expectations

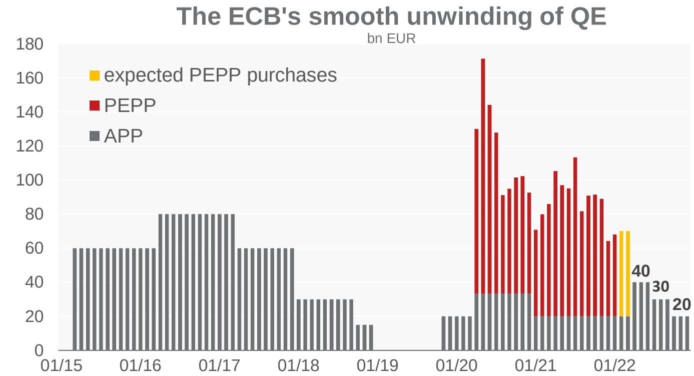
Market (implicit average inflation expectations from inflation swaps) versus Survey of Professional Forecasters (SPF), monthly data



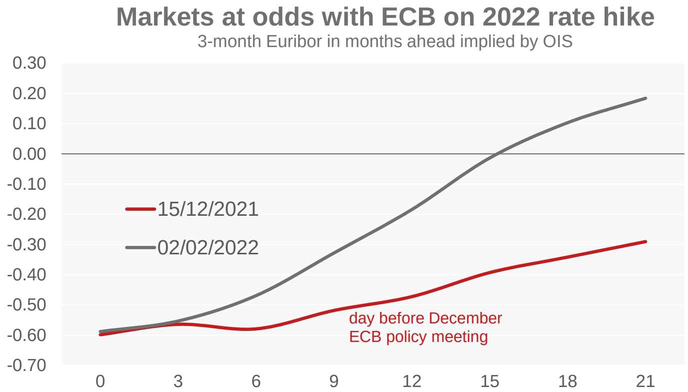
Source: Datastream, GIAM calculations

Pivotal meeting in March and 2022 hike no longer dismissed: The forthcoming meeting on March 10 will be pivotal. It became obvious during the press conference that the GC is becoming nervous about the inflation development. But Lagarde made clear that the situation will be highly data dependent and that within the GC there was "*determination around the table not to rush into decisions*". Clearly, the ECB's strategy demands inflation to reach its target "*well ahead of the end of its projection horizon and durably for the rest of the projection horizon*" and moreover the GC "*judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term*". The bar for hiking rates hence remains high. Still it is very noteworthy that unlike to the December meeting Lagarde not longer stated that a 2022 rate hike was "*very unlikely*". Instead she pointed out that this was a conditional statement based on the macro projections.

Risk of a 2022 rate hike increased: The uncertainty about the ECB policy path increased after today's meeting. Inflation with energy prices and wages are key. It became very clear that for most GC members the low inflation environment is probably over. However, when it comes to policy action Lagarde pointed out that the determination was made by the GC and that there is an "*element of judgement*." We deem it more likely than not that the ECB terminates QE in December and embarks on a first rate hike in 2023. Given the more hawkish tone of today's press conference this could be in March 2023. However, in case of upside risks to inflation materialising, the GC might be forced into an earlier rate hike. Hence it would need to step up its QE reduction and probably announce it at the March meeting. In such a case we could expect QE to end by September and envisage a first rate hike by December 2022.



Source: Datastream, ECB, GIAM calculations



Source: Datastream, GIAM calculations