

MARKET COMMENTARY

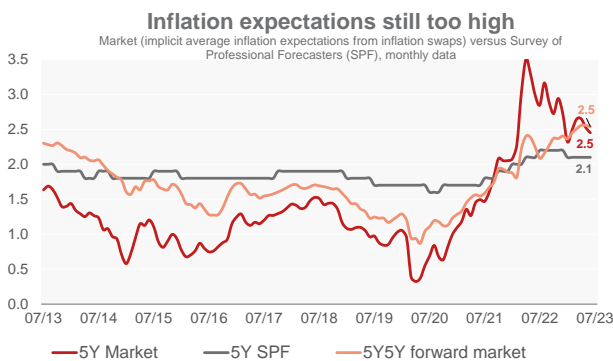
Hawkish ECB looks prepares for another hike in July, but hiking cycle may be nearing its end

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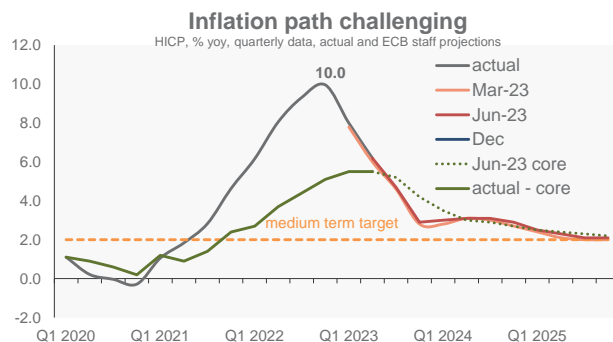
June 15, 2023

- At today’s meeting the ECB’s Governing Council (GC) lifted its key rates by another 25 bps, in line with expectations. It confirmed to stop of APP reinvestments from July onwards while sticking to its intention to continue PEPP reinvestments at least until the end of 2024.
- As in the previous meeting, inflation is seen as “*too high for too long*”. However, the Governing Council acknowledged that “*inflation has been coming down*”. It also no longer sees uncertainties regarding the effect of its policy but sees it “*gradually having an impact across the economy*”. Tighter financing conditions are a key reason why inflation is set to “*decline further towards target*”.
- The updated macro projections see headline inflation still averaging 3.0% in 2024 and GDP expanding healthily in 2023 and around potential in the 2024/25. The upward revision of core inflation is outstanding (by 0.5 pp in 2023 and 2024) and largely reflects higher labour costs. It also became clear from the press conference in between the lines that the GC sees the risk of second-round effects.
- Looking ahead, the GC reiterated that “*interest rates will be brought to levels sufficiently restrictive*” and President Lagarde stated that, barring a material change in the baseline scenario, a further hike in July is in the offing. We continue to look for one more 25 bps hike by then.
- However, we think that the end of the hiking cycle is nearing. We deem the ECB’s growth outlook too optimistic and think that the September macro forecast update will rather argue in favour of a pause. But as the tone of today’s press conference was rather hawkish, we acknowledge the risk of an additional September rate hike, which we fear would imply overtightening and the risk of low growth for longer.

A 25 bps rate hike today: At today’s meeting the GC lifted its key rates by another 25 bps thereby bring the deposit rate to 3.5% and the repo rate to 4.0%. As at the previous meeting it did not commit to further increases but maintained a data-dependent approach. It also expects to discontinue reinvestments under the APP from July on but did not change stance on PEPP reinvestments, expected to continue until year-end 2024 at least.



Source: Datastream, GIAM calculations



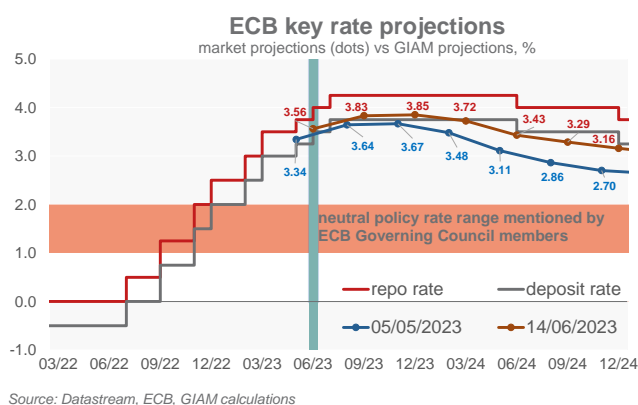
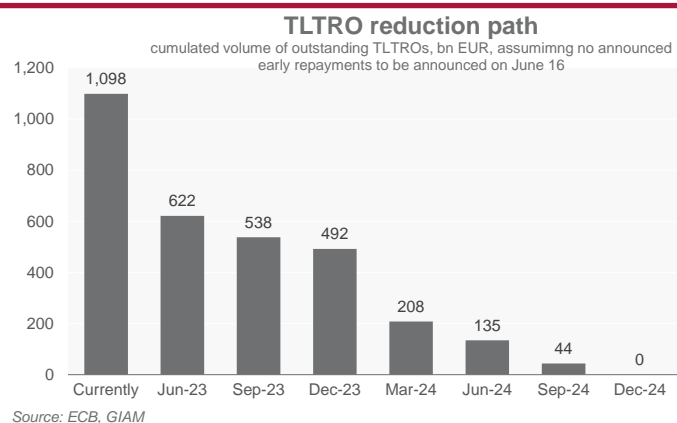
Source: Datastream, ECB, GIAM calculations

Inflation outlook still warrants higher rates: Since the last policy meeting inflation has continued to trend down. In April, even core inflation turned. There is indication of easing pipeline pressure as for instance producer price dynamics almost came to a stillstand (to 1.0% yoy in March from a peak of 43.5% yoy in Aug 2022) and energy prices moderated further. The GC acknowledged that the inflation outlook has been coming down while it is still projected “to remain too high for too long”. Most outstanding, the updated inflation projections saw an increase in the outlook for core inflation. It is now seen to average 5.1% in 2023 and 3.0% in 2024, up by 0.5 pp in each year. The 2024 headline inflation of 3.0% is above consensus (2.5%). As President Lagarde reiterated several times in the Q&A, labour market developments were crucial for the revised outlook on core inflation. Second round effects are not visible currently, but they could come into play later on.

A very optimistic activity outlook: The upwardly revised inflation projections rhymes with a very optimistic activity outlook. Euro area activity is set to expand by 0.9% this year and around 1 ½% in the 2024/25, broadly in line with potential. In the updated projection “the labour market remains a source of strength” with employment expanding and the unemployment rate coming down further. This is clearly above the 2023/24 consensus growth forecast of 0.7%/0.9% and in our view does not properly reflect the forthcoming headwinds from for instance the US falling into recession.

GC determined to hike in July again: There is no doubt that further policy tightening is ahead. The GC reiterated that “interest rates will be brought to levels sufficiently restrictive”. According to President Lagarde today’s decision was taken by “a very broad consensus” while the discussion was described as “harmonious”. During the press conference she stated that the ECB was not yet “at destination”, that there was “more ground to cover” and that barring a material change in the baseline scenario, a further hike in July was in the offing. Hence a further 25 bps hike in July looks highly likely.

Still, the end of the hiking cycle is nearing: With today’s 8th consecutive hike, key rates advanced by cumulatively 400 bps since July. Rates are now well into restrictive territory. Beyond the July meeting further ECB action is surrounded by high uncertainty. Already at today’s meeting the GC scaled down its wording about future hikes from “a lot more ground to cover” to just “more ground to cover”. We think that the ECB growth projections will need to be revised substantially down in September. At the same time, we expect the passthrough of tighter financing conditions to the economy to increase. We continue to expect that the ECB will stop tightening cycle with a peak (deposit) rate of 3.75% and stay on hold thereafter. However, as the tone of today’s press conference was rather hawkish, we acknowledge the risk of an additional September rate hike, which we fear would imply overtightening and the risk of low growth for longer.



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