MARKET COMMENTARY

ECB on hold amid heightened uncertainty

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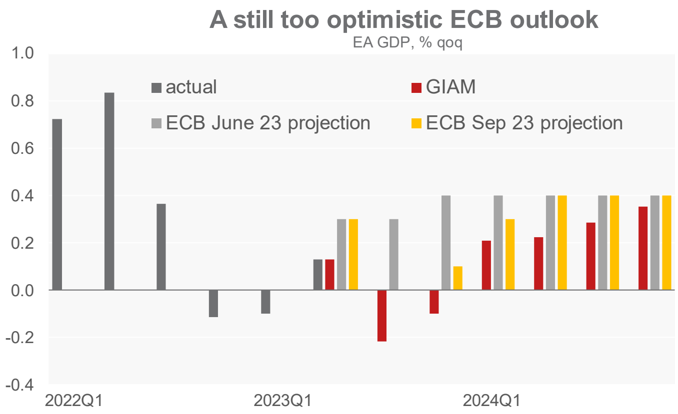
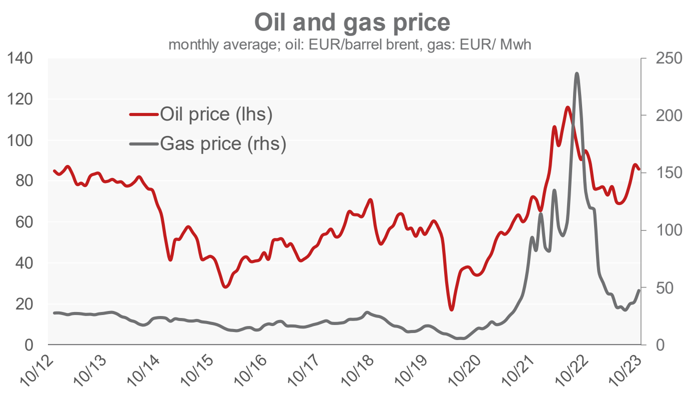
- **At today's meeting the ECB's Governing Council (GC) left its key rates unchanged, in line with expectations. The decision was made unanimously.**
- **President Lagarde acknowledged that inflation was broadly in line with the ECB's expectations but maintained the narrative that it was still "*too high for too long*". Unlike to the last meeting there seemingly was less confidence that current rate levels were sufficient to bring inflation back to target reflecting heightened uncertainty. On the other hand, negative growth risks were also emphasized.**
- **In the Q&A President Lagarde objected to any speculations about rate cuts qualifying this discussion as totally premature. But other policy measures like a higher Reserve Requirement Ratio or the stop of PEPP reinvestments had not been discussed either. Instead, the data-dependent approach and the possibility of further hikes were emphasized.**
- **Given increased geopolitical tensions it became clear that all eyes will be on the Dec 14 meeting when the macro forecasts will be updated, and projection horizon extended to 2026.**
- **All in all, we think that the peak of the hiking cycle is now reached but that it is still too early to envisage the first rate cut. For the time being, we stick to our call of a first cut by September 2024.**
- **Markets did not react much to today's decision, equity and bond prices advanced somewhat on weak growth vibes.**

GC decided to keep rates at an all-time high: At today's meeting the GC decided after 10 consecutive rate increases to leave key rates unchanged, the deposit rate at 4.00%, and the repo rate at 4.50%. It continues with APP non-reinvestments and sticks to PEPP reinvestments until year-end 2024 at least.



Source: Datastream, ECB, GIAM



Source: Datastream, GIAM calculations

A challenging growth outlook but ……: Since the September macro projections activity indicators like the PMIs deteriorated significantly implying contraction at the outset of the fourth quarter. And there is a high probability that Q3 growth (flash release on Oct. 31) will be negative. However, the latest ECB forecasts still assume expansion and the initial estimate of 0.3% qoq for

Q2 (instead of a downwardly revised 0.1% qoq) and look only for stagnation but not receding activity in the second half 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. At today's meeting, President Lagarde seemed to have lost some confidence in the ECB's latest projection. The official statement maintained a constructive view on growth arguing again that lower inflation improved global demand and would stimulate activity. However, in the Q&A the tone was much less constructive and she emphasized the downside risks. We think that at the December 14 meeting, a substantial downward revision of growth towards our projection of 0.4%/0.5% for 2023/24 will be ahead. This will significantly reduce the need for further tightening measures.

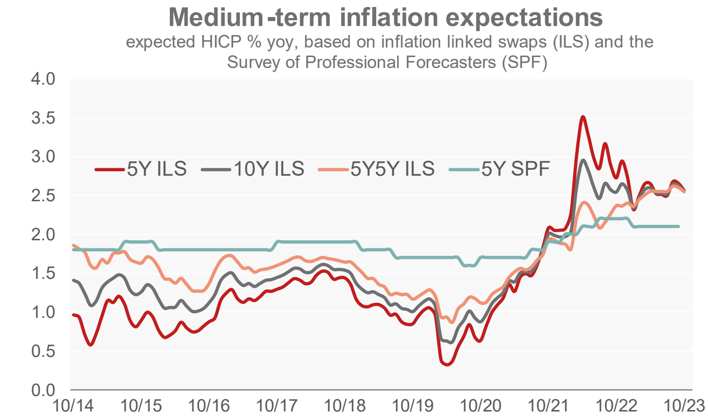
… inflation outlook still subject to significant upside risks: Disinflation continued over the past months and the latest data hint at easing pipeline pressure. The ECB had just lifted its projections for headline inflation to 5.6% in 2023 (from 5.4%) and 3.2% in 2024 (from 3.0%) and saw the current development broadly in line with that. Quite noteworthy, in the last quarter of the forecast horizon headline inflation is set to be with 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. But it is not enough to trigger a pivot yet. Higher energy and food prices as a result of the increased geopolitical tensions were mentioned as a new risk. More clarity about the need to keep rates at the current level should come at the next meeting when the forecast horizon is extended to 2026.

PEPP reinvestments or Reserve Requirement Ratio (RRR) not discussed: Quite surprisingly, at today's meeting neither the stop of PEPP reinvestments nor an increase of the RRR has been discussed. Instead, in the Q&A the importance of the key rates as the dominant policy tool was emphasized. This is in line with previous statements but the fact that there was no discussion of at least one of these instruments at all might also suggest to us that the ECB does not want to start that discussion not knowing whether it needs to fine-tune the dovish or hawkish side next.

A somewhat hawkish wait-and-see stance: In the current environment uncertainty for monetary policy makers has increased significantly. The GC faces a challenging situation of weakening growth amid prevailing downside risks and increased inflation uncertainty. The confidence about bringing inflation back towards target seems to have fallen compared with September. While at the Sep. meeting the GC expected "*a timely return of the inflation to target*", at today's meeting it only saw "*a substantial contribution to this goal*" from the current level of rates. Asked whether the ECB would look through another (energy price induced) inflation shock Lagarde pointed out that the ECB was data dependent. In the end, the impact on growth and inflation would be key, and the ECB's focus would be to bring inflation back to target. We conjecture that the ECB does not want to be again caught by an inflation shock on the wrong foot.

Discussion of rate cuts premature: Instead, Lagarde pointed out that policy tightening is being transmitted to the real economy. She forcefully dented speculations about the first key rate cut by revealing that it has not been discussed at all today and qualifying this discussion as "*totally, totally premature*". To us, this suggests that for the time being a first rate cut remains likely only by September 2024. All eyes will be on the next policy meeting on Dec. 14 and the question of whether the inevitable downward adjustment of the growth projections also lets the ECB become more open to an earlier start of the easing cycle. We see the risks tilted towards an earlier start or, if the ECB refuses to do so, the risk of a policy mistake rising.

Markets showed a moderate reaction: In a knee-jerk reaction, yields receded and equities gained on the back of weak growth vibes.



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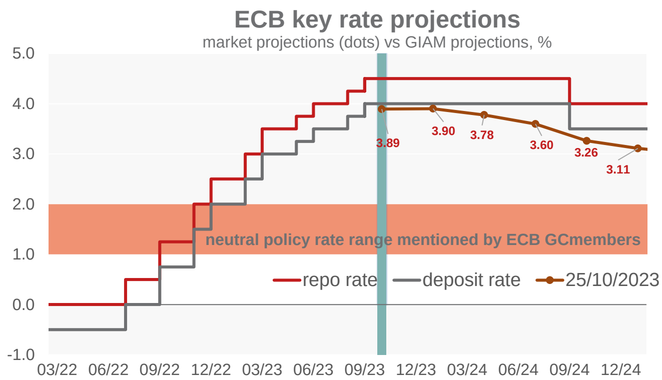

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