GENERALI INVESTMENTS

MARKET COMMENTARY

They did it – A hawkish 75 bps rate increase by the ECB with further hikes ahead

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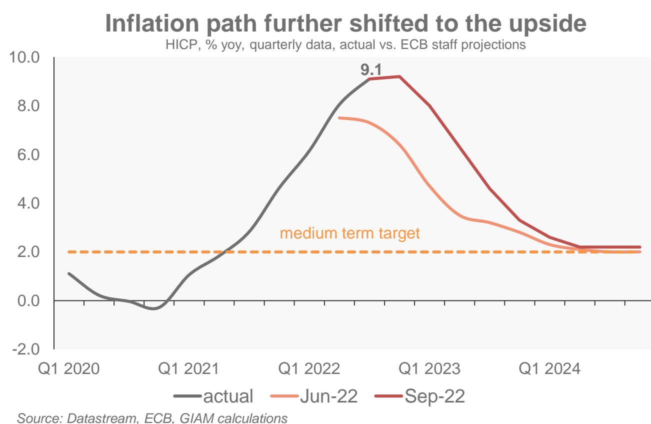
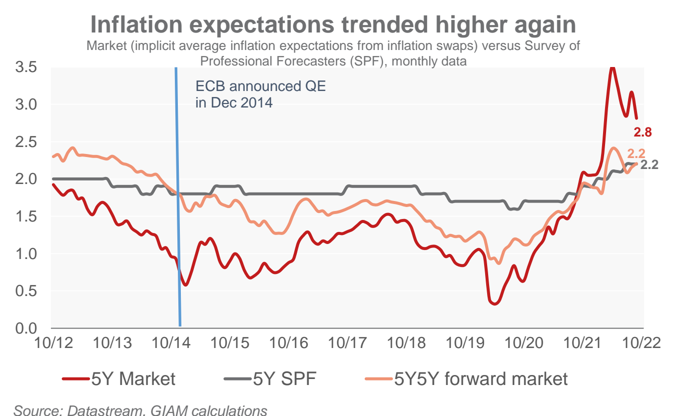
- **At today's meeting the Governing Council (GC) lifted its key rates by 75 bps. With the deposit rate in positive territory again, the ECB suspended the two-tier system for the remuneration of excess reserves.**
- **Continued flexible reinvestment of Pandemic Emergency Programme Purchases (PEPP) shall counter risks to monetary policy transmission. Temporary remuneration of government deposits shall also support policy transmission. However, we think this too little to counter dislocations at the front end of the curve.**
- **The GC's decision was taken unanimously. It wants to frontload "*the transition from the prevailing highly accommodative level*" and expects further rate increases over the "*next several meetings*". During the Q&A President Lagarde maintained a hawkish stance but gave no hint about the terminal or neutral rate and left the possibility of further bold hikes open.**
- **In the Q&A, Lagarde also suggested that rate hikes will remain the key policy tool for the time being. But in due course Quantitative Tightening (QT) and potential profits from deposing large amounts of TLTRO borrowing will be discussed.**
- **Given today's hawkish message we now even see upside risks to our adjusted year-end policy rate forecast of 1.75% and think that QT will become a topic for 2023. The ECB's hawkish stance amid the materializing energy crisis make a euro area recession a near certainty in our view.**

A 75 bps hike surprise amid ongoing QE reinvestments: At today's meeting the GC lifted its key rates by 75 bps (for the first time ever) thereby bringing the deposit rate to 0.75% and the repo rate to 1.25%. With the deposit rate in positive territory again it also suspended the two-tier system for the remuneration of excess reserves. There was no change regarding QE reinvestments namely, to fully reinvest PEPP purchases at least until the end of 2024 but to apply them flexibly to ensure proper policy transmission. Additionally, the GC reiterated to keep full Asset Purchase Program (APP) reinvestments "*for an extended period of time past the date when it starts raising the key ECB interest rates*". In order to prevent collateral scarcity the GC also decided to suspend until April 30 the zero remuneration of government deposits.



Source: Datastream, ECB, GIAM calculations



Source: Datastream, GIAM calculations

Further worsening inflation outlook sets the tone: Inflation readings soared as of late, thereby substantially outpacing the expectation by the June staff projection update. Not surprisingly, the updated projections shift the expected inflation path once

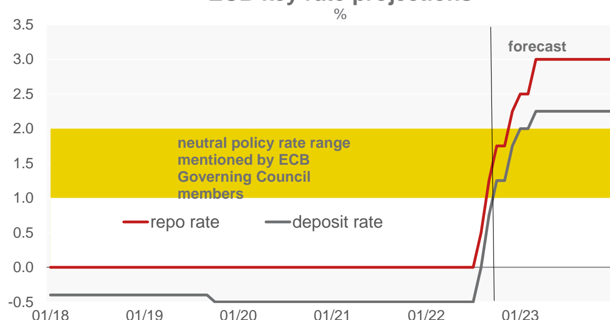
again to the upside predicting now annual inflation rates of 8.1% 2022 (from 6.8%), 5.5% for 2023 (from 3.5%) and 2.3% for 2024 (from 2.1%). Thereby inflation would stay above the ECB's target for the time being. Underlying inflation pressure is also set to stay firm. In the Q&A President Lagarde also emphasized the magnitude and persistence of inflation. However, the activity outlook also deteriorated with the 2023/24 growth expectations revised down. But – as President Lagarde made clear – in the ECB's central scenario the euro area will avoid a severe recession. It became very clear that in the current environment the focus will be on fighting inflation. The inflation risks remain clearly on the upside, especially in the near term. However, if "*energy costs were to decline or demand were to weaken over the medium term, it would lower pressures on prices*". That said, the ECB's updated downside scenario also sees inflation even higher than in the base case (8.4% in 2022, 6.9% in 2023, 2.7% in 2024) so that the rationale for higher rates would still remain in place.

Rates will remain the key policy tool for the time being: It is a no brainer that further rate hikes are ahead. On the crucial question where the GC sees the current neutral or terminal rates Lagarde remained indefinite but stated that it will still need several meetings to get there. She suggested that reaching a policy rate level that helps to bring inflation down requires ongoing hikes until the first quarter of 2023. Depending on the size of rate increases at the October, December, January and maybe also March meeting, the policy rate would then be well in the policy range between 1.0% and 2.0% that was seen as neutral by various GC members or even beyond that range. There is no doubt that the policy rate will remain the key policy tool for the time being.

Balance sheet reduction and QT to come on the table soon: It also became very clear from today's press conference that rate hikes are only one tool and that the unwinding of so-called unconventional measures might come rather sooner than later. Asked about QT Lagarde said that it was premature but that it will be discussed "*in due course*". Likewise, see commented on TLTRO conditions. In June 2023 a large TLTRO will expire and contribute to balance sheet shrinking.

Upside risks to our adjusted 2022 year-end policy rate expectation of 1.75%: All in all, we continue to expect determined rate hikes and adjusted in the light of today's meeting our year-end 2022 key rate expectation to 1.75% (from 1.50%). At the time of writing markets had lifted their expectation already to 1.79%. With headline inflation rates of around 10% yoy in September and October ahead we even see the risk of another 75 bps rate hike and hence a higher year-end rate as the ECB is very determined to fight inflation. However, in 2023 tentative signs of moderating inflation pressure and our expectation that tightening financing conditions amid a severe energy crisis will push the euro area economy into recession with near certainty let us expect a slower pace of rate hikes and a stop in Q1/2023. Moreover, with record high spreads at the front-end of the curve (Schatz-spread) we see the need for further action to improve policy transmission.

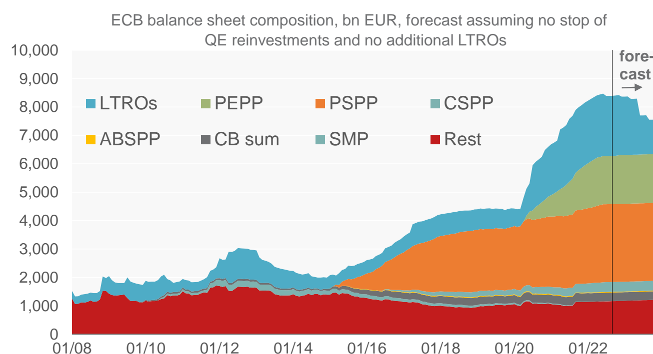
ECB key rate projections



Source: Datastream, ECB, GIAM calculations

ECB balance sheet to shrink

ECB balance sheet composition, bn EUR, forecast assuming no stop of QE reinvestments and no additional LTROs



Source: Datastream, ECB, GIAM calculations

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