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FLASH REPORT

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ECB: A Not Hawkish Maybe Final Hike

- **The ECB lifted its reference rates by 25bps each today, taking the closely-watched deposit facility rate to 4.00%, running counter to survey medians but more in line with markets that had braced for an increase. The EUR broadly weakened and European yields generally fell, but the read of markets was muddied by stronger-than-expected US data.**
- **The staff's new inflation projections that incorporate the recent run-up in energy prices supported the hawks' view that more tightening was needed today, countering the doves who likely pointed to downward revisions to GDP growth and core inflation forecasts as a reason to hold off on raising rates further.**
- **Today's rate hike was very likely the last that the ECB will roll out, with rates reaching "levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target." The firming up of "for longer" guidance is a key addition that prevented a less neutral/more dovish read of the decision. APP/PEPP changes were not discussed.**

The ECB pushed ahead with another rate increase of 25bps to each of its three reference rates today, taking the closely-watched deposit facility rate to 4.00%. Markets were better prepared, but the move ran counter to a relatively slim majority of economists that expected steady settings this week (30 of 53 in the Bloomberg survey, but most conceded a hike would not surprise). Our latest published forecast (see **here**) also had a 25bps hike penciled in for today, but a worsening economic outlook had us considering no more hikes or a delay to the October meeting (that would likely not materialize).

Today's rate hike was very likely the last that the ECB will roll out. The ECB now says that "based on their current assessment" they consider 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." Overall, the ECB's statement has little to suggest that, as things stand, the bank will hike again. It is also important to note that the upward revision to inflation forecasts was a clear trigger for today's rate increase, a hike that may not have come without the surge in energy prices since late-June. Still, the new headline inflation forecasts face upward risks considering the increase in oil prices since late-August.

Very importantly, the bank has expanded on the 'for longer' part of the story. A "sufficiently long duration" of rates at this level could do the job, so no more increases may be needed; according to Lagarde, they did not talk about what is thought of as 'long enough'. Lagarde could not say that they are at the peak, but seemed to indicate that the focus will be on duration of peak rates—but that both level and duration matter.

In any case, it does not seem like the ECB will be sure that more is needed for a few months, certainly October should be a hold. The optionality on more hikes remains, considering the "current" part of the assessment. Recall that this cycle has challenged central banks to come back and do more than they thought months prior (namely, the BoC). Instead of watching another round of data before the October 26th decision, including the ECB's quarterly bank lending survey, the Governing Council erred on the side of caution today rather than risking a six-week wait and realizing next month that they've underdone it. Inflation "is still expected to remain too high for too long", so more increases cannot be ruled out.

The staff's new projections of inflation that incorporate the recent run-up in energy prices supported the hawks' view that more tightening was needed today. A convenient leak to

Reuters on Tuesday night had already teed up the upwards revision to the 2024 inflation forecast, which now sits at 3.2% from 3.0% in the June round (2025 lower, at 2.1% from 2.2%). Note that the quarterly path still shows two-handled inflation at Q4-24, remaining at the 2.9% pace projected in June.

The doves ("some" which preferred a pause versus a "solid majority" for a hike, according to Lagarde) likely pointed to negative revisions to GDP growth forecasts as a reason to hold off on raising rates further. Growth projections went from 0.9% to 0.7% and 1.5% to 1.0% in 2023 and 2024, respectively. Ultimately, this inflation/tightening cycle has shown that when faced with a balanced decision, policymakers cannot bank on forecasts of economic weakness that would help them in their inflation fight, so the inflation forecast uptick came out on top.

There is evidence of policy moves making their way through the economy, however, given clear impacts on credit demand/supply and the dimming growth outlook from the bite of higher rates and poor external conditions. The most recent set of PMI data showed that echoes of weakness in the manufacturing sector are being heard in the service industry (and the call may be coming from inside the house). Interestingly, Lagarde also said that policy is transmitting faster than in past cycles which is a view not shared by US nor UK officials.

Regarding ECB APP/PEPP QT guideposts, 'sources' stories had already noted that possible changes to the APP roll-off pace or the end date of full PEPP reinvestments would not be debated today, with discussions centering on policy rates. Lagarde confirmed that they did not discuss these programs today, but we think this debate will emerge at the October and December meetings.

Market reaction: EUR weakness and lower yields

This morning, markets had 17bps priced in for today's decision, with a maximum of 25bps cumulatively seen by the December meeting; the 8bps 'surprise' relative to expectations and a couple more bps have now been added to year-pricing for a remaining ~40% chance that the ECB hikes again. Last Thursday, pricing sat at just under 10bps and 16/17bps, respectively, drifting higher and then jumping on Tuesday and Wednesday as leaks highlighting a much narrower decision and the expected lifting of inflation forecasts shifted pricing in favour of a hike today.

A very brief jump in European yields and the EUR was followed by a sharp leg lower on a closer read of the statement that gave a more dovish than neutral view of the decision (certainly not hawkish). German 2s and 10s rallied before US data, with stronger retail sales (but negative revisions) and higher headline PPI, acted to reverse the gains in the front-end. As the dust settles, German 10s show a clearer reaction to the decision, falling 6-8bps vs pre-decision, compared to about a 2bps move lower in 2s that have had to absorb at least some of the full 25bps hike versus the 17bps priced in. A steepening of the curve may be in store once markets digest today's decisions and as economic conditions turn, opening the door to eventual cuts which we don't see until Q2-24.

The EUR also chopped around on the US data but the read from the currency is clearly that the statement had a dovish tinge to it, losing its support at 1.07 to trade as low as ~1.0655 around where it is trading currently. Other currencies also faltered, but on a EURGBP basis, the shared currency is down 0.2% from pre-decision levels. UK yields actually moved lower by more than German yields (having already outperformed on the day), so perhaps markets are also getting more comfortable with the BoE also doing only the one hike next week. On the whole, the domestic economic backdrop, especially in comparison to strength in the US, as well as adverse energy prices remain headwinds for both the EUR and the GBP against the USD.

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