

FLASH REPORT

May 4, 2023

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- The ECB lifted its three key policy interest rates by 25bps at today's decision, matching the view of markets and economists that had broadly moved away from half-point bets.
- European curves bull steepened, with Italian debt underperforming amid the risk-off mood in markets and an announcement that APP reinvestments will end in July. The EUR is lagging almost all majors on the day.
- The decision text was on the dovish side, as it noted that "past rate increases are being transmitted forcefully", and vague guidance on how much more hiking is left does not inspire confidence in increased rate bets; less so amid banking risks.
- To us, the decision and presser suggest that the ECB's hike at the June meeting (which we see as highly likely) could be its last, with a roughly two-in-five chance of a July increase. We now have to wait until inflation data scheduled for late-May to materially refine these expectations.

The ECB lifted its three key policy interest rates by 25bps at today's decision, matching the view of markets and economists who, while allowing for a small chance of a half-point hike, looked well prepared for the downshift in tightening. This action takes the most closely watched deposit facility rate to 3.25%, from the -0.50% starting point in July 2022. Lagarde said all officials were in agreement about an additional hike being appropriate today, while some thought 50bps would have been better. Ultimately, it was an "almost unanimous" decision.

German 2-yr yields have fallen ~8bps since the text was released, as the curve steepens on the smaller than priced in hike and the full QT announcement, with 10s up 1bps over the past few hours; a beat in US unit labour cost data added some upward pressure to yields, however. The risk-off mood and the planned end of reinvestments has resulted in a widening of the Italy-Germany 10yr spread today of about 4bps (with only a quarter of that on the ECB's announcement).

Meanwhile, pricing for the ECB's June meeting has only marginally edged lower, still seeing 28bps in choppy dealing as markets adjust. Toss-up odds are roughly preserved for the July meeting (14bps priced in). When compared to what's seen for the Fed, i.e. just over 75bps in cuts by year-end, this is a hawkish view from markets that today are again struggling with a regional banks meltdown. The EUR's performance may be the cleanest read of the reaction in markets to the ECB. The currency is down 0.4% on the day to the 1.10 level (from the high-figure area overnight), lagging all majors barring the BRL, showing disappointment among some that the bank did not launch another half-point hike.

The decision text was on the dovish side, as it noted that "past rate increases are being transmitted forcefully" and that the "lags and strength" of their transmission to the economy "remain uncertain"—suggesting that there's some in the Governing Council concerned about overdoing it. On the transmission of policy, Lagarde highlighted the results of the latest Bank Lending Survey and that firms and executives have noted that high interest rates are hindering investment.

Still, for the ECB the "inflation outlook continues to be too high for too long" and "underlying price pressures remain strong", which certainly tees up more tightening, and Lagarde said as much, noting that they have more ground to cover. However, the lack of a clear suggestion of multiple hikes from this point adds a dovish tinge to the statement.

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The most hawkish element of the decision was the ECB's announcement that it will terminate APP reinvestments in July, as we had expected to happen, though we thought today would just see this teed up rather than firmly announced. This would roughly translate into a doubling of the current pace of APP assets that are allowed to roll-off each month (from about €15bn to about €30bn, on average). PEPP guidance was left unchanged (reinvestments intended until at least end-2024).

The tone of the statement is especially dovish in the context of lingering expectations that the ECB could hike 50bps today, as the message around additional tightening was further loosened. The decision suggests that the ECB's hike at the June meeting (which we see as highly likely) could be its last. For that to happen, the following would be needed: continuing encouraging inflation signals (such as decelerating core) and falling expectations, aided by additional declines in energy prices, as well as a tightening of credit in line with the latest ECB Bank Lending Survey. A firmer EUR would, of course, help all else equal.

Since its March meeting, when the bank felt a 50bps hike was warranted, the ECB has seen an expected sharp decline in headline inflation in March (holding roughly unchanged in April) as well as tentative signs that core prices growth has peaked on the basis of the past couple of prints. The results of the ECB's Bank Lending Survey released yesterday, which showed that credit standards "tightened further substantially" in Q1 as well as a material decline in business loan demand, further supported the case for a smaller-sized hike.

Our latest forecast has a somewhat conservative final 25bps hike at the June meeting and today's decision statement and press conference have not presented enough convincing arguments to alter this view to confidently include one more increase. In fact, a two-in-five chance of a final hike in July seems more appropriate than the roughly toss-up odds that we had in mind pre-announcement.

We don't expect more than two hikes of 25bps in the Eurozone, at most, under current economic conditions and ECB guidance. We now have to wait until inflation data scheduled for late-May to refine these expectations, with comments from policymakers over the next few weeks also worth watching—although, ultimately, it's all about the data.

Data-dependence and meeting-by-meeting decisions on rates seem to us the appropriate stance considering risks to the inflation outlook both to the downside and to the upside. Continued banking sector uncertainty and the impact of rate hikes to-date in one direction clash with resilient economies and labour markets with accompanying wage pressures. The weeks ahead, with new inflation data and the evolution of the stress in US regional banking and debt ceiling negotiations, will firm up rate expectations.

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