

FLASH REPORT

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ECB: No Big Surprises With 25bps Hike; Open Guidance Towards One or Two More

- The ECB lifted its key policy interest rates by 25bps today, as expected, taking the deposit facility rate to 3.50%. As teased up in the May decision, the ECB confirmed today that it will end APP reinvestments this month.
- Pres Lagarde called the decision a “very, very broad consensus”, and policymakers stuck to little-changed data-dependent guidance, with a July hike “very likely” according to Lagarde.
- The main hawkish takeaway from the statement was the upward revision to core inflation forecasts, with no strong optimism on the path for prices growth which “is projected to remain too high for too long”.
- In her presser, Lagarde struck a more balanced tone than the initial takeaway of the statement and, although she practically guaranteed a July hike, she walked around what they may decide in September.
- The current cycle and the experiences of other major central banks have shown that it's probably safer to lean in favour of more rather than fewer hikes.
- For now, we continue to expect a final 25bps hike in July but can see September as a toss-up that would become more likely on strength in services inflation and wages/employment.

The ECB again met well-telegraphed intentions and priced-in market expectations with a 25bps hike to its three key policy interest rates, taking the most closely-watched deposit rate to 3.50%. It also confirmed that, in July, there will be no more reinvestments of principal earned on maturing assets in its APP portfolio.

The market initially lifted the EUR, from ~1.0820 to ~1.0880, and juiced EGB yields (German 2s up 6/7bps). It is a bit more difficult to gauge the ‘pure’ reaction to the ECB’s decision and Lagarde’s presser as mixed US data (especially another high initial claims reading) saw rates well bid and the USD lose ground against all major currencies. At writing, German 2s are net 2bps lower vs pre-statement and the EUR is trading even stronger, through 1.09 and its 50-day MA for the first time since mid-May.

On the flipside, for a cleaner read, EURGBP is down 0.2/3% from the statement highs (+0.1% net from pre-statement) and the spread of German vs UK 2s has fallen 5bps over the period (+2/3bps net from pre-statement). At the margin, the ECB’s statement and projections and Lagarde’s presser combined for a marginally hawkish read in markets. This is while we wait for hawkish ECB leaks to inject some additional momentum (although this is now part of the process and should be somewhat expected).

Pres Lagarde called the decision a “very, very broad consensus”. Since last July, the ECB has hiked a cumulative 400bps, and we think there is a bit more tightening in the pipeline though whether this is one or two 25bps increases will depend on incoming data (as things stand, and based on guidance, a third hike in October is unlikely).

Eurozone policymakers stuck to little-changed guidance that foresees additional tightening as guided by incoming data; the plurality in “future decisions” was left unchanged. The statement had only small modifications, some hawkish—like saying that inflation is set to remain too high for too long—and some dovish—like highlighting the steep increase in borrowing costs and a slowing of loans growth.

June 15, 2023

The bigger hawkish takeaway from the statement, and what saw EGBs weaken and the EUR strengthen on the release, was the revision higher in core inflation forecasts. For the current year, ECB staff now project a 5.1% increase in core HICP, from 4.6% in the March forecast round, 2024 is now seen at 3.0% from 2.5%, and 2025 at 2.3% from 2.2%. GDP growth forecasts were knocked down 0.1ppts in each of 2023 and 2024—a rather inconsequential adjustment.

The core inflation revisions, or the 0.1ppts increase in headline forecasts, were not terribly unexpected given recent data, but the magnitude of the upgrade was—for 2024 in particular.

Lagarde also said that the higher inflation forecast is largely due to increasing labour costs, indicating concern about strong employment growth (from a resilient economy) that may have to cool for the ECB to stop hiking soon. She almost ended her presser without watering that down but said near the end that she is not seeing a wage-price spiral.

In her presser, Lagarde struck a more balanced tone than the initial takeaway of the statement and, although she practically guaranteed a July hike, she walked around what they may decide in September. On where the terminal rate may be, she said that the bank will know what level that is when they get there; there's still "ground to cover", but aside from a 25bps increase next month it's unclear.

This cycle has shown that central banks should be at the ready to hike more than current conditions or their latest projections point to; the BoC and the RBA have perhaps regretted their respective hike 'breaks'. As household spending and job gains prove more resilient than expected to rate increases, and unpredictable price pressures occasionally pop up, there has been no clear reward for taking the under on hike expectations.

For now, we continue to expect a final 25bps hike in July but can see September as a toss-up that would become more likely on strength in services inflation and wages/employment across data releases in the next month or two; the core CPI reading for June due at the end of the month is a key determinant for settling on one or two more hikes (and, who knows? Maybe October, too).

The ECB made the right call in delivering a message that still kicks the tires on a September hike. Markets had gone into today's meeting with only a cumulative ~55–60bps priced in across today and the next two meetings, which can be loosely interpreted as June and July hikes and a two-in-five chance of a September increase. Markets are still interpreting the decision but, on the whole, pricing is little changed; it will likely take strong data and/ECB hawks to round up September odds to greater than a toss-up chance.

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