MARKET COMMENTARY

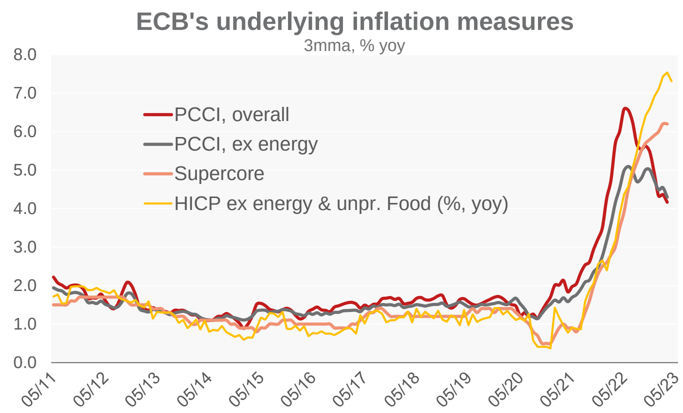
ECB makes clear that policy tightening is not yet completed

Author: Martin Wolburg

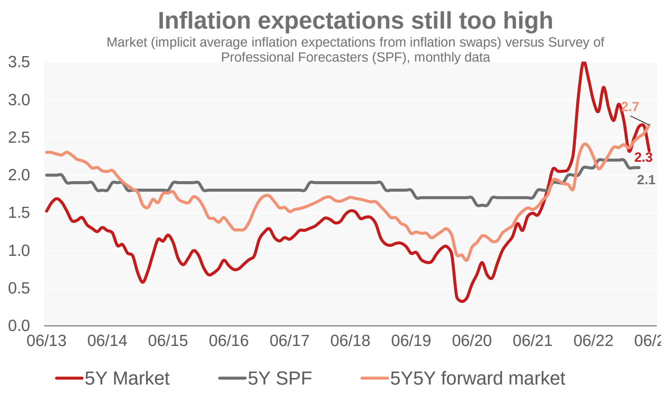
May 04, 2023

- **At today's meeting the ECB's Governing Council (GC) lifted its key rates by another 25 bps, in line with expectations. It stated that future decisions will remain data-dependent and announced that rates "*will be brought to levels sufficiently restrictive*" and kept there "*for as long as necessary*".**
- **The GC also announced to stop reinvestments under the APP as of July but maintained its intention to continue reinvestments under the PEPP until "*at least the end of 2024*". It became clear that the GC does not plan special facilities in light of the expiring big TLTRO (of € 477 bn) in June.**
- **As in the previous meeting, inflation is seen as "*too high for too long*". Price pressures are seen to stay strong, and it was noted that wage pressures had strengthened further. Concerns about second-round effects were growing. There were no concerns about the latest tightening of credit standards.**
- **President Lagarde maintained the wording that there was "*more ground to cover*" and the GC implied that more hikes are ahead to become sufficiently restrictive. At today's meeting the discussion was between 25 bps and 50 bps rate increases only.**
- **Looking ahead, we continue to expect a further 25 bps hike at the June meeting and see the ECB then stopping at 3.5% and leave it there until well into 2024. Risks are tilted to further hikes in our view.**

A 25 bps rate hike today: At today's meeting the GC lifted its key rates by another 25 bps bringing the deposit rate to 3.25% and the repo rate to 3.75%. As at the previous meeting it did not commit itself to further rate increases but maintained a data-dependent approach. It also expects to discontinue reinvestments under the APP from July on but did not change stance on PEPP reinvestments until year-end 2024 at least. Unlike to the Fed yesterday, the ECB did not signal an end of its tightening cycle yet.



Source: Datastream, ECB



Source: Datastream, GIAM calculations

Inflation outlook still warrants higher rates: Since the last policy meeting inflation has continued to trend down. In April, even core inflation turned. There is indication easing pipeline pressure as for instance producer price dynamics eased (to 5.9% yoy in March from a peak of 43.5% yoy in Aug) and energy prices moderated further. The latest gas price development combined with future prices suggest an annual average of 45 €/Mwh, well below the assumption of 58 €/Mwh in the March ECB macro projections. However, the inflation development in the first quarter (average of 8.0% yoy) is somewhat above the March projections (of 7.8%) and the high public sector wage increases in Germany (by 6% in 2023 and 2024) underline the risk of second-round effects and persistent inflation. The GC also noted that "*wage pressures have strengthened further*" and "*price pressures remain strong*". From the accounts of the last policy meeting we learned that some GC members were concerned about "*immaculate disinflation*" (i.e. without big costs in terms of unemployment) implied by the macro projections. Moreover, the GC warned that some indicators for inflation expectations had edged up and warrant continued monitoring, probably referring to the 5Y5Y inflation expectations (see upper right-hand chart). Lagarde stated that "*significant*" upside risks to inflation remain. It became very clear at today's press conference that the inflation outlook warrants further policy tightening.

Tightening of credit standards in Bank Lending Survey (BLS) not a concern: Against this backdrop the latest BLS results were closely watched by the GC. In the Q&A Lagarde stated that tightening was influencing the economy with corporate credit demand down and that interest rate were holding back investments. However, the GC does not seem concerned about risk to financial stability. With demand finally being dampened, the GC finally sees its policy tightening working on the real economy. However, the effect on inflation is not yet visible.

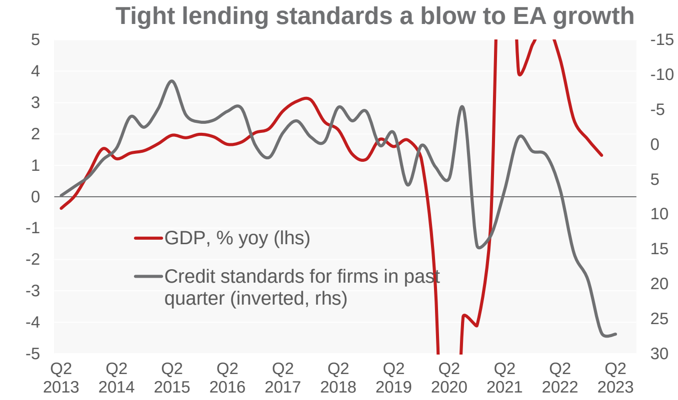
Stop of reinvestments of APP reinvestments and expiring TLTRO: The announced stop of APP reinvestments and the expiry of a big TLRO by June (of € 477 bn) will contribute to policy tightening. There is no concern about the liquidity drain as according to Lagarde banks have prepared for that and other tools (LTROs, full allotment) are available. All in all, according to her these measures do "*not have a massive impact*" suggesting that they do not substitute for additional rate hikes.

Still more ground to cover: All in all, with inflation still "*projected to remain too high for too long*" and rates are not yet sufficiently restrictive there is clearly leeway for further hikes to bring inflation back on track again. At today's meeting the discussion was just between a 25 bps or 50 bps hike and there was "*almost unanimous support*" for the decision. However, it remained unclear how much further rate hikes are needed. Lagarde merely suggested that with rates in clearly restrictive territory the ECB could "*return to a more standard*" increment of rate hikes supporting our view of only 25 bps steps from now on. All in all, there is "*still more ground to cover*" .

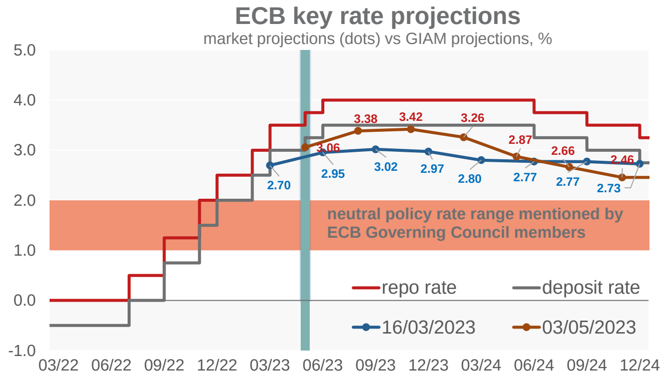
Data dependence remains the name of the game: How far the GC finally goes with further rate hikes will remain data dependent – a point again very much emphasized in the Q&A. Key will be the updated macro projections at the forthcoming June meeting and the question whether the banking crisis stays contained as it is now or not.

The end of the hiking cycle is nearing but first rate cut not yet in sight: With today's 7th consecutive hike, key rates rose by cumulatively 375 bps since July. Rates are now well into restrictive territory. Following today's ECB meeting we think that there is still room for further tightening but that the peak is closer. The GC scaled down its wording about future hikes from "*a lot more ground to cover*" to just "*more ground to cover*". We deem a further 25 bps hike by June most likely but think that the peak rate will then be reached. However, underlying inflation has only started to turn, is still way too high and strong wage increases amid a tight labour market highlight the risk of sticky core inflation. We therefore think that the ECB will keep rates at its peak level well into next year. Given the significant upside inflation risks we also see the risk of further rate hikes beyond June.

Markets perceived the ECB as dovish: As the ECB became less determined on future rate hikes markets have shifted their rate hike expectations down. While we agree with a peak rate of 3.5% we continue to doubt that a first rate cut will already take place in early 2024.



Source: Datastream, BLS, GIAM calculations



Source: Datastream, ECB, GIAM calculations

This document is based on information and opinions which Generali Insurance Asset Management S.p.A. Società di gestione del risparmio has obtained from sources within and outside of the Generali Group. While such information is believed to be reliable for the purposes used herein, no representation or warranty, expressed or implied, is made that such information or opinions are accurate or complete. The information, opinions estimates and forecasts expressed in this document are as of the date of this publication and represent only the judgment of Generali Insurance Asset Management S.p.A. Società di gestione del risparmio and may be subject to any change without notification. It shall not be considered as an explicit or implicit recommendation of investment strategy or as investment advice. Before subscribing an offer of investment services, each potential client shall be given every document provided by the regulations in force from time to time, documents to be carefully read by the client before making any investment choice. Generali Insurance Asset Management S.p.A. Società di gestione del risparmio may have taken or, and may in the future take, investment decisions for the portfolios it manages which are contrary to the views expressed herein provided. Generali Insurance Asset Management S.p. A. Società di gestione del risparmio relieves itself from any responsibility concerning mistakes or omissions and shall not be considered responsible in case of possible damages or losses related to the improper use of the information herein provided. It is recommended to look over the regulation, available on our website www.generali-investments.com. Generali Investments is part of the Generali Group which was established in 1831 in Trieste as Assicurazioni Generali Austro Italiche. Generali Investments is a commercial brand of Generali Investments Partners S.p.A. Società di gestione del risparmio, Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Generali Investments Luxembourg S.A. and Generali Investments Holding S.p.A..