

# MARKET COMMENTARY

Inflation is now a “major challenge” - ECB announces rate hikes for July and September

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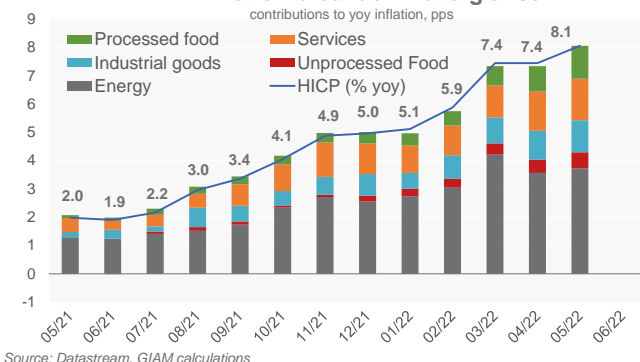
June 09, 2022

- At today’s meeting the Governing Council (GC) decided to end QE by July 1. It is on course to raise the policy rate by 25 bps in July and by at least another 25 bps in September. But if the inflation outlook persists or deteriorates a larger rate increase will come in September, by likely 50 bps in our view.
- The decision was taken unanimously as the new projections foresee headline as well as underlying inflation above target throughout the end of ECB’s forecast horizon in 2024, while the economy should continue to grow.
- Beyond September, a “*gradual but sustained path of further increases in interest rates will be appropriate*” according to the statement. However, the range of the neutral rate and hence the end-range for normalisation has not been discussed today.
- Fragmentation risks took a backseat at today’s meeting. President Lagarde merely reiterated the flexibility of PEPP reinvestment and that the ECB would deploy a new tool if needed.
- Given upside risks to inflation, today’s hawkish shift of the GC poses upside risks to our forecasts of a cumulated 100bps rate increase by year-end.

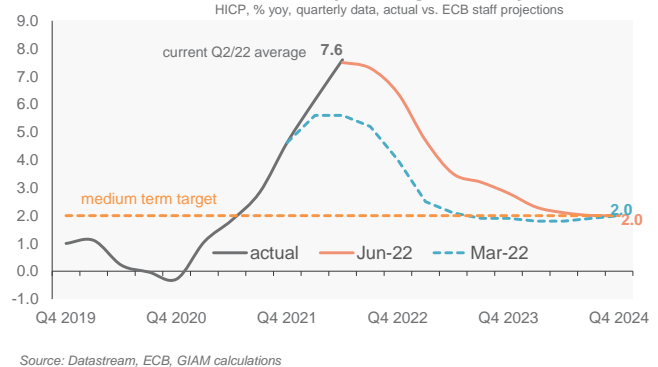
**End of QE by July and a 25 bps rate hike in July announced:** As expected, the GC announced to terminate QE by July 1. Surprisingly it announced a 25 bps rate hike in July and another rate hike in September. Beyond September, the GC looks for “a gradual but sustained path of further increases in interest rates”.

**Updated macro projections now imply need for policy action:** Today’s meeting again took place at a time of sky-rocketing inflation readings coupled with forward-looking components in key indicators that suggest a deceleration of activity. Looking ahead, the ECB now acknowledges that inflation will stay way above target and only come close to it towards the end of 2024. The updated macro projections foresee annual headline inflation at 6.8% in 2022 and to decline only slowly to 3.5% in 2023 and 2.1% in 2024. Also underlying inflation is set to stay clearly above the ECB target and to average 3.3% in 2022, 2.8% in 2023 and 2.3% in 2024. Thereby the conditions for raising rates the ECB implemented as part of its new strategy “*have been satisfied*” implying the need for higher rates. On activity, the ECB remains constructive with growth seen to stay above 2% in 2022 (2.8%) and 2023/24 (2.1%). The GC as well as President Lagarde in the press conference were very clear that all eyes are now on inflation.

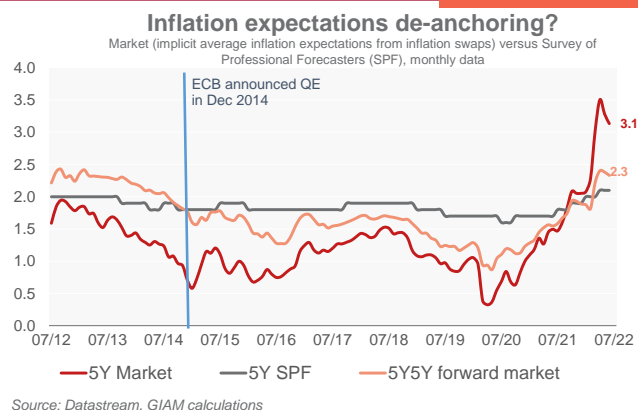
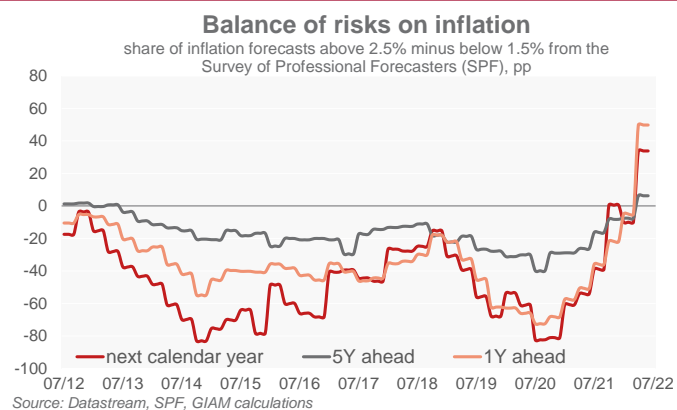
**EA inflation breakdown at a glance**



**Inflation to only converge to 2% by H2/24**



**Inflation expectations and wage growth underline need to act:** Over the past weeks, market inflation expectations came down from their peaks but stayed well above the 2% threshold (see rh graph below). However, in April, the latest the Survey of Professional Forecasters (SPF) – closely watched by the GC – showed an average inflation rate of 2.1% over the coming five years for the first time in the survey’s history. Against this backdrop it did not surprise us that the GC again stated: “*While various measures of longer-term inflation expectations derived from financial markets and from expert surveys largely stand at around two per cent, initial signs of above-target revisions in those measures warrant close monitoring.*” Wage growth, the key indicator emphasized by GC members to assess the risk of second-round effects has left the comfort zone. Negotiated wages accelerated sharply to 2.8% yoy in Q1, up from 1.6% yoy before. Given tight labour markets we expect it to stay strong and to even accelerate. In the press conference President Lagarde commented that the ECB was very attentive to wages, wage negotiations and risks of second-round effects. Therefore, it does not come as a surprise the inflation risks “*are primarily on the upside*” according to the GC with only weaker demand a factor hinting at reduced price pressure.



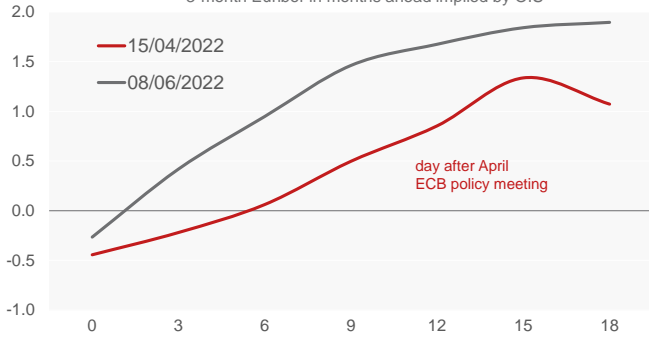
**Start of normalization cycle in July:** The sharp upward revision of the inflation projections was the last piece needed for the GC to finally launch the key rate normalisation process. It was unanimous in its decision to announce a rate hike by 25 bps for July. In the Q&A session Lagarde stressed that it was useful “*to start by an incremental increase that indicates a path*”. The GC was very clear in stating that “*If the medium-term inflation outlook persists or deteriorates, a larger increment will be appropriate at the September meeting.*” In such a case we would deem a 50 bps hike most likely. In any case, a key message from today’s meeting is that the “*journey*” has begun and that data-dependency and optionality continue to rank high for the GC. Asked about the neutral rate and hence when normalisation would be completed, Lagarde said that it will be discussed later. In recent public statements, however, GC members saw the neutral range between 1.0% and 1.5%. But even if it was slightly below the message would be clear: there is still plenty of leeway for higher rates in 2022.

**Fragmentation takes a backseat:** Regarding the risk of strongly diverging sovereign yields the GC merely restated that “*in the event of renewed market fragmentation related to the pandemic, PEPP reinvestments can be adjusted flexibly across time, asset classes and jurisdictions at any time.*” No further specific potential measures were announced or discussed by the President in the press conference. Instead, she merely reiterated the narrative of previous statements that the ECB was “*committed to prevent fragmentation*”, that is was monitored “*constantly*” and that the ECB would if needed stand ready to “*design*” and “*deploy*” new instruments.

**We expect 25 bps hikes over the rest of 2022:** Today’s GC meeting has confirmed us in our view that the ECB will continue to hike at each meeting (July, September, October, December) throughout the rest of 2022, for a total of 100bp tightening. Markets currently look for even more than 125 bps hikes in 2022. We are more cautious on economic activity and see euro area growth coming close to stalling with even the risk of a recession. Also we think that fragmentation is a factor that is still on the GC’s mind. Financing conditions deteriorated significantly as of late (see rh table below). However, we acknowledge that given the tilt towards a more than 25 bps hike in September, the expectations of headline inflation staying around 8% yoy over the coming months and the somewhat concerning signals from inflation expectations and wages the risks are clearly towards more aggressive rate hikes in 2022.

## Markets expect start of hiking cycle

3-month Euribor in months ahead implied by OIS



Source: Datastream, GIAM calculations

## The ECB's Financing Conditions Dashboard

z-scores of respective variables with values > 0 indicating better than average financial conditions, < 0 the reverse; own calculations, latest data on lending rate estimated, BLS data monthly interpolated

	2021	Q4 2021	Q1 2022	Mar-22	Apr-22	May-22
Gov. bond spread (GDP weighted)	1.45	1.48	1.28	1.20	-0.15	-0.98
Term premium (10Y-1Y OIS)	1.01	0.75	-0.08	-0.41	-0.46	-0.46
BLS credit standards	-0.52	0.24	0.19	-0.07	-0.49	-0.91
BLS credit demand	-0.30	0.02	-0.14	-0.22	-0.32	-0.42
High Yield spread	1.02	0.78	0.09	-0.53	-0.20	-1.06
Lending rate	1.39	1.38	1.06	0.82	0.44	n.a.
unweighted mean	0.67	0.78	0.40	0.13	-0.20	-0.76
~ ex Lending rate	0.53	0.66	0.27	-0.01	-0.32	-0.76

last update: 08/06/2022

Source: Datastream, GIAM calculations

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