

# MARKET COMMENTARY

ECB will stay the course and keep key rates at the peak level for longer

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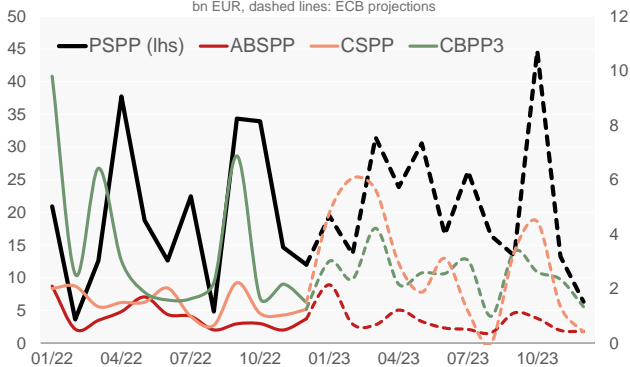
- At today's meeting, the ECB's Governing Council (GC) lifted its key rates by another 50 bps, in line with expectations, and "intends" a further 50 bps hike for March. Thereafter the monetary policy path will be evaluated.
- Starting in March, the APP reduction by € 15 bn per month will be done according to the redemption's share of each sub-program. Regarding sovereign bonds (PSPP), this principle will also apply to the share of redemptions of each sovereign. Corporate bond reinvestments will be tilted towards greener firms.
- In the accompanying press conference, President Lagarde again adopted a hawkish tone in our view. She made clear that further hikes would be needed beyond March as there is still "ground to cover" and that rates should be kept at a sufficiently restrictive level to ensure inflation goes back to target.
- We continue to look for a further 50 bps hike in March, followed by two further 25 bps hikes in Q2, lifting the deposit rate to 3.5%. This is at odds with markets that somewhat scaled down their expectation and see the peak at 3.4%.
- Markets perceived today's message as relatively dovish. In a knee-jerk reaction, equities gained, sovereign yields fell, and the EUR declined.

**A 50 bps rate hike today and another one in March:** At today's meeting, the GC lifted its key rates by another 50 bps, thereby bringing the deposit rate to 2.5% and the repo rate to 3.0%, in line with expectations. It also almost committed to another 50 bps hike at the next meeting in March. Then it will "evaluate the subsequent path of its monetary policy."

**QT with a green tilt:** As already announced in December, QT will start in March with redemptions of € 15 bn not being reinvested until the end of June. Thereafter, the GC will decide on the pace of QT again. This means the ECB will buy € 71 bn out of € 131 bn of redemptions in this period. [Details about QT](#) were released today. Key principles are: First, "the remaining reinvestment amounts will be allocated proportionally to the share of redemptions across each constituent program of the APP." Second, regarding the public sector purchase program (PSPP), redemptions will be allocated according to the share of redemptions of each jurisdiction. Third, corporate bond purchases will be "tilted more strongly towards issuers with a better climate performance."

**APP redemption profile in 2023**

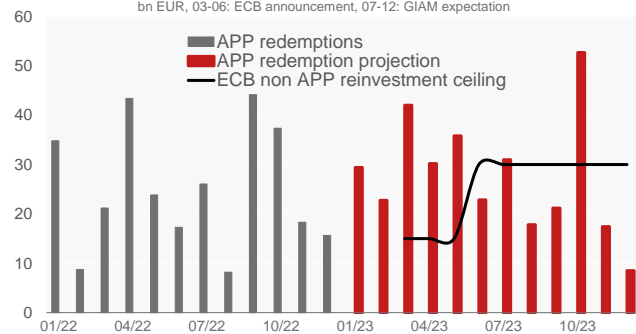
bn EUR, dashed lines: ECB projections



Source: ECB, GIAM calculations

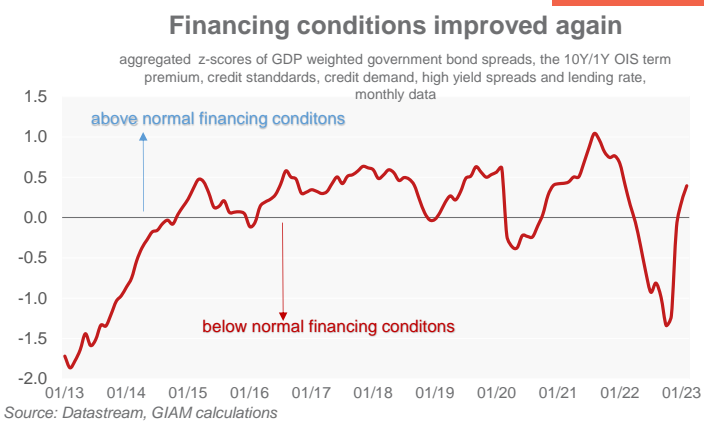
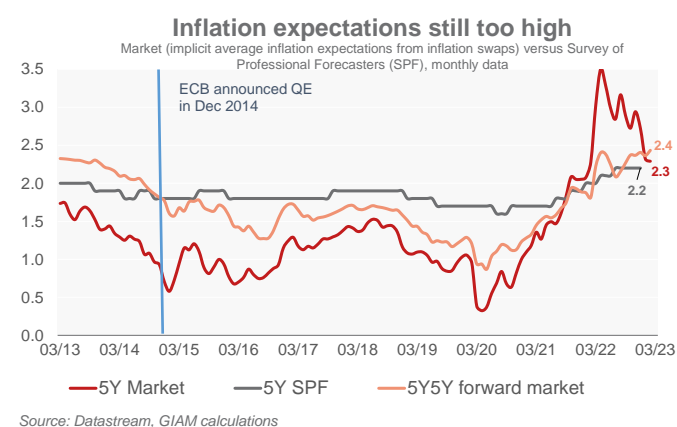
**APP redemptions and QT in 2023**

bn EUR, 03-06: ECB announcement, 07-12: GIAM expectation



Source: ECB, GIAM calculations

**An improved macro environment amid ongoing headache on core inflation:** The recent economic news flow supports the ECB's positive activity view outlined by the updated December macro projections. With output in the final quarter of 2022 having expanded (by +0.1% qoq vs -0.2% qoq projected) and likely to at least not shrink at the outset of this year either (ECB projection is -0.1% qoq), there is clear upside potential for the annual growth expectation of 0.5% for 2023. Also quite positive from a monetary policy perspective, euro area headline inflation receded to 8.4% yoy by January, well below the October peak of 10.6% yoy. Likewise, various measures of inflation expectation receded. The GC accounted for that by stating that the growth and inflation risks have become more balanced. That said, President Lagarde made clear that high underlying inflation pressure remains a concern and that there was still huge pressure in the pipeline. The risk of second-round effects also seems to have gained importance as the GC stated, "catch-up to high inflation becoming the main theme in wage negotiations" and it continues to see the "risk of a persistent upward shift in inflation expectations". Moreover, it was stated in the press conference that energy costs and the effect of fiscal measures were key factors of concern for the GC regarding the inflation outlook.

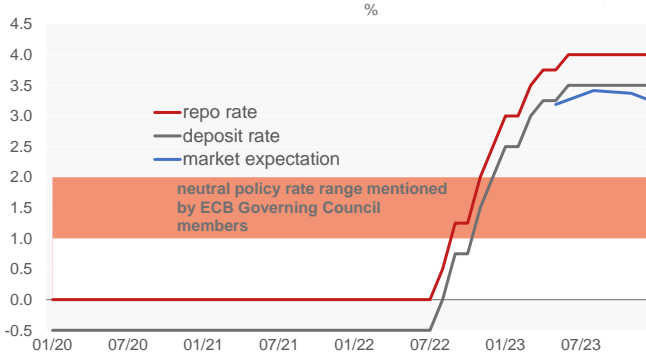


**No pivot but further rate hikes on the cards:** The GC clearly communicated that it "will stay the course in raising interest rates significantly at a steady pace and keeping them at sufficiently restrictive levels." How much further will the ECB need to go? Lagarde merely stated that the ECB was "certainly not there now nor will be there in March" and that there was more ground to cover. Key will be the March macro projections. Today she tried to take doubts about further hikes off the table by stating that the determination of the ECB to reach the 2% target should not be doubted. It became very clear that an ECB pivot is not on the horizon yet.

**How far will the ECB go?** That said, it is also clear to us that the pace of rate increases will likely slow after another 50 bps hike in March. With today's decision, rates went into outright restrictive monetary policy territory. And the results of the latest Bank Lending Survey (see right-hand graph below) as well as higher interest rates for corporates suggest that monetary policy has started to bite. When balancing ongoing high underlying inflation pressure against dampening monetary policy effects on demand, we expect the policy peak to be nearing after March. Today's decision was reached in a "very very large consensus" according to Lagarde. It suggests that the GC sees the need to move further into restrictive policy territory to bring inflation back to target. However, we also continue to expect the pace of tightening to come down to 25 bps after March and the depo rate to peak at 3.5% by the end of Q2.

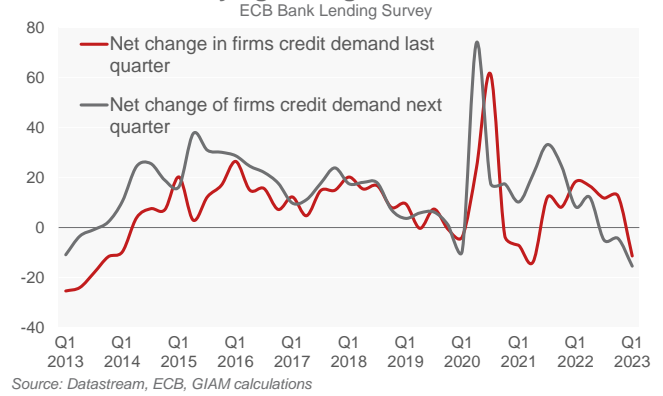
**ECB not as hawkish as markets had expected:** While today's ECB message was undoubtedly hawkish again, it lagged somewhat behind market expectations. Most importantly, this time, Lagarde did not actively push back against market expectations as she did in December. Markets not only expect a terminal rate of only 3.40% but have also started to price rate cuts towards the end of the year. As a result, equities gained, sovereign yields receded, and the EUR lost. Apart from the terminal rate, a key message from today's meeting is that the peak rate will be maintained for longer. We think that markets have not yet fully digested this message.

## ECB to hike further into restrictive territory



Source: Datastream, ECB, GIAM calculations

## Policy tightening starts to bite



Source: Datastream, ECB, GIAM calculations

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