MARKET COMMENTARY

Another jumbo 75 bps ECB rate hike but focus shifts to balance sheet reduction

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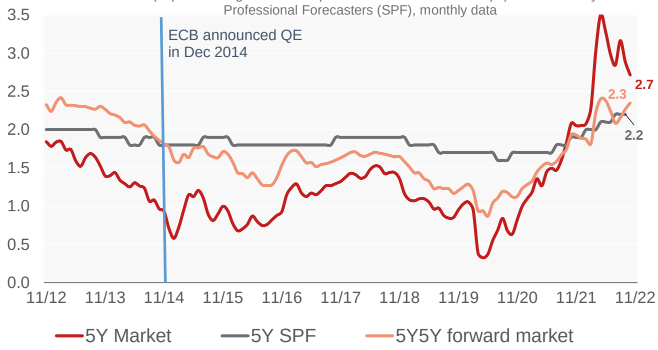
- **At today's meeting the Governing Council (GC) lifted its key rates by another 75 bps, in line with expectations.**
- **The ECB also announced new measures incentivizing banks to repay TLTRO holdings earlier. It will link TLTRO III interest rates to less favourable terms (the average of applicable key rates) and it also decided to lower the remuneration of minimum reserves to the ECB's deposit facility rate.**
- **The key rationale is, as inflation remains "*above the target for an extended period*", to reduce "*support for demand and guarding against the risk of a persistent upward shift in inflation expectations*."**
- **The GC stated that it "*expects to raise interest rates further*" but also finds that it "*made substantial progress in withdrawing monetary policy accommodation*" while reiterating its "*meeting-by-meeting approach*" to interest rate decisions". Also, the statement no longer points at further rate hikes "*over the next several meetings*".**
- **The market response was on a very dovish note with yields and EUR falling and euro area non-core bond spreads tightening, likely due to the more cautious assessment of the rate outlook.**
- **We continue to look for a 50 bps hike in December and another 50 bps in Q1/2023. But we expect the ECB to increasingly focus on quantitative tightening (QT) as President Lagarde stated that at the December meeting the key principles of the reduction of purchases made under the Asset Purchase Programme (APP) will be released.**

Another 75 bps hike and tighter TLTRO III conditions: At today's meeting the GC lifted again its key rates by another 75 bps thereby bring the deposit rate to 1.5% and the repo rate to 2.0%, in line with expectations. Regarding TLTRO IIIs it decided to offer additional early repayment dates and to link from November 23 onwards the applicable interest rate to the average applicable key rates in order to "*reinforce the transmission of policy rate increases to bank lending conditions*". It also decided to set the remuneration of minimum reserves at the ECB's deposit facility rate instead of the higher main refinancing operations (MRO) rate so far. The forward guidance on reinvestments made under the APP ("*for an extended period*" past the first rate hike) and the Pandemic Emergency Purchase Programme (PEPP) ("*at least the end of 2024*") was maintained.

Inflation expectations still too high

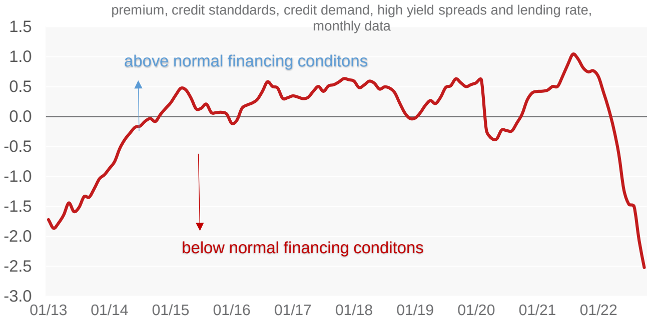
Market (implicit average inflation expectations from inflation swaps) versus Survey of Professional Forecasters (SPF), monthly data



Source: Datastream, GIAM calculations

Financing conditions sharply down

aggregated z-scores of GDP weighted government bond spreads, the 10Y/1Y OIS term premium, credit standdards, credit demand, high yield spreads and lending rate, monthly data



Source: Datastream, GIAM calculations

Inflation remains the elephant in the room: With a reading of 9.9% yoy in September headline inflation reached a high.

Looking ahead, the ECB expects ongoing broad-based inflation pressure. It also sees that "*the growth of wages may be picking up*" and underlying inflation pressure is also set to stay firm. The GC sees "*most measures of long-term inflation expectations currently stand at around two per cent, although further above-target revisions to some indicators warrant continued monitoring*." The risks to the inflation outlook are primarily on the upside. The activity outlook also deteriorated and the euro area economy "*is likely to have slowed significantly in the third quarter of the year*" and the GC looks for "*a further weakening in the remainder of this year and the beginning of next year*". In the Q&A session President Lagarde acknowledged that for 2023 the ECB's latest growth projection (of 0.9%) looks too optimistic but that the downside scenario (of -0.9% growth) was not applicable either. She also acknowledged that the risk of a recession had increased.

No doubt about further policy tightening but less eager on rate hikes: All in all it became very clear that the GC remains on a tightening path. But with the deposit rate now in the middle of a corridor considered as the neutral range the magnitude and speed of future rate hikes is less certain. In the Q&A President Lagarde mentioned the inflation outlook – amid an increased recession likelihood -, the measures taken so far – 200 bps increase over the past 3 meetings – and the transmission of past monetary policy action as factors determining future policy action. She also emphasised very much the meeting-by-meeting approach and the data dependency. With the GC finding that it made "*substantial progress in withdrawing monetary policy accommodation*" it "*expects to raise interest rates further*" but no longer "*over the next several meetings*" as it did in September.

Balance sheet reduction to increasingly come into focus: Instead it became clear that the ECB will intensify measures to reduce its balance sheet. The announced changes in the TLTRO III conditions amid three further early repayment dates will let the balance sheet shrink faster and contribute to transmit the tightened policy conditions to the real economy. A positive side-effect explicitly mentioned by Lagarde is that if banks were to decide to repay earlier more collateral will be available by mitigating the collateral squeeze somewhat. Moreover, while there was no change regarding APP reinvestments today, Lagarde announced that the key principles on QT will be announced at the December 15 meeting.

The LTRO reduction path

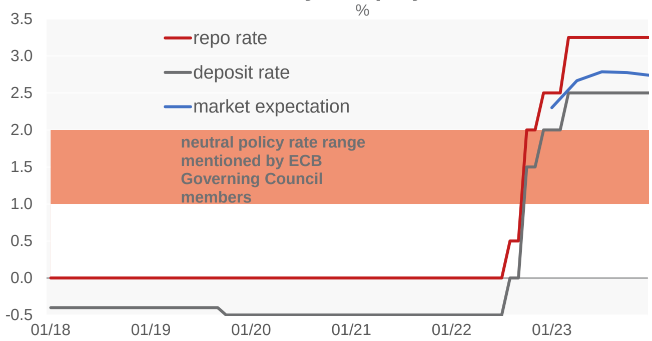
without future early repayments, bn EUR

LTRO	Maturity	Outstanding (incl. repayments)	Dec-22	Jan-23	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
20190129	21/12/2022	63.1	63.1									
20220112	29/03/2023	0.7	0.7									
20210154	26/01/2023	1.1		1.1								
20200029	29/03/2023	87.8			87.8							
20200131	28/06/2023	1194.2				1194.2						
20200207	27/09/2023	158.6					158.6					
20200248	20/12/2023	48.4						48.42				
20210034	27/03/2024	323.9							323.9			
20210078	26/06/2024	97.4								97.4		
20210119	25/09/2024	93.4									93.4	
20210155	18/12/2024	46.5										46.5
Maturity pattern			**63.8**	**1.1**	**87.8**	**1194.2**	**158.6**	**48.4**	**323.9**	**97.4**	**93.4**	**46.5**
LTRO volume		**2115.1**	**2051.4**	**2050.3**	**1962.4**	**768.2**	**609.6**	**561.2**	**237.3**	**139.9**	**46.5**	**0.0**

source: ECB, GIAM calculations

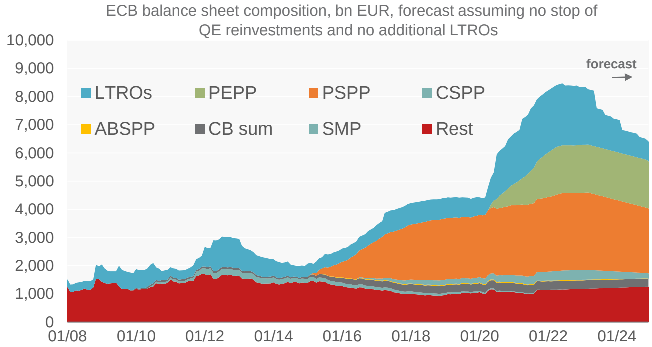
Peak key rate of 2.5% still reasonable to us: Overall today's ECB meeting confirms us in our view that most of the hiking (by already cumulatively 200 bps currently) is behind us. As we look – in contrast the current ECB projection – for a euro area recession we see leeway for the ECB to reduce the magnitude of further rate hikes also from this perspective. Another 50 bps rate hike in December and further 50 bps in Q1/2023 still seem most likely to us and we continue to see the policy rate peaking at 2.5%. The market response to today's policy meeting was on a very dovish note with yields and EUR falling and euro area non-core bond spread tightening. Indeed, right after the meeting the market has priced out some rate increases (with the implied policy rate no longer above 2.5%). But we doubt that it is has yet priced the forthcoming effect of QT due to lacking information. Overall, the risks to the ECB's rate outlook now appear more balanced.

ECB key rate projections



Source: Datastream, ECB, GIAM calculations

ECB balance sheet to shrink



Source: Datastream, ECB, GIAM calculations