# MARKET COMMENTARY

## With a hawkish wait-and-see stance through the (hopefully transitory) energy price shock

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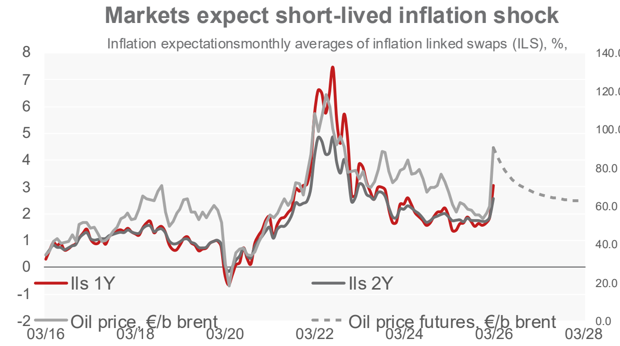
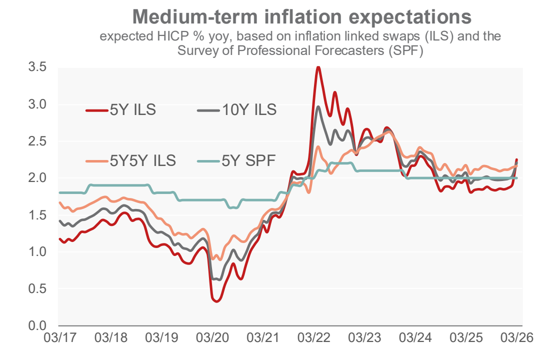
- **At today's meeting the Governing Council (GC) unanimously decided to again keep its key rate unchanged at 2.0%.**
- **Staff projections that include information up to March 11 see only a temporary inflation overshoot: Headline inflation is expected to jump to 2.6% in 2026 before easing to around 2% in 2027–28, with only moderately rising core inflation and no major second-round effects assumed. However, since March 11 energy prices and market inflation expectations rose further.**
- **Risks are tilted towards stagflation as the Iran war creates upside inflation risks and downside growth risks; adverse and severe scenarios include stagnation or recession with inflation far above target, which would put ECB rate hikes back on the table.**
- **The ECB now sees itself no longer "*in a good place*" but "*well positioned*" to deal with the energy price shock and will be particularly attentive to wage developments.**
- **We maintain our baseline of unchanged rates, but the risk skew is to the upside: an escalation of the Iran conflict that lifts energy prices and heightens second-round risks could warrant a hike as early as April.**

Today's ECB meeting came about three weeks after the start of the Iran war that has been triggering a sharp rise in energy prices and turned the monetary policy discussion from potential rate cuts to rate hikes. While the Governing Council decided not to act today – as generally expected – its hawkish wait-and-see stance not only mirrored the communication thus far but suggests that a rate hike could be warranted rather sooner than later.




Source:Datastream, GenAM




Source: Datastream, ECB, GenAM calculations

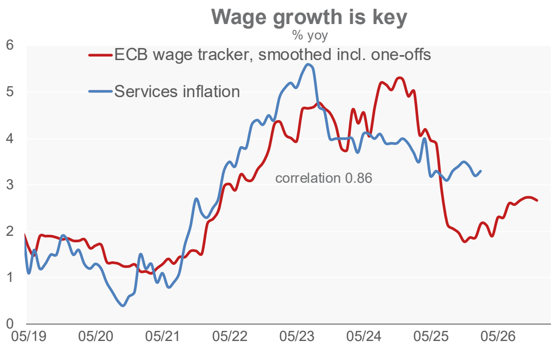
**Updated staff projections look for a transitory inflation shock**. Staff now project a temporary spike in headline inflation—rising to 2.6% in 2026 (from 1.9% previously), before easing to 2.0% in 2027 (from 1.8%) and staying close to target at 2.1% in 2028 (from 2.0%). This path assumes only a modest pickup in core inflation — annual averages of 2.3%/2.1%/2.1% for 2026–28 (from 2.2%/1.9%/2.0%) — pointing to limited second-round effects from the energy-price shock. Consistent with this, President Lagarde noted that indicators of underlying inflation have changed little in recent months and remain aligned with the ECB's 2% objective. A slightly weaker growth profile — 0.9%/1.3%/1.4% for 2026–28 (down from 1.2%/1.4%/1.4%) — also helps contain price pressures. The projections are based on data through 11 March, a later cut-off than usual, and use energy assumptions more conservative than market pricing: average oil prices of €70/b for 2026 and €62/b for 2027 (vs. market indications of €74 and €65; previously €64 for both years). In tandem with oil prices also market-based inflation expectations advanced further.

**Stagflationary development would bring rate hikes on the table**. The GC acknowledges that the war involving Iran "*has made the outlook significantly more uncertain*," creating "*upside risks for inflation and downside risks for economic growth*." In an adverse geopolitical scenario, the euro area would face stagnating or slightly contracting output in the summer half of this year, with average inflation spiking to 3.6% in 2026 before moderating in 2027. In a severe, outright stagflationary scenario, the ECB considers a 2026 recession with inflation remaining well above target over the forecast horizon (2026/27/28: 4.4%/4.8%/2.8%), as the price shock feeds into faster wage growth that only gradually loses momentum towards end-2028. These scenario analyses underscore that the GC sees the balance of risks tilted towards stagflation. As President Lagarde noted, the scenarios abstract from monetary-policy reactions, implying that in such outcomes rate hikes would at least be under consideration (adverse) and could be strongly warranted (severe).

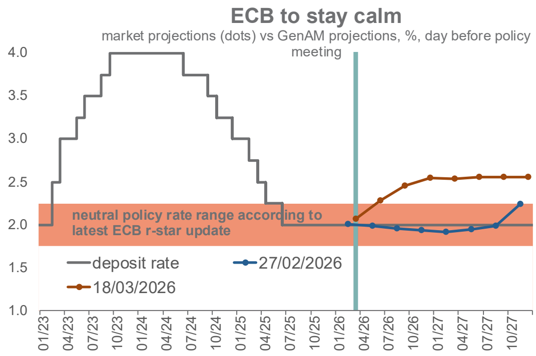
**The ECB's key signposts to watch.** In the Q&A President Lagarde mentioned developments in the commodity markets, supply bottlenecks, selling price expectations of firms, all kinds of demand indicators as well confidence indicators as signposts to watch but stated that the ECB will "*be particularly attentive to wage trackers*". So far wage agreements imply (services) inflation rates consistent with price stability (see lh-chart below).

**Not a good place any longer but well positioned.** The GC unanimously decided to leave rates constant at today's meeting and there was "*no range of views*". That said in the presence of the war-induced energy price shock the ECB sees itself no longer in "*a good place*" according to Mrs Lagarde but "*well positioned and well-equipped"* to deal with it.

**Situation better than in 2022.** That said, President Lagarde also put the current situation into perspective by pointing out that in 2022 the labour market was hotter and inflation already at 6% yoy (vs 1.9% yoy in February) when the energy price shock hit the economy. Moreover, at the current level of 2.0% the policy rate is in the middle of the neutral range (of 1.75% to 2.25%) that ECB staff had derived. This is another important difference to the 2022 inflation shock when the key rate had still been at -0.5% as it is putting the bar for policy action higher than in 2022.




Source: Datastream, GenAM




Source: Datastream, ECB, GenAM

**Hawkish wait-and-see stance but no hike in base case**. The ECB reaffirmed its data-dependent, wait-and-see stance. President Lagarde emphasized that the duration and intensity of the war and any emergence of second-round effects will be decisive. If the base case of a transitory inflation spike is confirmed, we see no need for additional tightening. Markets broadly share this view: oil prices are expected to moderate further out, while inflation expectations remain contained (see upper charts). In this context, current pricing for about two 25 bps hikes looks overdone. That said, the risk skew is to the upside—higher rates would come into play only if inflation detaches from target for longer due to mounting second-round pressures. Likewise, a further significant rise in energy prices could trigger policy actions as early as April.