

MARKET COMMENTARY

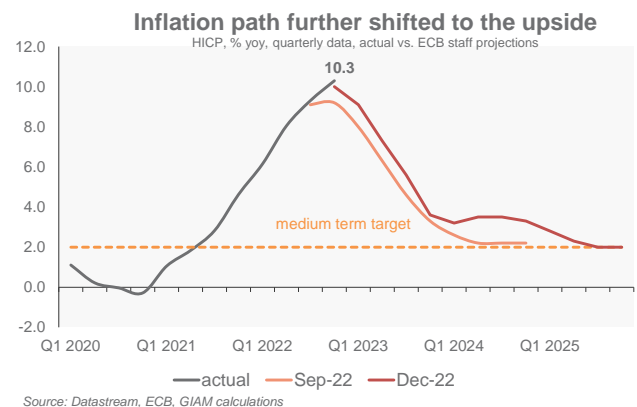
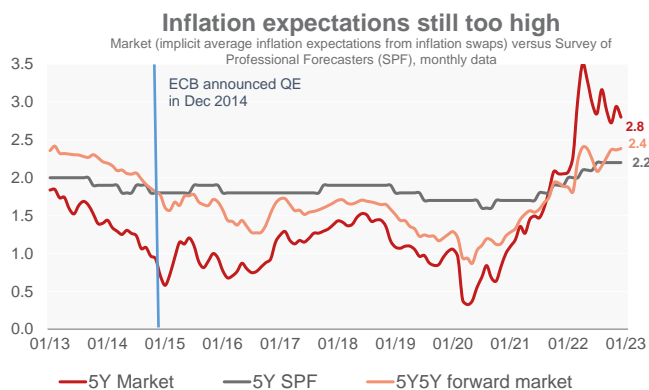
Hawkish ECB not pivoting but in for a long game – further 50 bps hikes ahead

Author: Martin Wolburg

December 15, 2022

- At today's meeting the ECB's Governing Council (GC) lifted its key rates by another 50 bps, in line with expectations. Yet the more measured pace was accompanied by a hawkish statement and press conference.
- The ECB also pledged to start reducing its asset purchase programme (APP) portfolio in March, starting with € 15 bn per month on average until the end June. Then the pace will be recalibrated. Details about the parameters for reducing APP holdings will be provided at the February meeting.
- The key rationale is a "substantial upward revision to the inflation outlook" with neither headline nor core inflation foreseen to converge to the 2% threshold by 2025.
- The GC dashed any hopes of a policy pivot, stating that "interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive" and that it would keep them at such levels to bring inflation down. The GC stated that key rates are the "primary tool for setting the monetary policy stance" and President Lagarde suggested that further 50 bps rate hikes are ahead
- In a knee-jerk reaction equity markets suffered and government bond yields rose.
- We now expect another 50 bps hike in February, followed by further increase by 50 bps thereafter, leading to a 3.0% terminal rate

A 50 bps rate hike and QT to start in March: At today's meeting the GC lifted its key rates by another 50 bps thereby bring the deposit rate to 2.0% and the repo rate to 2.5%, in line with expectations. It also announced the start of quantitative tightening (QT) by March 2023. Purchases made under the APP) will be reduced by on average € 15 bn until June and then the size of the shrinkage will be recalibrated. Details (e.g. composition, treatment of green bonds) will be provided at the February meeting. In contrast, the forward guidance on reinvestments made under the Pandemic Emergency Purchase Programme (PEPP) ("at least until the end of 2024") was maintained.



New projections show even more entrenched inflation spike: With a reading of 10.6% yoy in October, headline inflation reached a high. That said, the updated inflation projections by the ECB foresee neither annual headline (2.3%) nor core inflation

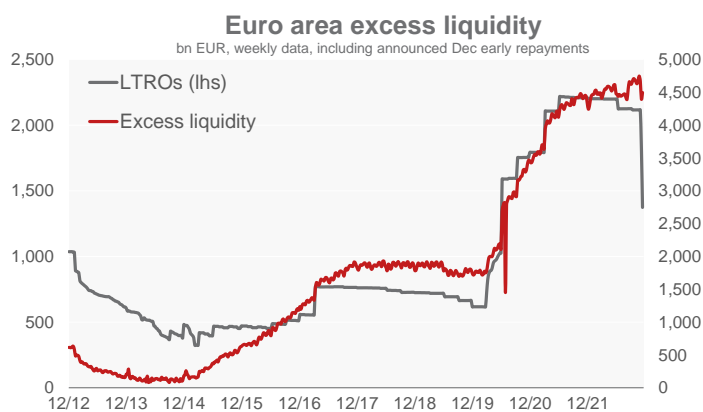
(2.4%) to converge to the 2% target by 2025. Only by the second half of 2025 inflation is set to come down to 2% again. President Lagarde emphasized the broadness of inflation and that risks primarily stemming from domestic factors like wage rises and inflation expectations over the medium-term, with little contribution from supply factors. Moreover, the GC flexed its muscles against fiscal policy makers by stating that fiscal measures related to the energy price spike that are not temporary, targeted and tailored “are likely to exacerbate inflationary pressures, which would necessitate a stronger monetary policy response”.

A shallow recession ahead: In contrast, the ECB has a relatively benign activity outlook. While acknowledging near-term economic weakening it looks for a shallow and short-lived recession only. The projected cumulative drawdown over the 2022/23 winter half is just -0.3%. Thereafter the economy is set to gain momentum again with annual growth rebounding further from 2024 onwards as dampening factors like supply-chain bottlenecks will large have run its course. This sound somewhat too optimistic to us as we look for a cumulative GDP drawdown of 0.9%.

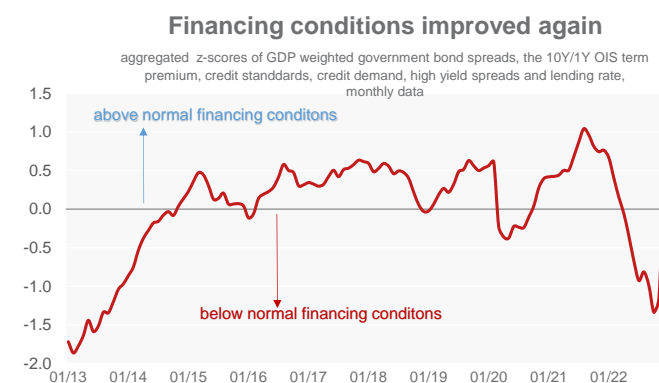
Further rate significant rate hikes at a steady pace on the cards: All in all the updated macro projections are backing ongoing policy tightening. The GC was very clear on that by stating that given “the substantial upward revision to the inflation outlook”, key rates “will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive”. That is quite a powerful hawkish statement. In the Q&A session President Lagarde continued to hammer down the message. She explicitly stated that the ECB was not pivoting, that it has more ground to cover, longer to go and that it is in for a long game. She backed these powerful statements by referring to the current terminal rate from market expectations as not being high enough to bring inflation down to target. Quite openly she stated that “based on the information that we have available today, that predicates another 50 bps rise at our next meeting and possibly at the one after that, and possibly thereafter”.

GC agreed with a broad majority but will it persist? At today’s meeting there was broad consensus about the assessment of the economic situation. However, the policy decision was only backed by a “broad majority”. With the deposit rate now at the upper end of the neural policy range, the next step clearly lifts rates into restrictive territory. While a restrictive policy stance is currently probably backed by most GC members, its magnitude and speed might become more controversial going forward. Some factors might make the ECB think twice about too aggressive rate hikes:

- **TLTRO expiry and repayments also contribute to tightening:** Already at the October meeting the ECB announced new measures incentivizing banks to repay TLTROs earlier causing banks to pay back € 743 bn (out of € 2.1 tr before) in November and December. This reduced the ECB’s balance sheet significantly and indirectly also contributes to a tightening of monetary conditions. Without further repayments the amount of outstanding TLTROS will shrink by about an additional € 800 bn in 2023. Reduced excess liquidity will support higher money market rates and tighter financing conditions.
- **QT to add to tightening of financing conditions:** The announced reduction of APP reinvestments will additionally drag on financing conditions and contribute to a widening of intra-EMU government bond spreads.
- **Financial stability risks to increase:** The ECB acknowledged already for increased financial stability risk. While they should clearly be addressed by means of macroprudential policy in the first place, Vice-President de Guindos nevertheless adopted a more cautious tone. He stated that higher rates will increase banks’ funding costs and the slowing of the economy will raise the solvency risk for clients. He also admitted that the reduction of the balance sheet was a new experience.



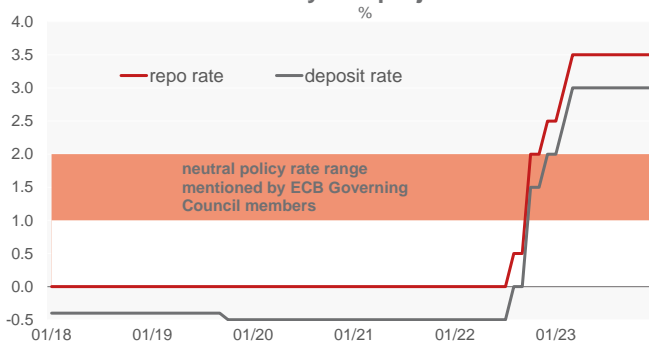
Source: Datastream, GIAM calculations



Source: Datastream, GIAM calculations

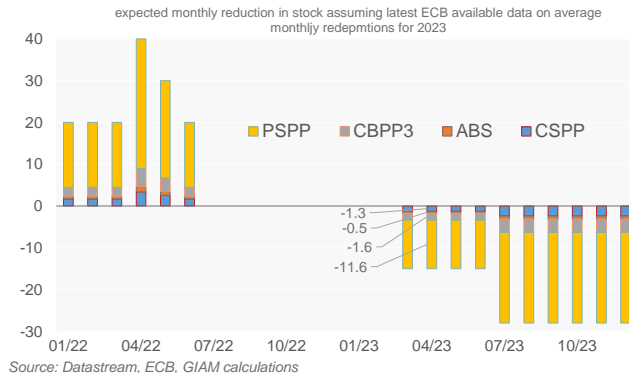
We now expect the ECB to hike by another 100 bps: Overall today's ECB meeting sent a very strong hawkish message. We have lifted our key rate expectations significantly up and now see 3.0% as the terminal rate, up from 2.5%. Lagarde was very hawkish and suggested even three further 50 bps hikes in 2023. For the above mentioned reasons, we are more sceptical on that. Also, we have a less benign view on the euro area recession. With sobering activity data and increased financial stability risks we expect the doves to re-gain some ground within the GC. We even deem it possible that the ECB slows down the magnitude of rate hikes after February. QT will become something taking place in the background rather than a tool actively fine-tuning the policy stance. We expect the ECB to also become more determined here after June 2023 and introduce higher reinvestment caps. A doubling from the currently announced € 15 bn to around € 30 bn appears likely to us, this would be close to the average of the expected average monthly redemptions in 2023.

ECB key rate projections



Source: Datastream, ECB, GIAM calculations

ECB's APP: From QE to QT



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 Italiane. 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..