No Regrets: The ECB Keeps Policy on Hold

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Inflation in the euro area is falling and the economy is rapidly weakening. Against that background, the ECB kept rates on hold at its policy meeting today.

Investors broadly expected that the ECB would keep rates at 4%. But it was a welcome surprise that its Governing Council didn't discuss bringing forward the end of reinvestments under the pandemic emergency purchase programme (PEPP). Doing so would have risked a significant rise in long-dated bond yields. That could have put further stress on Italy at a fragile time.

The ECB had previously said that it wouldn't end its PEPP reinvestments "until at least the end of 2024." So, reversing that commitment could have damaged its credibility. In our view, it will not regret keeping its policy on hold at this time.

Our Take on the Meeting

Thursday's hold by the ECB marks its first pause in rate rises since it started hiking in the summer of 2022. And against investors' speculation, the ECB announced no changes to its balance sheet operations. President Lagarde said that the ECB Governing Council hadn't even discussed bringing forward the end of PEPP reinvestments today.

Lagarde emphasized that euro area inflation remains uncomfortably high. However, our assessment is that the ECB struck a dovish tone. Both Lagarde's monetary policy statement and her comments emphasized that the euro area economy is weakening. Previous interest rate hikes are already hitting European households and firms - and forward-looking indicators suggest there is more pain to come.

That said, Lagarde noted that talk of interest rate cuts was "premature." We think the ECB will want to see core inflation continue to fall in coming months, and wage growth ease in early 2024, before it even contemplates lower rates. That would make the second quarter of 2024 the earliest opportunity for a rate cut.

In addition, Lagarde highlighted the asymmetric impact of plausible shocks that could further challenge the euro area. Those could include higher energy prices, on the back of the Israel-Hamas conflict, and effects of climate change on food prices. If either risk crystallizes, inflation could stay high for longer against the backdrop of a stagnating economy - a toxic mix for any central bank.

The bottom line for us is that we welcome the ECB's dovish tilt at today's meeting, against the backdrop of a weakening euro area economy and falling inflation. That said, we expect interest rates to stay at their current levels well into 2024, particularly in light of the plausible upside risks to inflation.

The ECB's continued silence on PEPP has made it less likely that it reneges on its commitment to continue reinvestment until at least the end of 2024. This should help contain Italian government bond spreads through the winter - another welcome development. Our forecast for euro area GDP growth in 2024 stands at 0.5%. Consensus has come down markedly over the course of this year, and currently stands at 0.8%.

Market Implications

The ECB's decision to keep rates on hold and not alter its balance sheet runoff was also prudent from a market perspective. Financial conditions have deteriorated in the past weeks. The Middle East conflict has added a layer of uncertainty to the headwinds from higher government bond yields. Tighter monetary conditions could have been damaging for European assets.

Nervousness in global financial markets was already high, so it is difficult to gauge how prices reacted to the ECB's meeting. However, there are several noteworthy patterns.

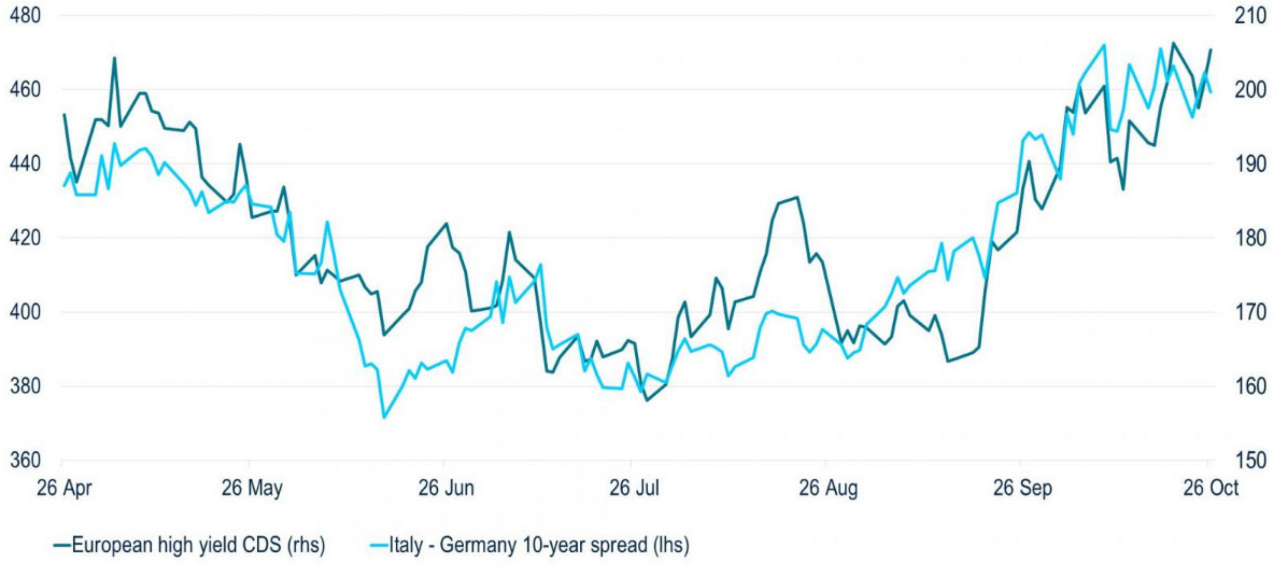
- First, the ECB's decision to pause largely reflected a weaker economy and gradually falling inflation. As a result, German bond yields continued to fall. This contrasts with the more resilient U.S. economic outlook. So far in October, 2-year German Bund yields are down around 15 basis points, whereas 2-year U.S. Treasury yields are broadly flat (Figure 1). After today's decision, the euro also weakened versus the U.S.-dollar, after several weeks of strength.

Two-year German Bund yields are lower so far in October, but 2-year U.S. Treasury yields are broadly unchanged

Source: Bloomberg, PGIM Fixed Income

- A more important observation, we believe, is that the ECB's decision to keep policy unchanged doesn't necessarily reduce the risks to euro assets. It just doesn't increase risk. Higher U.S. rates are spilling over to Europe and keeping financial conditions tight, even if the ECB leans dovish. In addition, the threat of another energy shock is real. In this context, it is unsurprising that corporate credit spreads and Italian government bond spreads to German Bunds remained wide even after the ECB's decision (Figure 2).

FIGURE 2: Euro high-yield credit default swaps (iTraxx Crossover) and 10-year Italian government bond spreads over German Bunds have started to reflect a challenging macroeconomic and corporate outlook



Source: Bloomberg, PGIM Fixed Income

- Further, any news about the ECB bringing its balance sheet runoff forward could compound financial market risk, especially at a time when governments issue materially more debt than in previous years. This combination of tighter monetary policy and fiscal largesse has raised the term premium in the U.S. The same combination also presents in the euro area.
- Higher interest rates are restoring some value to euro-denominated fixed income. But conditions may not be supportive enough to give investors high conviction on euro risk assets just yet.

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