Bond Blog

PGIM FIXED INCOME

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The ECB Laments Rates "So Far Away" from Achieving Target Inflation

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As investors expected, the European Central Bank's (ECB) Governing Council raised interest rates by 75 basis points (bps) today. This takes the ECB's policy rate into positive territory for the first time in a decade.

Despite this decisive action, ECB President Lagarde stressed that the end of the hiking cycle was still "so far away." Her press conference combined upward revisions to economic activity in the first half of this year with downside risks, such as further reductions in Russian gas flows. This combo underpinned a marked pivot in the ECB's messaging: the bank now says that it will do what is necessary to bring down demand to meet constrained supply and deliver on its price stability mandate.

Our Take on Today's Meeting: The Prospects for Above-Neutral Rates

With investors largely pricing in an out-sized move, the key takeaways from today's meeting include the ECB's sizable upward revision to its inflation outlook. Inflation is expected to remain slightly above its 2% target, even at the end of the forecast horizon. This revision not only suggests that rates will need to rise further, but that they will also need to go above neutral to bring down demand and return inflation to target.

The bank also revised its projection for next year's GDP growth from 2.1% to 0.9%. That said, even sluggish 0.9% growth looks aspirational in light of the energy crisis and recession risks that engulf the region. Our own forecast is for GDP to slow markedly into this winter and to contract by 1.4% in 2023.

During her press conference, President Lagarde would not be drawn into revealing the ECB's playbook if activity deteriorates as markedly as we expect and inflation remains high. She signalled that further negative supply-side news would probably not derail the Governing Council from its tightening path.

Stronger demand going into a supply-constrained winter has led us to raise our outlook for ECB rates. We now expect policy rates to rise to at least 1.5% by year-end before peaking somewhat above 2.0%, which is our high-end estimate of the neutral rate.

Market Reaction: Resilience in Risk Assets

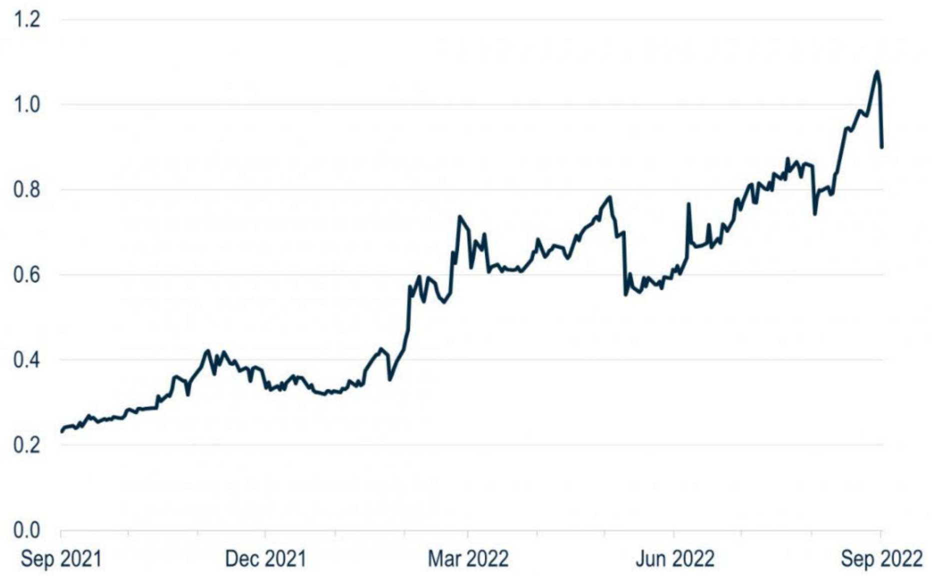
Investors had largely factored in the stronger demand and weaker supply that the ECB reminded us about today. Ahead of the meeting, a 75 bps policy rate increase had higher odds than a 50 bps increase, so there was little surprise.

However, the ECB's message was hawkish enough to raise German bond yields and flatten the yield curve. Interestingly, despite today's hawkish tone, the euro didn't strengthen materially versus most G10 currencies. At the time of writing, it is slightly weaker versus the U.S. dollar, partly due to Fed Chair Powell's hawkish comments at roughly the same time.

The most surprising part of investors' reaction today is perhaps the resilience of risk assets in the euro area. Corporate credit and peripheral government bond spreads tightened and equity markets firmed, with the exception of the euro-sensitive German DAX index. This is consistent with the view that the ECB message helped restore its credibility as an inflation-fighting central bank. For now, this effect appears to be more than offsetting the impact of higher risk-free rates in the euro area.

The ECB's temporary removal of its 0% interest rate ceiling on government deposits should also help its credibility. Investors' anxiety had risen due to the potential rotation out of poorly remunerated ECB deposits into government bonds as policy rates rise. This could have intensified the growing gap between swap rates and German bond yields (Figure 1).

FIGURE 1: Euro Two-Year Swap Rates vs. Two-Year German Government Bond Yields (%)



Source: PGIM Fixed Income, Bloomberg.

But raising the rate ceiling to the lowest of the deposit facility or the euro short-term rate (ESTR) significantly reduces the incentive for an abrupt rotation out of ECB deposits. This helps ensure that the transmission mechanism of monetary policy remains effective as rates rise.

Looking ahead, tighter monetary policy with high inflation and weakening growth doesn't bode well for risk assets. Investors may feel reassured for now, but their sentiment does not seem to reflect the prospect of stagflation further down the line.

Conclusion

Today's interest rate decision did not surprise investors. But the bank's upward revision to its inflation outlook now suggests that rates will rise above neutral to bring down demand and return inflation to target, even if further supply-side shocks occur.

That inflation-fighting message was loud enough for German yields to rise and to help the ECB's credibility. This effect, in turn, gave breathing room to euro area risk assets, for now. Looking ahead, however, the investment outlook remains challenging, as the ECB continues to tighten while the economy and corporate fundamentals weaken.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of September 8, 2022

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