

A Most Hawkish Hike by the ECB

Katharine Neiss, PhD, Deputy Head of Global Economics and Chief European Economist
Guillermo Felices, PhD, Global Investment Strategist

Thursday's ECB (European Central Bank) rate hike and its confirmation of a faster balance sheet reduction were in line with most investors' expectations. But its projections and its policy statement suggested a notably more hawkish policy outlook.

The ECB downgraded its projections for GDP growth - but just a touch, considering how much weaker recent data has been. More importantly, it raised its outlook for inflation in every year of its forecast. That includes 2025, for which the ECB now sees inflation at 2.2%, still above its target.

All this suggests that the ECB is prepared to take its main policy rate from 3.50% to close to 4% against a backdrop of weakening consumption, which remains below its pre-pandemic level. For now, though, it looks like the ECB's key variable is real-time inflation data.

Our Take on the Meeting

The ECB delivered a further 25 bps rate hike, as investors had expected. Alongside this hike, it confirmed that it would reduce its balance sheet more quickly than previously announced. So far, so predictable.

But President Lagarde's decidedly more hawkish tone was a surprise. Her press conference made clear that the ECB is determined to differentiate its policy plans from the Fed's hawkish skip earlier this week ([Will the Fed's Policy Bundle Bundle Morph into a Bungle?](#)). The question is why.

In its updated economic projections, the Bank downgraded its GDP growth outlook - but just a touch, considering the weaker data flow. More surprisingly, it raised its inflation outlook in every year of its forecast. That includes 2025 (the final year of its projections) for which the ECB now sees inflation at an average 2.2%, still above its target. President Lagarde attributed this miss to high unit labor costs that are expected to persist. But when probed, she conceded that, although the eurozone labor market is strong, there are no signs of a wage-price spiral.

Our take is that the ECB has incorporated the risk that a wage-price spiral will crystallize into its forecast and that this underpins its more hawkish stance. This suggests that it is on track to take its main policy rate to close to 4%, even if domestic demand is weakening, with consumption still below its pre-pandemic level.

As a result, our view is that the ECB will hike rates a further 25 bps at its next meeting, before pausing as economic activity continues to deteriorate in the second half of 2023. This view reflects our forecast that GDP growth will fall from 0.6% (market consensus) in 2023 to 0.4% (below market consensus) in 2024.

Market Reaction

The ECB's decision on interest rates and on its balance sheet was as investors expected. But the Bank's inflation projections and its press conference were a hawkish surprise. Comparisons with the Fed's decision one day earlier are hard to avoid: if the Fed's decision was a hawkish skip, the ECB's was a most hawkish hike.

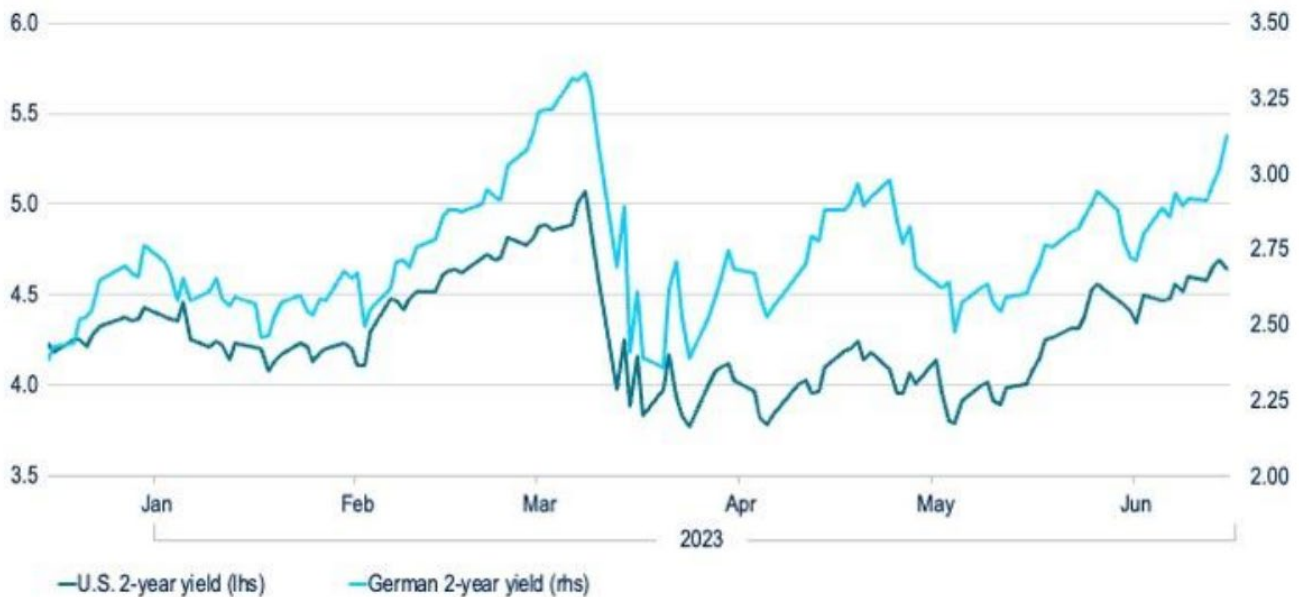
Thursday's market reaction reflected that hawkish message. German Bund yields rose sharply, with rising short-dated yields further flattening the German yield curve. Short-term government bond markets moved quickly to price in more than a 25 bps ECB rate hike in July and close to another 25 bps in September.

Risk assets were generally resilient after the ECB's rate hike. That resilience was remarkable, given that the Bank's hawkish message comes as the eurozone economy is still weakening. Italian and Spanish spreads over German yields for example, remained broadly stable. After an initial spike, credit spreads widened only marginally on the day.

The most prominent move, perhaps, was in the currency market, where the euro appreciated sharply relative to the U.S. dollar. Its surge, despite the threat of weaker eurozone growth, reflected interest-rate differentials that moved sharply in favor of the single currency.

Investors have been surprised recently, as developed-market central banks refuse to pause but continue to fight inflation. The ECB is in a league of its own as it continues to signal further tightening, with no hint of a pause. Its stance raises a significant concern for European risk assets, because further tightening would coincide with a weakening economy that is vulnerable to further supply shocks. Together with higher interest rates across the yield curve, this confirms our view that risk assets (including corporate bond spreads) in the eurozone are vulnerable.

FIGURE 1: German 2-year Bund yields have risen sharply, relative to 2-y U.S. Treasury yields, following the ECB decision (yields in %).



Source: Bloomberg.

The comments, opinions, and estimates contained herein are based on and/or derived from publicly available information from sources that PGIM Fixed Income believes to be reliable. We do not guarantee the accuracy of such sources or information. This outlook, which is for informational purposes only, sets forth our views as of June 15, 2023. The underlying assumptions and our views are subject to change. Past performance is not a guarantee or a reliable indicator of future results.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of June 15, 2023

For Professional Investors only. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. All investments involve risk, including the possible loss of capital.

Important Information

PGIM Fixed Income operates primarily through PGIM, Inc., a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and a Prudential Financial, Inc. ("PFI") company. Registration as a registered investment adviser does not imply a certain level or skill or training. PGIM Fixed Income is headquartered in Newark, New Jersey and also includes the following businesses globally: (i) the public fixed income unit within PGIM Limited, located in London; (ii) PGIM Netherlands B.V., located in Amsterdam; (iii) PGIM Japan Co., Ltd. ("PGIM Japan"), located in Tokyo; (iv) the public fixed income unit within PGIM (Hong Kong) Ltd. located in Hong Kong; and (v) the public fixed income unit within PGIM (Singapore) Pte. Ltd., located in Singapore ("PGIM Singapore"). PFI of the United States is not affiliated in any manner with Prudential plc, incorporated in the United Kingdom or with Prudential Assurance Company, a subsidiary of M&G plc, incorporated in the United Kingdom. Prudential, PGIM, their respective logos, and the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide.

These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary. PGIM Fixed Income as a general matter provides services to qualified institutions, financial intermediaries and institutional investors. Investors seeking information regarding their particular investment needs should contact their own financial professional.

These materials represent the views and opinions of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person's advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Fixed Income is prohibited. Certain information contained herein has been obtained from sources that PGIM Fixed Income believes to be reliable as of the date presented; however, PGIM Fixed Income cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Fixed Income has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy.

Any forecasts, estimates and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, as an offer or solicitation, nor as the purchase or sale of any financial instrument. Forecasts and estimates have certain inherent limitations, and unlike an actual performance record, do not reflect actual trading, liquidity constraints, fee. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. PGIM Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Fixed Income or its affiliates.

Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and low interest rate environments increase this risk. Reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. Mortgage- and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and while generally supported by a government, government agency or private guarantor, there is no assurance that the guarantor will meet its obligations. High yield, lower-rated securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Investing in foreign-denominated and/or -domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Currency rates may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. Commodities contain heightened risk, including market, political, regulatory and natural conditions, and may not be suitable for all investors. Diversification does not ensure against loss.

In the United Kingdom, information is issued by PGIM Limited with registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority ("FCA") of the United Kingdom (Firm Reference Number 193418). In the European Economic Area ("EEA"), information is issued by PGIM Netherlands B.V., an entity authorised by the Autoriteit Financiële Markten ("AFM") in the Netherlands and operating on the basis of a European passport. In certain EEA countries, information is, where permitted, presented by PGIM Limited in reliance of provisions, exemptions or licenses available to PGIM Limited under temporary permission arrangements following the exit of the United Kingdom from the European Union. These materials are issued by PGIM Limited and/or PGIM Netherlands B.V. to persons who are professional clients as defined under the rules of the FCA and/or to persons who are professional clients as defined in the relevant local implementation of Directive 2014/65/EU (MiFID II). In certain countries in Asia-Pacific, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan Co. Ltd., registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is provided by PGIM (Hong Kong) Limited, a regulated entity with the Securities & Futures Commission in Hong Kong to professional investors as defined in Section 1 of Part 1 of Schedule 1 (paragraph (a) to (i) of the Securities and Futures Ordinance (Cap.571). In Australia, this information is presented by PGIM (Australia) Pty Ltd ("PGIM Australia") for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the FCA (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws. In Canada, pursuant to the international adviser registration exemption in National Instrument 31-103, PGIM, Inc. is informing you that: (1) PGIM, Inc. is not registered in Canada and is advising you in reliance upon an exemption from the adviser registration requirement under National Instrument 31-103; (2) PGIM, Inc.'s jurisdiction of residence is New Jersey, U.S.A.; (3) there may be difficulty enforcing legal rights against PGIM, Inc. because it is resident outside of Canada and all or substantially all of its assets may be situated outside of Canada; and (4) the name and address of the agent for service of process of PGIM, Inc. in the applicable Provinces of Canada are as follows: in Québec: Borden Ladner Gervais LLP, 1000 de La Gauchetière Street West, Suite 900 Montréal, QC H3B 5H4; in British Columbia: Borden Ladner Gervais LLP, 1200 Waterfront Centre, 200 Burrard Street, Vancouver, BC V7X 1T2; in Ontario: Borden Ladner Gervais LLP, 22 Adelaide Street West, Suite 3400, Toronto, ON M5H 4E3; in Nova Scotia: Cox & Palmer, Q.C., 1100 Purdy's Wharf Tower One, 1959 Upper Water Street, P.O. Box 2380 - Stn Central RPO, Halifax, NS B3J 3E5; in Alberta: Borden Ladner Gervais LLP, 530 Third Avenue S.W., Calgary, AB T2P R3.

© 2023 PFI and its related entities.

2023-4652

留意事項

※本資料はPGIMフィクト・インカムが市場動向に関する情報提供としてプロの投資家向けに作成したものです。PGIMフィクスト・インカムは、米国SECの登録投資顧問会社であるPGIMインクの債券運用部門です。

※本資料は情報提供を目的としたものであり、特定の金融商品の勧誘又は販売を目的としたものではありません。また、本資料に記載された内容等については今後変更されることもあります。

※記載されている市場動向等は現時点での見解であり、これらは今後変更することもあります。また、その結果の確実性を表明するものではなく、将来の市場環境の変動等を保証するものでもありません。

※本資料で言及されている個別銘柄は例示のみを目的とするものであり、特定の個別銘柄への投資を推奨するものではありません。

※本資料に記載されている市場関連データ及び情報等は信頼できると判断した各種情報源から入手したものです。その情報の正確性、確実性について当社が保証するものではありません。

※本資料に掲載された各インデックスに関する知的財産権及びその他の一切の権利は、各インデックスの開発、算出、公表を行う各社に帰属します。

※過去の運用実績は必ずしも将来の運用成果等を保証するものではありません。

※本資料は法務、会計、税務上のアドバイスあるいは投資推奨等を行うために作成されたものではありません。

※当社による事前承諾なしに、本資料の一部または全部を複製することは堅くお断り致します。

※“Prudential”、“PGIM”、それぞれのロゴおよびロック・シンボルは、プルデンシャル・ファイナンシャル・インクおよびその関連会社のサービスマークであり、多数の国・地域で登録されています。

※PGIMジャパン株式会社は、世界最大級の金融サービス機関プルデンシャル・ファイナンシャルの一員であり、英国プルデンシャル社とはなんら関係がありません。

PGIMジャパン株式会社

金融商品取引業者 関東財務局長（金商）第392号

加入協会：一般社団法人日本投資顧問業協会、一般社団法人投資信託協会、一般社団法人第二種金融商品取引業協会

PGIMJ99887