Bond Blog

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ECB : Not Pausing - Yet

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The European Central Bank's (ECB) decision to raise policy rates by 25 basis points (bps) on Thursday was all about avoiding surprises and distinguishing itself from the Fed's dovish message earlier this week. Eurozone inflation remains uncomfortably high and core inflation continues its upward march. As a result, in President Lagarde's words, the ECB "is not pausing."

That said, the slowdown in the ECB's pace of tightening is notable. It reflects uncertainties around the monetary transmission mechanism and potential spillovers from the U.S. banking sector. The ECB is no doubt keen to avoid overtightening at the risk of affecting economic growth.

Our Take on the ECB's Policy Decision

As expected, the ECB's latest rate hike accompanied plans to accelerate its balance sheet run-off. That further march into restrictive territory reflects the fact that inflation remains uncomfortably high. That said, the slowdown in the pace of hikes - from 50 bps or 75 bps increments to 25 bps - is notable. It likely reflects several considerations on the minds of members of the ECB Governing Council.

First, today's stepdown recognises that the ECB has increased rates aggressively over a short timeframe. The impact of that aggressive series of hikes on the real economy is yet to feed through. Early signs are as eye-catching as they are worrying; for example, in the ECB's bank lending survey, firms' net demand for loans in the first quarter of 2023 fell by the most since the global financial crisis. Clearly, the central bank is keen to avoid cooling the economy too much as it tries to bring inflation back to target.

Second, and relatedly, there are signs that the euro area economy is weakening. The job vacancy rate has come off its peak, and consumption remains weak as the rising cost of living squeezes household budgets.

Finally, any weakness in the U.S. will have a dampening effect on the eurozone, even in the absence of contagion to the European banking sector. The U.S. is a hugely important market, and reduced U.S. demand for European exports would cool the economy. That would bring inflation back to target faster, without the need for the ECB to do much more.

President Lagarde sent a hawkish message today, that further rate hikes will be needed. But our view remains that the ECB will probably raise rates just one more time, in June, before pausing. In that sense, we see the ECB as only a few steps behind the Fed.

Market Reaction

Investors had expected the ECB's decision to increase its policy rates by 25 bps. ECB president Lagarde's comments in the press conference were deliberately hawkish, but investors chose to follow actions rather than words. In that respect, the ECB's decision to stop reinvestments under its asset purchase programme (APP) from July was an important piece of news.

Investors' reaction today reflected their view that the ECB is slowing its rate hikes because they are hurting the demand for credit, as mentioned in the ECB's bank lending survey. The German sovereign bond yield curve shifted lower following the ECB's decision today, but clearly steepened: short-dated yields are lower, but longer-dated yields are stable to higher (Figure 1). The latter is consistent with the ECB's decision to discontinue reinvestment under its APP.

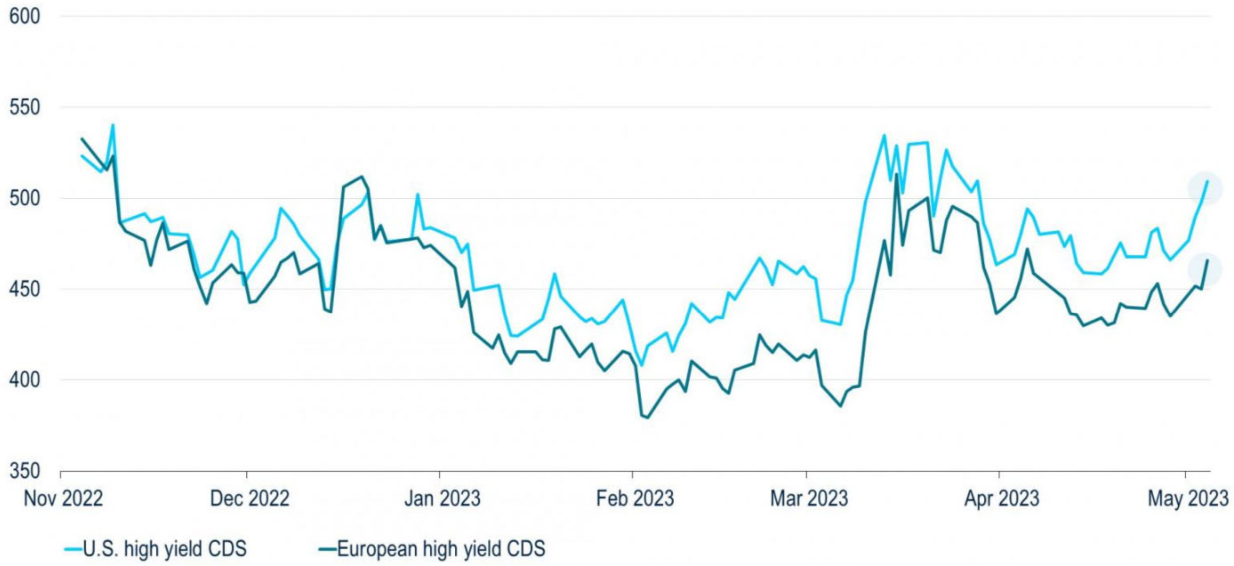
FIGURE 1: German short-dated yields fell as long-dated yields rose after today's ECB decision (lhs: %; rhs: bps)

Source: Bloomberg, PGIM Fixed Income

Risk assets had already showed signs of concern just after the publication of the bank lending survey. Peripheral sovereign bond spreads have widened since the start of May, mostly in France where fiscal fundamentals have weakened. Corporate spreads, for investment-grade and high-yield bonds, have also widened in May and continued to widen after today's ECB decision.

Admittedly, the weakness in euro assets this week may be linked to risk aversion in the U.S. Stress among U.S. banks lingers, and the Fed has also raised concerns about tighter credit conditions. Euro high-yield credit default swap (CDS) spreads have widened in May, and a similar pattern is observable in U.S. high-yield CDS (Figure 2).

FIGURE 2: Euro high-yield credit default swap (CDS) spreads continued to widen today, as the ECB meeting didn't alleviate concerns about credit tightening that are already visible in the U.S. (bps)



Source: Bloomberg, PGIM Fixed Income

Interestingly, recent moves in the euro-U.S. dollar exchange rate have been tightly linked to the interest-rate differential between the two currencies. If investors question the ECB's ability to hike rates much further, and reduce the number of Fed cuts they expect later this year, that could halt the euro's multi-month rally against the U.S. dollar.

We had previously taken a cautious view on eurozone risk assets, as cumulative ECB tightening weakened credit conditions. Macroeconomic data have been resilient this year, but the ongoing fight against inflation will eventually hurt the recovery. In our view, prices for risk assets were not fully taking those risks into account.

Today's ECB meeting confirmed this tricky juncture: the inflation fight continues, but how much longer can it go on without hurting growth? Inflation will probably keep short-dated interest rates high and maintain pressure on prices for European risk assets.

Important Information

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