

## ECB : Not Pausing - Yet

Guillermo Felices, PhD, Global Investment Strategist  
Katharine Neiss, PhD, Chief European Economist

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,

**For Professional Investors Only. All Investments involve risk, including the possible loss of capital.**

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.

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 May 4, 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 May 4, 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.

2023-3768

## 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はありません。

※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のですが、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、英国ブルー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

PGIMJ99038