Asset Management

ECB continues hiking

Investment event | 15 June 2023

ECB hikes rates by another 25bps

The European Central Bank (ECB) increased policy interest rates by 25 basis points (bps) at its June meeting, as anticipated. The move took the deposit rate to 3.50% while the main refinancing rate and the marginal lending facility rose to 4.00% and 4.25%, respectively. The ECB also confirmed that it will end reinvestments of maturing assets under its Asset Purchase Programme (APP).

The ECB cited inflation as the main motivation for the hike, noting that is likely to remain *"too high for too long"*. It highlighted that a strong labour market and high wage growth were increasingly driving price pressures, even as energy and food price disinflation was underway.

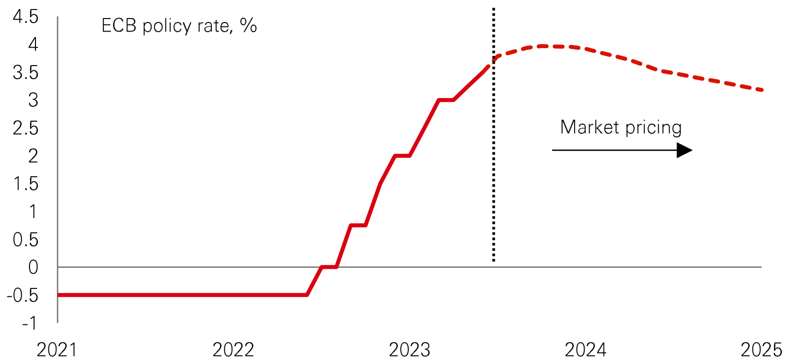
Policy outlook

The ECB released fresh forecasts at the meeting, although changes from the numbers produced in March were marginal. Staff projections put inflation 0.1ppts higher across the next three years on the back of stronger labour market data. At the same time, the ECB reduced its economic growth forecasts by 0.1ppt for the next two years. Broadly, it sees inflation as too high, and growth returning to around trend next year.

In the press conference, President Lagarde continued her run of hawkish comments by making clear that the ECB *"still has more ground to cover"* and that *"[the interest rate] is not at destination yet"*. Whilst there was no explicit forward guidance in the official press release, Lagarde stated that the Governing Council *"will likely raise rates in July"* and that it wasn't yet thinking about pausing.

In response to the meeting, interest rate swap market pricing moved to price in a peak interest rate of 4.00%, versus 3.75% prior to the meeting (Figure 1).

Figure 1: Market pricing for policy rates



Economic outlook

The ECB's decision to hike at its June meeting and deliver further hawkish rhetoric came despite the economy experiencing a technical recession in late 2022/early 2023. In the coming months, however, strong wage growth and declining headline inflation could offer a degree of relief to household budgets. Indeed, consumers currently sit on a healthy pile of excess savings, which if spent, could bolster spending.

But downside risks to the outlook appear large at the 6-12-month horizon. The sharp rise in interest rates is having a substantial impact on money creation and credit demand. It is also compounding the weakness observed in the manufacturing sector. We anticipate this will ultimately lead to a contraction in aggregate demand, lower profits, a rise in unemployment. Consistent with this expectation for a meaningful recession starting in early 2024, we see inflation falling back towards target over the medium term.

Investment implications

The decision today has little impact on our current views regarding European assets. We **maintain an underweight stance on equities**, given our expectation of a policy-induced recession around the year-end. Considering that neither markets nor the consensus of economists currently predicts a eurozone recession, we believe this could weigh on risk-assets.

Our position remains **neutral on eurozone government bonds**. Yields may continue to rise in the near term, as the ECB raises policy rates further. However, we expect yields to decline meaningfully in the medium term once the economy enters a downturn and policy is eased.

The ECB increased the deposit rate by 25bps to 3.50% at its June meeting

The Governing Council expects to continue hiking interest rates with no pause yet on the horizon

Our view:

Today's decision does little to impact our cautious investment outlook

We remain underweight European risk assets with a policy-induced recession on the horizon

Government bonds are the natural asset class in this environment, but we remain cautious with the ECB still in hiking mode

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