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CIO Flash

Raising rates, calming markets – testing times for the ECB

Investment Solutions

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The European Central Bank (ECB) will start hiking interest rates in July, as expected, following in the footsteps of other developed market central banks. Yet the ECB faces very different challenges from the US Federal Reserve. That makes a shallower hiking cycle in Europe more likely, with rates peaking at 1.25% in the first quarter of 2023.

On 9 June, the ECB confirmed its intention to end its bond-buying programme on 1 July, and raise rates by 25 basis points (bps) at its 21 July meeting. The central bank also cut its growth forecasts and raised its inflation projections. Rising consumer prices remain ECB policymakers' main concern. Inflation may reach 2.1% in 2024, they said, slightly above the central bank's target.

If the inflation outlook does not improve, ECB President Christine Lagarde indicated that a larger rate increase of 50bps in September is possible. Consumer prices in the eurozone hit a record 8.1% in May compared with a year earlier, above consensus expectations of 7.8%. The war in Ukraine is keeping energy and food costs high, but is not the only source of price pressures. Core inflation, which excludes energy and food, also rose more than expected, to 3.8%. Services gained 3.5% and manufactured goods were 4.2% higher. Although there are signs that inflation may be near a peak, headline figures may increase in coming months.

The ECB can do little to reduce imported gas prices, yet policymakers say they are concerned about 'second-order' effects, including inflation expectations and wage negotiations. In contrast with inflation in America, which is mainly being driven by booming consumer demand, supply shocks are largely behind price rises in Europe, and wage growth is much more subdued. While the Fed is using aggressive rate rises to temper demand, European governments are expected to shield consumers from the worst of the rising energy costs.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- The ECB confirmed the end of asset purchases and a first 25 bps rate increase in July
- President Christine Lagarde indicated larger rate rises from September are possible, raising the risk of a monetary policy mistake
- Compared with the US, European inflation is more supply-driven, growth is weaker, and a fragmented euro area is a concern
- Given the growth risks, the ECB's hiking cycle will be shallower than the Fed's. We expect rates to peak around 1.25% in Q1 2023.

Rising risk

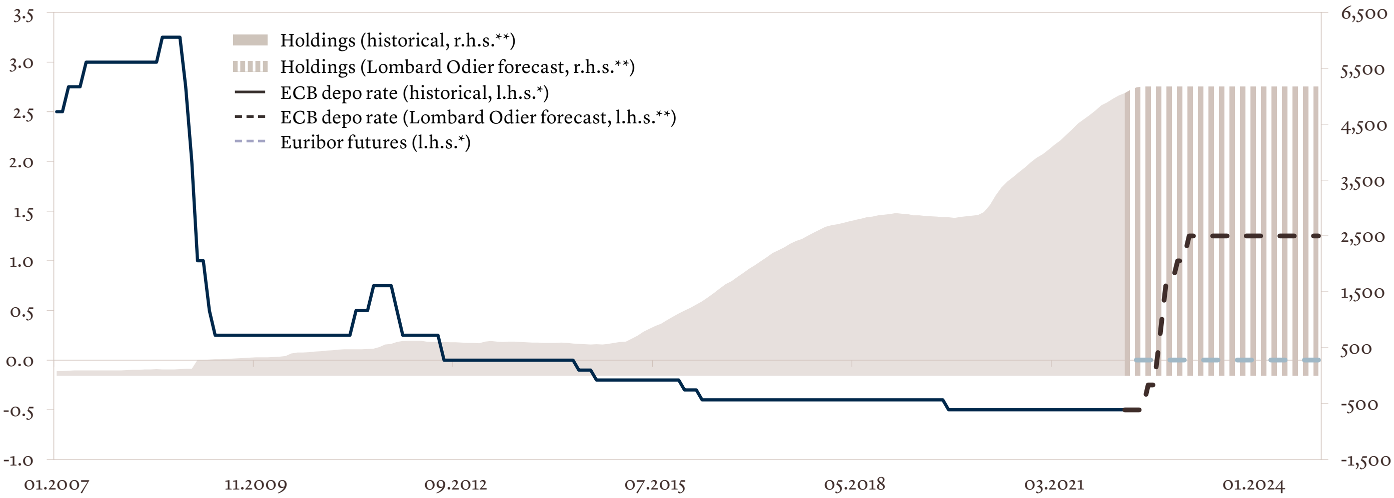
Faster monetary policy tightening in the eurozone would increase the risk of a policy mistake. Markets expect the ECB's policy rate to peak above 2%. We think that is too high, as monetary policy would then weigh on the economy, endangering growth. The region's economy is in a more difficult position than the US because its growth is more affected by the war in Ukraine, and remains below pre-pandemic levels. The ECB now expects GDP growth of 2.8% in 2022 (we forecast 2.5%).

The ECB must also maintain financial stability, steering policy for different economies without fragmenting the bloc. The strain is visible in the differences between sovereign debt yields. The spread between Italian and German debt is more than 200 bps, its widest since 2018. If this widens to 300 bps, the ECB may have to act and remains open to buying European countries' bonds.

Investors are focused on the speed and scale of rate rises, as well as measures to prevent spread widening. Ending asset purchases in July, plus the rate hike, and a further 50 bps increase in banks' borrowing costs for three years on 23 June when another measure expires, would significantly tighten financial conditions. The ECB will of course remain 'data dependent', but after July's hike we expect rate increases to continue in a gradual and flexible manner until the deposit rate reaches 1.25% in early 2023.

ECB getting closer to lift-off

ECB policy rate and size of asset holdings versus expectations



*left hand scale, ** right hand scale

Sources: Bloomberg, ECB, Lombard Odier calculations

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