Asset Management

ECB delivers a dovish hike

Investment event | 28 July 2023

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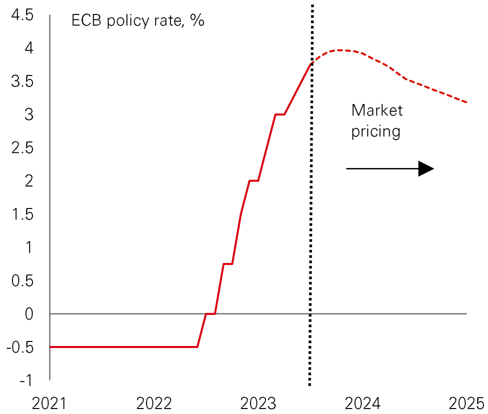
ECB hikes rates by another 25bps

The European Central Bank (ECB) increased policy interest rates by 25 basis points (bps) at its July meeting, as anticipated. The move took the deposit rate to 3.75% while the main refinancing rate and the marginal lending facility rose to 4.25% and 4.50%, respectively.

Motivating the change was its view that inflation will "remain too high for too long". In particular, developments since the June meeting were consistent with the view that inflation will "stay above target for an extended period".

The Governing Council also decided to stop paying interest on corporate bank minimum reserves. The move will hit banks who have been seeing windfall profits from maintaining near-zero deposit rates while charging increasingly higher interest rates on loans. The move is expected to preserve the effectiveness of monetary policy.

Figure 1: Market pricing for ECB policy rate, %



Source: Bloomberg (27 July 2023)

Data-dependency with dovish details

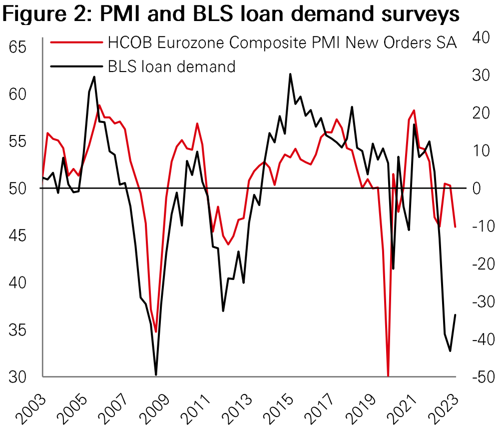
In its statement and in President Lagarde's press conference, the ECB gave little away on the future path of policy. Indeed, it maintained a commitment to following a "data-dependent approach". The ECB also did not pre-commit to any further rate hikes.

The unwillingness to commit to further interest rises reflects a change in the ECB's assessment of the economy. The Governing Council now sees previous rate hikes as being "transmitted forcefully" with financial conditions "increasingly dampening demand". This, it says, will be "an important factor in bringing inflation back to target", particularly given it sees inflation pressures as being increasingly domestically generated.

Overall, Lagarde struck a more dovish tone than in June and her recent speeches. She dropped her comments around interest rates "having more ground to cover", while also highlighting that aggregate demand, money growth, and credit creation were continuing to weaken. However, she noted that services inflation remains too high, which could necessitate additional tightening.

In response to the meeting, interest rate swap pricing was little changed with markets still expecting at least one more hike before the ending the rate hiking cycle (Figure 1).

Figure 2: PMI and BLS loan demand surveys



Source: Macrobond, HSBC AM calculations

Our take

The ECB's seemingly more dovish tone came on the back of weaker-than-expected economic data. Of note, GDP growth has been negative in the last two quarters, the S&P Global Purchasing Manager Indices (PMIs) now sits below 50, and the ECB's Bank Lending Survey (BLS) shows demand is now at levels seen in the Great Financial Crisis (Figure 2).

We agree with the ECB that, in the short-run, there are downside risks to the growth outlook. However, we disagree with its view that following some near-term weakness, with inflation falling towards target, the economy can recover to a more favourable rate of growth.

Indeed, we believe the ECB and other economists underestimate the full impact that current weak rates of money creation and credit demand will have on the economy. In particular, it could have a larger-than-expected impact on the labour market, which would then have significant second-round effects on activity. Ultimately, we expect a recession, starting in early 2024, although with a risk of an earlier material weakening of the economy.

The ECB increased the deposit rate by 25bps to 3.75% at its July meeting

The ECB struck a more dovish tone, noting that interest rates were increasingly dampening demand

Our view:

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

High-quality fixed income is the natural asset class in this environment, but we remain cautious on European government bonds amid sticky services inflation

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Investment Implications

For us, the ECB's decision today emboldens our view that the interest rate hiking cycle is close to its end. Its interpretation of recent weakness in economic data also aids our view that policy rates will fall more sharply than markets expect at the 12-24-month horizon on the back of a recession.

Overall, we **maintain an underweight view on European equities**. This comes on the back of our view of current market pricing which remains optimistic relative to our expectation of economic recession and a meaningful deterioration in corporate profits.

Our view **remains neutral on eurozone government bonds**. Yields may continue to rise in the near term, with inflation pressures, particularly in services, remaining elevated. However, we expect yields to decline meaningfully in the medium-term once the economy enters a downturn and policy is eased faster than currently embedded in market pricing.

More broadly, from a **global multi-asset perspective**, we continue to argue for a defensive positioning in portfolios. Specifically:

- Our central scenario for advanced economy recessions emerging from late-2023/early-2024 is consistent with "choppy waters" for global risk assets over the next 12 months, and room for downside in market prices for credits and stocks. Current market pricing looks to be incorporating a "soft-landing" outcome for major Western economies.
- Our house view is consistent with a preference for short-duration fixed income assets, especially US Treasuries, given our view of a US recession. We also want to take advantage of the carry that high quality credits offer and believe solid corporate balance sheets offer protection against default risk.
- Finally, we remain positive on most EM asset classes given tailwinds from relatively favourable valuations, cautious investor positioning, more resilient growth, lower EM inflation, the prospect of US Fed interest rate cuts and further dollar weakness later in the year. EM rate cuts, particularly given they are coming before the Fed, is also positive for EM risk.

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