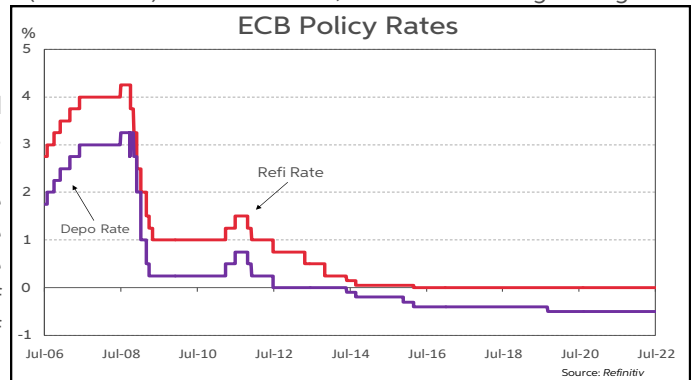


ECB hikes by more than expected but no forward guidance

The ECB's Governing Council meeting for July saw the central bank announce a rate hike for the first time since July 2011. The central bank is implementing a 50bps increase in its key interest rates. The deposit rate will increase to 0.00% (from -0.50%), while the refi rate will rise to 0.50% (from 0.0%). In other words, the ECB is ending its negative interest rate policy.

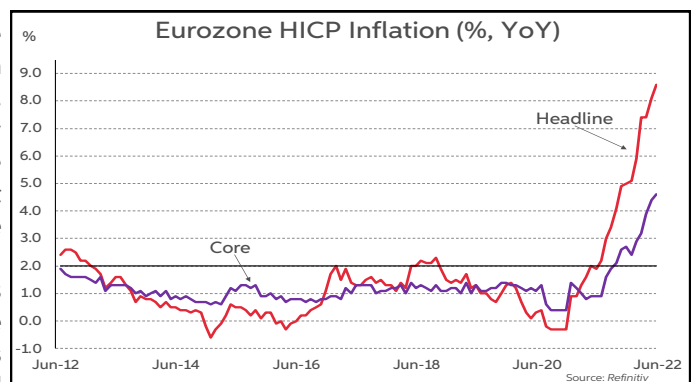
The rate hike is more than the 25bps that the ECB had guided at its previous meeting in June. Speculation had increased in recent days on the back of news reports that the ECB was contemplating a 50bps rate hike. However, the market had not fully priced in a 50bps rate increase for today. President Lagarde stated during the press conference that following the debate within the Governing Council on the "pros and cons", at the end of the discussion all "members rallied to the consensus of 50bps".



The Governing Council stated that its decision to raise rates today by more than it had previously guided was due to its updated assessment of the inflation risks facing the Eurozone. It also referenced the fact that it had approved the Transmission Protection Instrument (TPI) which would support the effective transmission of monetary policy. This instrument is an asset purchase programme designed to be used if there is "unwarranted, disorderly, market dynamics" that would pose a threat to the transmission of the ECB's monetary policy

In terms of its forward guidance, the ECB is no longer providing any, other than that rates will continue to rise. The meeting statement noted that at its upcoming meetings further "normalisation of interest rates" will be appropriate. The ECB stated that the front loading of its exit from negative interest rates will allow it to adopt a "meeting-by-meeting" approach to interest rate decisions. In the press conference, President Lagarde faced numerous questions on the issue of forward guidance and what should be expected at its next meeting on September 8th. She eventually stated that the ECB is "not offering forward guidance of any kind". At the same time, she continued to emphasise that the pace of rate hikes will be data dependent.

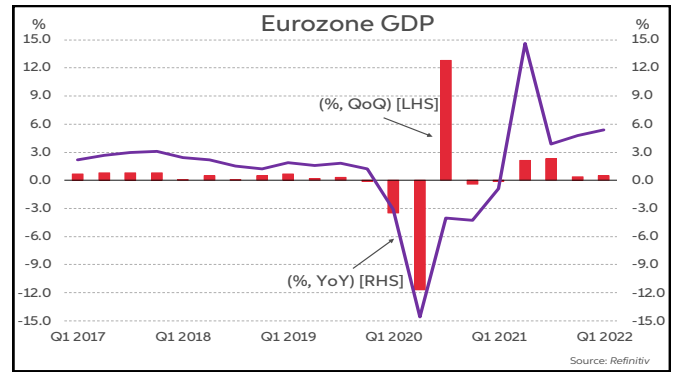
There has been a lot of volatility in terms of market rate expectations over the last number of weeks in reaction to central bank newsflow and key data releases. Futures contracts indicate that the market is currently pricing in around 125bps of rate hikes over the remaining three ECB meetings this year. There it at least 50bps priced in for the next meeting in September. The market sees the key deposit rate near to 1.25% by end year. Prior to today's meeting the market had rates being in and around 1% by year end. Further out, there is 25bps of tightening envisaged for 2023. The market is expecting that rates will peak at 1.5% by mid 2023 and remain at this level into the end of next year and through 2024. At the time of its last meeting in June, the market was eyeing rates getting up to near 2% by the end of next year.



Today's ECB meeting has been a source of volatility for markets as investors reacted to the policy announcement, the press conference as well as the details of the TPI. On the currency front, the euro initially strengthened on the back of the larger than expected 50bps rate hike. EUR/USD traded up to a high of \$1.0275, while EUR/GBP moved up from 85.2p to 85.7p. However, the lack of guidance on the pace of future rate hikes meant that these gains were short-lived. EUR/USD has struggled to hold onto the \$1.02 level, while EUR/GBP is back down changing hands in the lower half of 85-86p. On bond markets, the 10-year Italian BTP-German Bund spread which had already widened to 235bps on the back of Italian PM Draghi's resignation, widened to around 245bps following the press conference. It has since narrowed slightly as the market digests the details of the TPI.

Recession risk continues to rise, as does inflation

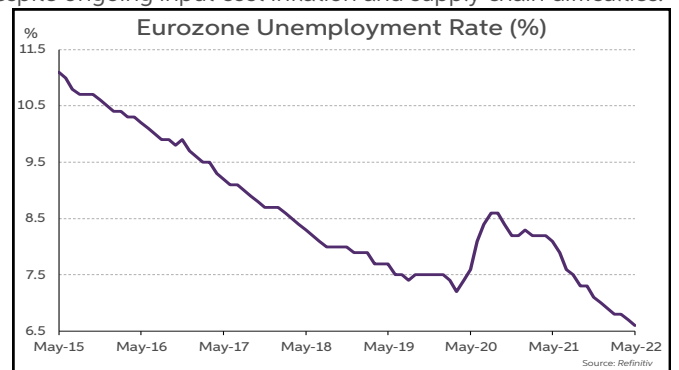
The Eurozone economy grew by 0.6% in the first quarter of 2022. However, the Q1 growth figure was boosted by a strong 6.3% rise in Irish GDP. More generally, COVID restrictions continued to impact activity over the winter months, while rising inflation weighed on spending power. The key drivers of growth in Q1 were net trade and stockbuilding. Exports and imports contributed a combined 0.4 percentage points (p.p) to the total. Inventories added a further 0.6pp to output. In contrast, domestic spending was a drag on growth. This included consumption, which contracted by 0.7% in the quarter, knocking 0.3pp from GDP.



Survey data for Q2 suggest the Eurozone economy lost some momentum in the quarter. The manufacturing PMI, averaged just 54.1 in Q2, down from an average of 57.8 in Q1, as ongoing supply constraints, increased input costs and weaker demand weighed on the sector. Indeed, the June survey recorded a fall in new orders and output for the first time since the initial wave of Covid-19 in 2020. Although, the services PMI averaged 55.6 in Q2, vs. 54.1 in Q1, this was partly due to a rebound in activity as the sector re-opened fully, following the removal of pandemic related restrictions. However, after a strong start in April, the May and June readings suggest the sector lost momentum as the quarter progressed. Meanwhile, consumer confidence, which plunged lower in March following the Russian invasion of Ukraine has deteriorated further throughout Q2, due to surging inflation. The flash reading shows that consumer sentiment fell again in July, to a new all-time low of -27.

The limited amount of available hard data for Q2 have been mixed. Retail sales rose by a meagre 0.2% in May, having declined by 1.4% in April. However, retail sales account for less than half of Eurozone consumption, and spending on services likely improved at the start of Q2 as restrictions were eased. Industrial production rose by a solid 0.5% and 0.8% in April and May, respectively, despite ongoing input cost inflation and supply chain difficulties.

In terms of inflation, headline HICP jumped to 8.6% in June from 8.1% in May, and compared to just 1.9% a year ago. Energy prices remained the main contributor to inflation, and were 42% higher year-on-year. Worryingly, inflation has become more broad based in recent months, with prices rising in all of the major categories. The ex-food & energy annual rate rose to 4.6% from 4.4% in May. The conflict in Ukraine has placed continued upward pressure on a large swathe of commodity prices, most notably, natural gas, wheat and oil. The latest ECB inflation forecasts show inflation averaging 6.8% in 2022 and 3.5% in 2023.



Meanwhile, having recovered strongly, labour market conditions appear to be quite tight. The unemployment rate which has been trending lower since the start of 2021, fell to a new record low of 6.6% in June, down from a “Covid peak” of 8.7% in mid-2020. Perhaps even more impressively, employment moved above its pre-pandemic level in Q4 2021, and rose again by 0.6% in Q1 of this year. Overall, it is estimated there are circa 1.5m more people in employment now, than before the pandemic. In contrast, both US and UK, employment levels have been slower to recover. Tight conditions are contributing to increased labour costs. Wages rose by 3.3% on an annual basis in Q1 2022, although the data remain somewhat distorted by base effects.

It is clear the Eurozone economy is now facing a very challenging period. There are signs that economic activity is already slowing, while at the same time, inflation has continued to increase by more than anticipated, in part, due to the war in Ukraine. The war will continue to weigh on economic activity both directly and indirectly, by negatively impacting trade flows, and by reducing real incomes through higher inflation. If the EU were to be cut-off from Russian gas, the risks of a recession would increase significantly. Meanwhile, monetary policy and financial conditions are tightening. The most recent ECB staff projections are for GDP to grow by 2.8% this year, slowing to 2.1% in both 2023 and 2024. Meanwhile, the latest European Commission forecasts are for growth of 2.6% this year, easing to 1.4% in 2023. We are more inclined towards the EC forecasts given the headwinds facing the economy.

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