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Special Coverage:

“A gradual but sustained hiking path” for the ECB

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Key takeaways

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- The European Central Bank admitted inflation will remain "undesirably high" in its latest economic forecasts, as it announced an end to its Asset Purchase Programme and confirmed it plans to hike rates by 25bps next month. Any subsequent hikes should be "gradual but sustained", implying the market should expect multiple 25bps moves to follow after September.
- Although the market welcomed clarity on the expected path of interest rate normalisation, it was disappointed by the lack of detail surrounding financial fragmentation. European equities also erased their gains to trade -1.3% lower on the day. All sectors traded down, with IT and real estate underperforming, whereas energy, utilities and consumer staples outperformed on a relative basis.
- We remain underweight in European equities, due to the region's greater vulnerability to the Ukraine war (energy security and growth prospects) as well as cost of living squeeze. On the fixed income side, we find select opportunities in short dated high quality credit given the extent of hikes already priced in the yield curve.

What happened?

- European headline inflation hit a new record high of 8.1% as food and energy prices continued to rise. But with core inflation reaching 3.8%, there is growing evidence that price pressures have broadened, especially as 75% of the index constituents are above the 2% price target, adding pressure on the central bank to normalise policy.
- With this context in mind, the ECB staff projections echoed recent warnings from the Organisation for Economic Cooperation and Development (OECD) and World Bank, by raising inflation forecasts and citing further upside risks on the one hand and trimming growth forecasts on the other. The inflation forecast was increased to 6.8% for 2022 and 3.5% for 2023, although it is worth noting that the OECD forecast released a few days ago for the Euro area is even more pessimistic for next year.
- With inflation more than four times above the official target and a deposit rate of -0.50% currently, the ECB announced the termination of the Asset Purchase Programme by 1st July and the end of negative rates in September. However, the ECB will still continue to reinvest maturing assets under its PEPP by 2024.
- The ECB confirmed their intention to "raise the key rate by 25 bps" in July and to hike again in September, a commitment which was signaled in a blog from President Christine Lagarde weeks earlier ago and subsequently by Chief Economist Philip Lane. The June 9th meeting clarified its expected policy stance, suggesting that a larger (50bps) move is a possibility in September, should inflation deteriorate further.

ECB's revised growth and inflation assumptions

GDP Growth	2022	2023	2024
ECB (new)	2.8	2.1	2.1
ECB (old)	3.7	2.8	1.6
OECD	2.6	1.6	n/a
World Bank	2.5	1.9	1.9

HICP Inflation	2022	2023	2024
ECB (new)	6.8	3.5	2.1
ECB (old)	5.1	2.1	1.9
OECD (June 2022)	7.0	4.6	n/a

Source: HSBC Global Private Banking and Wealth, ECB, OECD, World Bank as at 9 June 2022.

- Beyond September, the market should expect a "gradual and sustained path of further increases," suggesting several more hikes of 25bps. When questions about the level that constitutes the neutral path, Ms Lagarde mentioned this topic will be debated when we are closer to that point, however the level would be lower than historical precedents.

Market reaction

- Although the ECB affirmed its commitment to fight against the so-called "financial fragmentation" in the Eurozone, no information was provided regarding what policy tools it could use to prevent this, nor what it would take in order to intervene to stabilise the markets. The ECB tried to respond by confirming to consider "flexibility" regarding the reinvestment of proceeds relating to maturing bonds from its PEPP, the lack of further guidance disappointed the market.
- With more than 60 Central Banks around the world having already raised rates this year, the market was assigning a 50% probability the ECB would signal a 50 bps hike as early as July in order to demonstrate credibility against tackling inflation. "Fed-style" 50 bps hikes were increasingly debated, as the region's medium-term growth risks linked the Ukraine war and energy security implied that any action is desired sooner rather than later (i.e. hike rates before it becomes too late to do so).
- The futures market continues to price almost 150 bps to hikes by December, implying as many as 2 hikes of 50 bps and 2 hikes of 25 bps in the next four scheduled meetings. This means that markets are taking for granted that the ECB will conduct not one – but two larger hikes. Although a larger hike is now on the table for September, it is not assured. Even if the ECB ultimately follows such a path, the bar to pursue more than 140 bps hikes this year seems to be very high compared to ECB guidance.
- Equity markets gave back their initial gains to trade weaker on the day, with real estate and technology leading indices in Europe lower, whilst energy, consumer stapes and utilities faring better on a relative basis but still recording losses on the day. Although the removal of negative rates will support interest margins for financials, the cyclical outlook for Europe remains a headwind to near term performance.

Investment summary

- Due to its geographical proximity to Ukraine, the Eurozone is more negatively exposed to the implications of the war. The bloc was importing more than 4 million bpd (barrels per day) of crude and oil products from Russia, which it will need to replace as it seeks to enforce the 6th round of sanctions it recently legislated, which call for a progressive embargo on Russian oil. The region's greater reliance on natural gas has also exposed it to higher energy related pressures, which account for more than 50% of today's inflation rate.
- Although the labour market remains strong and accumulated savings from the pandemic provide some relief, wage growth is lagging the US and the cost of living squeeze seems larger, adding to downside risks to growth. For these reasons **we remain underweight in European equities, favouring more defensive sectors such as consumer staples on a relative basis**.
- In fixed income, we believe the rise in interest rates provides **opportunities in high quality credit with short maturities.**

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