

## Special Coverage:

# The ECB's 50bp hike and end of forward guidance

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### Key takeaways

- ◆ With European inflation at a new record of 8.6% and not yet having peaked, the European Central Bank surprised the market with a 50bp rate hike. The decision brought a swifter end to the 8-year experiment of negative rates, as the ECB effectively abandoned forward guidance, and instead turned to a “meeting by meeting,” data-dependent approach.
- ◆ The ECB held its July meeting during a challenging time. Natural gas imports remain depressed and uncertain, spurring the European Commission (EC) to recommend a 15% reduction in domestic consumption, as governments and industries plan for a scenario of more prolonged energy disruptions. The latter would create a headache for the central bank which needs to forcefully anchor inflation but at the same time proceed with caution to avoid a further worsening of the growth outlook.
- ◆ Within the Eurozone, we retain our preference for Investment Grade over High Yield, whereas in equities we have been turning more defensive, going underweight in financials and real estate which are more vulnerable to the domestic outlook. We have been reinforcing our preference for defensive sectors and upgrading our view on communication services.

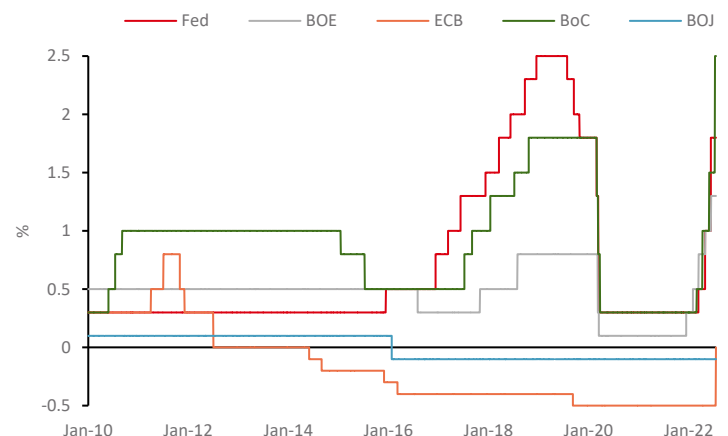


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### What happened?

- With inflation reaching another record of 8.6% for the Eurozone, but soaring as high as 20% for some Baltic nations, the ECB Governing Council voted for a larger 50bp hike, ending its negative interest rate policy after 8 years. The decision was a difficult one given that it undermined the ECB's credibility on its own forward guidance. In June, the ECB explicitly stated it “intends to raise rates by 25bp in July”, whereas it laid out several arguments that a larger, pre-emptive increment would be “excessive” and “counterproductive.”
- In order to maintain maximum flexibility in its decisions and reduce the risk of similar contradictions, the ECB stated future decisions would be data dependent, with further normalisation appropriate and decided on a meeting-by-meeting approach.
- The decision to hike by 50bp was attributed in part to the need to anchor elevated inflation expectations, and in part to the launch of a new anti-fragmentation tool called Transmission Protection Instrument (TPI). This new mechanism “can be activated to counter unwarranted, disorderly market dynamics that pose a threat to the transmission of monetary policy across the euro area” (financial fragmentation).
- The criteria for activation are rather broad and subjective and the tool is potentially unlimited in size. According to ECB President Lagarde, some aspects explaining the tool “are best kept unpublished,” with investors still having unanswered questions.

### The ECB (finally) joined the Global hiking cycle with its largest hike since 2000



Source: HSBC Global Private Banking and Wealth, Bloomberg as at 21 July 2022

- Fiscal discipline and prerequisites are conditions for its activation, but the ECB would still retain some flexibility surrounding its use. Despite the lack of full details at this point in time, the tool is certainly welcome news. But we also know from the statement that this is a backstop facility and that the first line of defense remains applying flexibility in reinvestments of the Pandemic Emergency Purchase Programme (PEPP). The latter would allow the ECB to front load purchases and target specific countries as it deems appropriate.

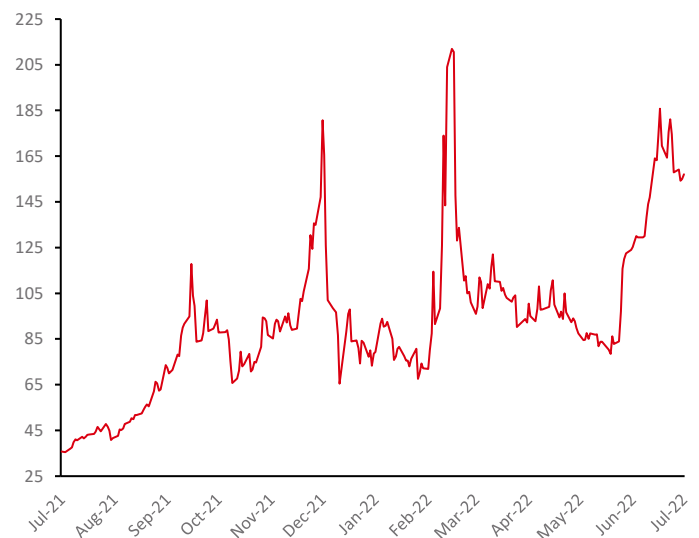
## Market reaction

- The market was pricing in a 50% chance of a 50bp hike. In equities, the Eurostoxx was little changed on the day, paring some of the initial gains. The energy sector underperformed as oil prices declined. Defensives held up well, whereas IT saw some relief from lower core yields. Although the removal of negative rates will support interest margins for financials, the cyclical outlook for Europe remains a headwind to near-term performance.
- The futures market continues to price 145bp of hikes by December, including a 70bp hike in September. The market is essentially pricing in the fact that any hiking will need to happen as quickly as possible, given that the growth outlook may become more challenging, especially as winter approaches and the risk of natural gas disruptions remains elevated. Although we agree that the ECB's hawkish move suggests more rate hikes will come, the amount of hikes priced in continue to be higher than our expectations, whereas the lack of forward guidance and "meeting by meeting" approach suggests that the evolution of data in the coming months along with the evolution of gas flows will ultimately dictate the rate trajectory from here.

## Natural gas imports remain fragile and uncertain

- The Nord Stream 1 pipeline resumed flows after a planned 10-day maintenance period which brought relief to investors, who were concerned on more imminent halt of gas flows from Russia. Prices however remain at elevated levels, as imports from Russia have only been restored to June levels, which were still drastically cut compared to prior months and represent only 40% of total Nord Stream's total capacity.
- Even if further cuts do not materialise, a prolonged period of subdued flows would still weigh heavily on the region's outlook. More than half of European inflation is explained by the rise in energy prices. With natural gas prices expected to remain elevated and volatile, inflation is likely to remain well above target even next year. EUR weakness does not help either given it makes the cost of imports more expensive.
- The EC has proposed 15% cuts in gas consumption to ensure member states are prepared for a shortage in supplies. Reliance on Russian imports remains high, and although renewables and liquefied natural gas (LNG) are a more viable longer term strategy, they cannot fully replace a complete halt of Russian flows. As such, in addition to securing more energy sources, a key proposal includes encouraging lower demand and impose rationing.
- With economic growth already expected to stagnate in the coming two quarters, natural gas flow disruptions have the potential to tip the Eurozone into recession. Energy intensive industrials may suffer more relative to other companies, whereas households would also face higher cost of living in this case.

### Natural gas prices have retracted from recent highs as Nord Stream 1 flows resumed but remain at high levels



Source: HSBC Global Private Banking and Wealth, Bloomberg as at 21 July 2022

## Investment Summary

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- The Eurozone is more negatively exposed to macro-economic risks due to its geographical proximity to Ukraine. With more than 4 million bpd of crude and oil products being imported from Russia, the bloc will need to find alternative sources, as it seeks to enforce the sixth round of sanctions 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.
- With natural gas flows remaining depressed and unpredictable, we remain underweight Eurozone equities and hold a cautious view on industrials which are energy-intensive and vulnerable to higher costs. We recently downgraded the region's **financials and real estate to underweight** – both sectors are heavily correlated to domestic developments.
- European financials have certainly cheapened, and the end of negative rates is certainly welcome. But on the other hand, we seek to reduce cyclicality in our portfolios. Lower M&A activity, slowing demand for loans and lower business confidence remain headwinds. The regulator has signalled it may wish to restrict banks from returning cash to shareholders, whereas gains made from cheap TLTROs (targeted longer-term refinancing operations, i.e. financing to credit institutions) may also be scrutinised as rates increase.
- On the other hand, we reiterate our **preference for defensive sectors such as consumer staples**, and have increased our allocation to **communication services** which remain under-owned despite their relative outperformance to the rest of the European market.
- In fixed income, we reiterate a **neutral view on European high yield**, which has seen spreads underperform on the back of growth concerns and repeat our **overweight on high quality, short dated bonds** instead.

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