

## The ECB Pivots its Focus

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The European Central Bank's (ECB) latest policy announcement represents a dovish tilt. We expect its focus to shift from hiking rates to managing its balance sheet and project a near-term peak in the ECB's deposit facility rate of 2.0% in December 2022. Thereafter, we expect the ECB to pause its rate hikes and pivot to ensuring that tighter financial conditions transmit to the real economy and that market functioning improves.

### A Dovish Tilt

As investors expected, the ECB raised its key policy rates by 75 basis points (bps) today. Alongside that increase, the central bank announced technical changes to finetune its targeted longer-term refinancing operations (TLTROs) as well as the rate at which it remunerates the minimum reserves that private-sector banks hold with it.

The four following themes emerged from the latest package of policy measures:

1. Front-loaded rate hikes may be at a near-term peak. ECB President Lagarde stressed that there was "still ground to cover" for further increases, but the bank has made substantial progress towards normalisation. Going into this winter, the Eurozone's energy situation is uncertain. A near-term pause in raising rates would allow the impact of existing rate hikes to work their way through the real economy. That would offer the ECB breathing space to assess whether additional rate increases may be warranted in future.
2. The ECB pivoted its attention from rate hikes towards ensuring that tighter financial conditions transmit to the real economy. It intends to finetune its targeted lending operations (TLTROs) to ensure that lending conditions in the real economy reflect tighter monetary policy, much in the same way that it finetuned looser conditions during the pandemic to support lending.
3. The recent UK experience offered lessons to European policymakers. One lesson, in particular, was that fiscal policy should not run counter to monetary policy. The bank's monetary policy is becoming more restrictive to reduce demand and bring inflation back to target. But inflation remains too high, and any fiscal intervention should, therefore, be "temporary, targeted and tailored." Governments' fiscal policies should not be expansionary as this would require an even more forceful monetary response.
4. Finally, the ECB has its eye on market functioning. Taken together, the technical changes announced should widen the pool of eligible collateral and ease some dislocations. Similarly, President Lagarde confirmed that the Governing Council would discuss principles around reducing the size its balance sheet. If managed in an orderly fashion, this too could improve market functioning.

The bottom line is: we now expect rates to rise by 50 bps at the ECB's December meeting, taking the deposit facility rate to 2.0%, before pausing through the winter period. Thereafter, we see the deposit facility rate peak at less than 3%. However, if inflation continues to surprise on the upside, particularly if nominal wages or inflation expectations inch above levels consistent with the ECB's 2% inflation target, then such a dovish pivot could prove premature. In that case, we would expect sequential rate hikes to continue, with rates peaking above 3%.

### Bull Yield Curve Steepening, Higher Inflation Expectations, Risk Assets Up

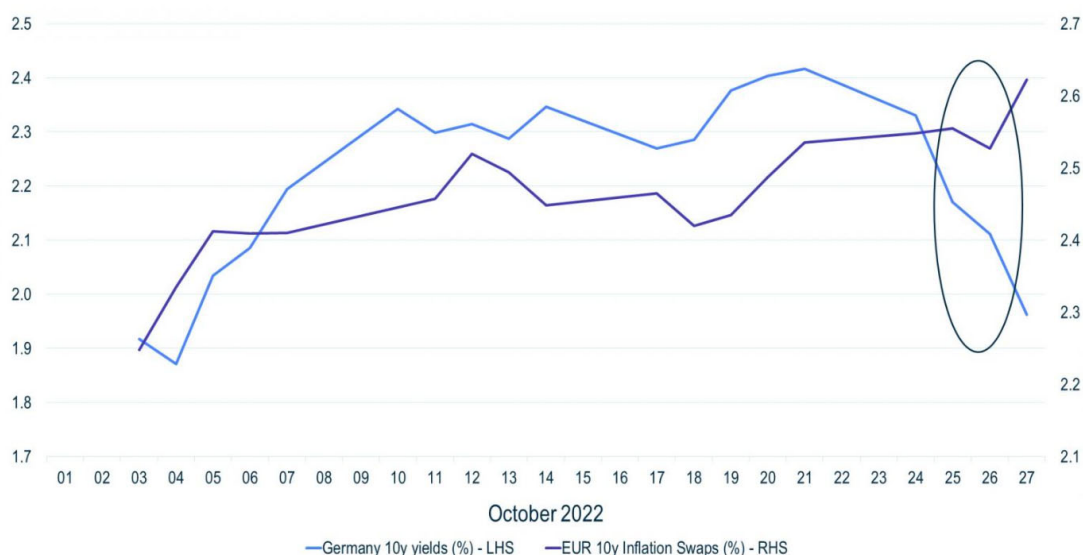
Investors largely expected that the ECB would hike policy rates by 75 bps, but the market reaction so far is consistent with a dovish tilt. President Lagarde sounded much less committed to continue to aggressively tighten monetary policy. Instead,

she sounded more cautious about the proper functioning of markets and the transmission of monetary policy to the real economy.

German government bond yields reversed drastically today. Short-dated yields were 15 bps lower at the time of writing, and yields beyond 10-year maturities were down by less than 10 bps. Such bull steepening is consistent with the ECB taking its foot off the brake. As one would expect, market-implied inflation expectations rose, given this less hawkish approach (Figure 1). The euro also weakened relative to the U.S. dollar as the interest rate differential shifted in favour of the latter.

The ECB's dovish tilt gave risk assets a bullish tailwind. Peripheral government bond spreads and corporate credit spreads were tighter on the day, at the time of writing. Italy's 10-year government bond spreads versus Germany's were close to 10 bps tighter for the day, while prices of five-year credit default swaps (CDS) on Euro high-yield corporate bonds (the iTraxx Xover index) were also around 10 bps lower. Major Eurozone equity indices were somewhat higher, but that rally was more evident in interest-sensitive sectors, such as real estate investment trusts (REITs).

**FIGURE 1: Lower German bond yields and higher market-implied inflation expectations suggest that investors saw the ECB meeting as a dovish tilt**



Source: Bloomberg.

## Conclusion

Similar to recent communications from Federal Reserve officials, the ECB appears to be taking a more moderate approach to policy tightening, despite uncertainty about inflation. Taking its foot off the brake is supportive of risk assets. Given investors' generally bearish positioning and what some saw as excessive pessimism over Europe, this rally may persist. But all is conditional on inflation easing, on the economic fallout being limited, and on market functioning being restored. Investors shouldn't forget that none of these are a given.

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Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of October 27, 2022

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