

Asset Management

ECB's last hike?

Investment event | 15 September 2023



ECB makes it 10 hikes in a row

The European Central Bank (ECB) increased policy interest rates by 25 basis points (bps) at its September meeting. The deposit rate was adjusted to 4.00%, while the main refinancing rate and the marginal lending facility rose to 4.50% and 4.75%, respectively. The decision came with markets and economists split between no hike and 25bps prior to the meet.

Motivating the rate hike was inflation that is expected to “remain too high for too long”. Indeed, the Governing Council upgraded their forecasts for inflation in 2024, to 3.2% from 3.0% in June on the back of higher energy prices.

How long rather than how high

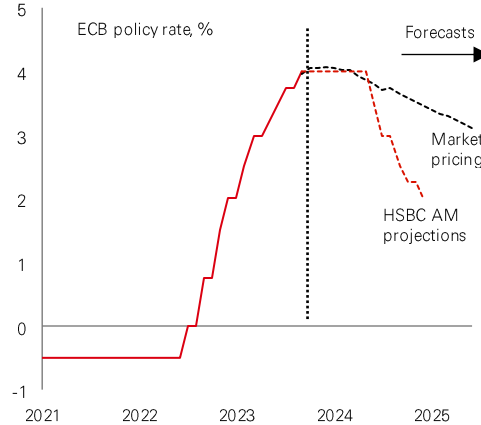
Despite the move, the Governing Council considers that “interest rates have reached levels” that should make a “substantial contribution to the timely return of inflation to target”. This is a significant change in language from their last meeting, and now shifts the question to how long rates will stay high, instead of how high rates go.

The ECB also published fresh forecasts along with the decision. On the growth front, they made significant downwards revisions. They now expect the economy to grow by 1.0% in 2024, down from 1.6% in June. They see this as being important in cooling an overheating economy, and thus inflation over their forecast horizon. This was indicated by their 2025 inflation forecast being revised down to 2.1% from 2.2%.

At the press conference, President Lagarde gave little away on how long rates could stay high and reiterated that she cannot confirm whether the ECB has reached its peak.

In response to the meeting, interest rate swap pricing was little changed with markets still expecting that 4.00% would be the peak in interest rates (Figure 1).

Figure 1: ECB policy rate expectations. %



Source: Bloomberg, HSBC AM (14 September 2023)

The ECB increased the deposit rate by 25bps to 4.00% at its September meeting

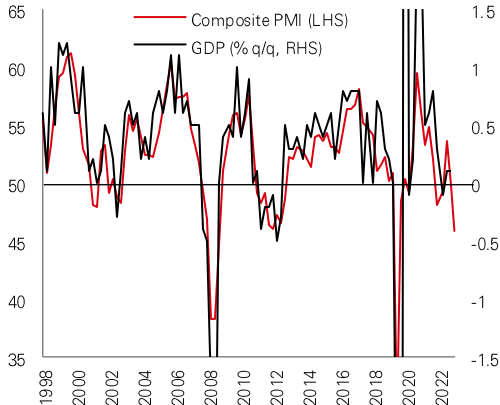
The ECB largely indicated that rates are likely at their peak with the focus switching to how long rates stay restrictive

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

Figure 2: Composite PMI v GDP



Source: Macrobond, HSBC AM (7 September 2023)

Our take

The decision today was on a knife-edge, with comments from members prior to the meet indicating the hike was not unanimous.

We think there is a very good chance this is the last rate hike by the ECB. Policy is now at highly restrictive levels and a host of economic indicators have weakened materially, which will ultimately bring down inflation over the medium-term.

Of note, GDP growth has stalled in the last three quarters, the S&P Global Purchasing Manager Indices (PMIs) now indicates the economy is in contraction (Figure 2), with the ECB's Bank Lending Survey (BLS) and money growth data are at levels not seen outside of recessionary periods.

We agree with the ECB that growth is

going to be weaker than previously expected. However, we disagree with its view that following some near-term weakness in H2 of 2023, the economy can recover to a more favourable rate of growth through 2024. This pickup they attribute to real incomes being boosted by higher real wage growth.

Instead, we believe the ECB and other economists underestimate the full impact that the historically fast hiking cycle will have on the economy. Our house view is that the Eurozone experiences a policy-induced recession, starting in H1 2024, although with a risk of an earlier material weakening of the economy, as indicated by the PMIs. Critically, we see more weakness in the labour market next year.

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Investment Implications

For us, the ECB's decision today leads us to the view that its interest rate hiking cycle has ended. Given an elevated probability of recession relative to ECB's more optimistic growth outlook, there is also scope for a more significant easing of policy in 2024 versus market expectations.

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 H1-2024 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 is now clearly 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 are broadly positive on EM asset classes given tailwinds from relatively favourable valuations, cautious investor positioning, more resilient growth, and lower EM inflation. EM equities have shown they can perform well after the Fed has concluded its hiking cycle. There is also a case for a structural decline in the US dollar which typically benefits EM asset classes.

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