PREVIEW: ECB Policy Announcement due Thursday 2nd February 2023

- **ECB policy announcement due Thursday 2nd February; rate decision at 13:15GMT/08:15EST, press conference from 13:45GMT/08:45EST**
- **Consensus and market pricing look for a 50bps hike, taking the deposit rate to 2.5%**
- **President Lagarde will likely reaffirm the Bank's hiking intentions beyond the February meeting**

OVERVIEW: Consensus and market pricing looks for a 50bps hike in the deposit rate to 2.5%; this would take the deposit rate into slightly restrictive territory. The December meeting saw President Lagarde state that "based on the information that we have available today, that predicates another 50-basis-point rate hike at our next meeting, and possibly at the one after that, and possibly thereafter". This statement saw consensus coalesce around the idea of a 50bps hike for the upcoming meeting and comms from ECB officials have done nothing to lead markets away from this view. That said, some confusion around the rate hiking cycle was observed after a Bloomberg report suggested that policymakers are reportedly beginning to consider just a 25bp hike in March. Nonetheless, commentary from policymakers has done little to suggest that the GC is considering such a step down at this stage and has leaned against such reporting. With regards to the balance sheet, the prior meeting saw the GC announce that from the beginning of March 2023 onwards, the APP portfolio will decline at an average pace of EUR 15bln per month until the end of Q2 with its subsequent pace to be determined over time. For the upcoming meeting, further technical details on the programme are set to be announced.

PRIOR MEETING: As expected, the ECB stepped back from its 75bps cadence of rate hikes and opted to raise its key three rates by 50bps a piece. Furthermore, the Governing Council judged that "interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive". On the balance sheet, from the beginning of March 2023 onwards, the APP portfolio will decline at an average pace of EUR 15bln per month until the end of Q2 with its subsequent pace to be determined over time. The accompanying macro projections saw 2022 HICP upgraded to 8.4% from 8.1%, 2023 raised to 6.3% from 5.5%, with 2024 and 2025 seen at 3.4% and 2.3% respectively. At the follow-up press conference, Lagarde noted that info predicated a 50bps hike at the next meeting, "possibly the next one as well and possibly thereafter". Note, sources showed that over a third of ECB policymakers wanted to opt for a larger 75bps hike.

RECENT ECONOMIC DEVELOPMENTS: Headline Y/Y HICP for the Eurozone fell to 8.5% in January from 9.2%, however, core (ex-food and energy) rose to 7% from 6.9% and super-core remained at 5.2%. In terms of market gauges of inflation, the carefully-watched 5y5y forward is currently at around 2.31% vs. circa 2.32% at the time of the December meeting. On the growth front, Q4 GDP printed at +0.1% vs. the market consensus of -0.1% and therefore just managed to avoid a contraction, however, tepid growth of 0.1% is suggestive of stagflation in the Eurozone. More timely PMI data for January showed an increase in both the manufacturing and services components with the latter rising into expansionary territory, and lifting the composite metric to 50.2 vs. prev. 49.3. The accompanying report from S&P Global stated "a steadying of the eurozone economy at the start of the year adds to evidence that the region might escape recession". In the labour market, the unemployment rate in November held steady at 6.5%, whilst wages continue to rise, but are yet to show signs of a spiral. In terms of market proxies for the Eurozone, the IT/GE 10yr spread is currently around 195bps vs. the 265bps peak seen in September last year.

RECENT COMMUNICATIONS: Since the prior meeting, President Lagarde (19th Jan) has stated that the economic news has become much more positive, however, the ECB "will stay the course with rate hikes". In a later speech, Lagarde noted that "rates will still have to rise significantly at a steady pace". Chief Economist Lane (17th Jan) stated in an interview with the FT that rates need to be brought into restrictive territory and are currently "ballpark" neutral. The influential Schnabel of Germany (10th Jan) remarked "Preliminary inflation data for December point to a persistent build-up of underlying price pressures even as energy price inflation has started to subside from uncomfortably high levels". Villeroy of France (18th Jan) remarked that guidance from President Lagarde, that rates will continue to rise in 50bps increments remains valid, later adding (24th Jan) that the Bank will likely reach peak rates by summer. At the hawkish end of the spectrum on the GC, Austria's Holzmann (20th Jan) stated that he expects multiple 50bps hikes, at least in the first half of 2023, adding that there could be rate hikes if headline inflation has fallen significantly, but core inflation has not. From a more dovish perspective, Greece's Stournaras (23rd Jan) stated that rate hikes should be more gradual. Italy's Panetta (24th Jan) remarked "we strive to be predictable, but the current situation does not require us to commit to a specific rate path for too long or without reference to the data".

RATES: 55/59 surveyed analysts look for a 50bps hike in the deposit rate to 2.5% with market pricing assigning a circa 83% chance of such an outcome; this would take the deposit rate into slightly restrictive territory. The December meeting saw President Lagarde state "based on the information that we have available today, that predicates another 50-basis-point rate hike at our next meeting, and possibly at the one after that, and possibly thereafter". This statement saw consensus coalesce around the idea of a 50bps hike for the upcoming meeting and comms from ECB officials have done nothing to lead markets away from this view. That said, some confusion around the rate hiking cycle was observed after a Bloomberg report suggested that policymakers are reportedly beginning to consider just a 25bp hike in March. Nonetheless, commentary from policymakers (see Villeroy above) has done little to suggest that the GC is considering such a step down at this stage. If the Governing Council was to opt for a tweak to its guidance to signal a potential step down in the pace of hikes, it could remove the word "significantly" from the following sentence "rates will still have to rise significantly at a steady pace". However, this view is not a base case. In terms of market pricing, a 50bps increase in March is priced at around 80% with another 25bps expected to come thereafter in May; what happens beyond May is subject to divided opinion.

BALANCE SHEET: The prior meeting saw the GC announce that from the beginning of March 2023 onwards, the APP portfolio will decline at an average pace of EUR 15bln per month until the end of Q2 with its subsequent pace to be determined over time. For the upcoming meeting, further details on the programme are set to be announced, on which, Morgan Stanley expects "more details on how the decline in reinvestments will be distributed between the different APP programmes, as well as jurisdictions (most likely to be done proportionally in line with the capital key)". MS adds that a detailed announcement of the entire expected QT path is less likely, with guidance to be kept "general". SocGen has offered a deeper dive on the PSPP in which it stated that around EUR 25-29bln of OATs and EUR 21-24bln of BTPs may not be reinvested if the ECB follows capital keys. SocGen adds that "although this is a relatively small volume compared to the annual net supply...it would be an additional amount to absorb and so is likely to put some pressure on country spreads".

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