

The ECB joins the hawkish central bank club

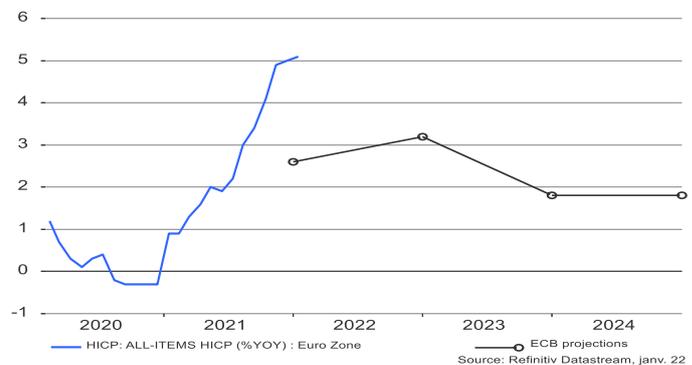


Summary

- The statement of the ECB meeting did not contain any major surprises, but the hawkish tone of President Lagarde surprised the market. Rates surged as a direct result.
- We think that Lagarde did not want to commit to future rate hikes to keep her options open, as inflation is high and very uncertain. Inflation is expected to fall over the year but remain elevated.
- We now expect the ECB to reduce its asset purchases earlier than expected, which will pave the way for a first rate hike, +25bp on the deposit rate, in December, when there should be evidence that wages have started to rise. We expect three rate hikes in 2023. Thus, at the end of 2023, the deposit rate should reach 0.50% and the main refinancing rate 0.75%.

EUROZONE INFLATION AND ECB PROJECTIONS

ECB projections as at December 2021



Source: BNP Paribas Wealth Management

Hawkish ECB

The ECB has changed its view on inflation by recognising that it is likely to remain high for longer than expected. The risk in the short term is that price pressures will result in higher-than-expected wage increases, or that the economy will return to full capacity more quickly. However, the ECB continues to expect inflation to fall over the course of this year.

The ECB forecasts a robust outlook for the labour market. It mentioned record low unemployment and labour force participation being back at pre-Covid levels, and strongly implied that this would lead to stronger wage pressures, resulting in medium-term inflation in line with the target.

Edouard Desbonnets

Senior Investment Advisor, Fixed Income
BNP Paribas Wealth Management



Flexibility and optionality

President Lagarde had several opportunities during the press conference to push back against a rate hike in 2022, but this time she did not do so. The market has taken this change in rhetoric as a green light for a rate hike this year and is already forecasting a 10 basis point increase in the deposit rate by June. This seems far too early in our view.

We think that Lagarde did not want to commit herself because she stressed that the inflation outlook was very uncertain. Half of the inflation is due to energy prices, and these are volatile by nature and the ECB cannot do anything about it.

In essence, the ECB wants to keep its options open and a hawkish tone helps to keep inflation expectations anchored, i.e. higher inflation in the short term does not directly translate into higher inflation in the long term.

The sequencing holds

Lagarde said that rate hikes were not imminent and that the sequencing remains in place: no rate hikes until the end of net asset purchases.

The ECB committed to a higher amount of asset purchases with the conventional asset purchase programme (APP) at the last meeting in December 2021, to compensate for the end of the pandemic asset purchase programme (PEPP) in March. The APP was increased to €40bn per month of asset purchases in Q2, €30bn per month in Q3 and €20bn thereafter.

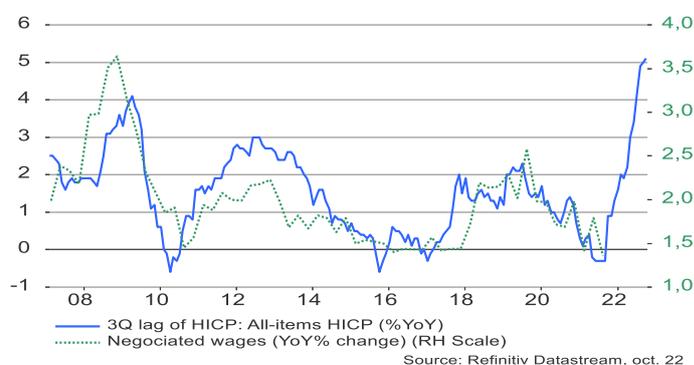
Strong revisions to inflation projections in March?

We expect the ECB to revise up its inflation forecasts in March, which would lead to the decision to reduce the amounts of asset purchases and end the programme sooner than expected, allowing for earlier than expected rate hikes.

We believe that the dovish members of the Monetary Policy Committee will need to be reassured about the durability of inflation before they agree to raise policy rates. They will need to have a clearer view of wage developments and this will only be visible in the data at the end of the year. Indeed, wage negotiations take place at the end of the year in Germany. Moreover, negotiated wages react to inflation with a time lag of three quarters. Thus, the high inflation in January should not be reflected in negotiated wages until the fourth quarter.

NEGOTIATED WAGES AND INFLATION IN THE EUROZONE

Negotiated wages react to realised inflation with a lag of around three quarters



Source: BNP Paribas Wealth Management

We expect another rate hike in March 2023, bringing the deposit rate to 0% and the main refinancing rate to +0.25%. Then, two more rate hikes in the same year should take the deposit rate to +0.50% and the main refinancing rate to +0.75% by the end of 2023.

Bond yields

We are raising our bond yield target from -0.50% to 0% for the German 2-year yield and from 0% to 0.25% for the 10-year yield.

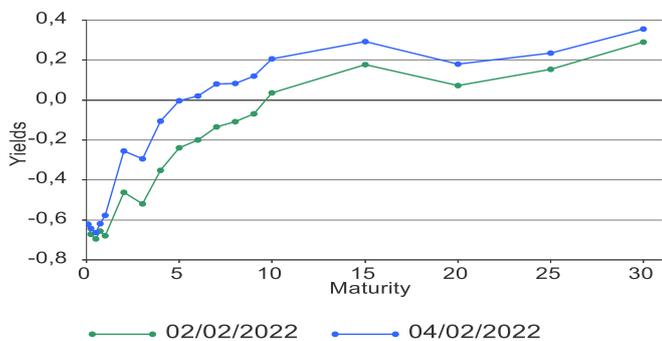
A temporary overshoot is quite possible given the uncertainty surrounding the inflation outlook. While short-term yields are directly affected by expectations of ECB policy rates, long-term yields will be affected in particular by the diminution of ECB support. Long-term yields will remain historically low given a) the stock of bonds accumulated by the ECB, which will continue to reinvest maturing bonds until probably the end of 2024, and b) the extremely low free float of German government bonds. According to the IMF, foreign private non-bank investors, i.e. investors who can sell bonds and drive up yields, held about €16 billion of German government bonds in mid-2021, or about 1% of bonds in circulation.



The challenge for the ECB will be to keep intra-EMU yield spreads tight in a rising yield environment.

THE GERMAN YIELD CURVE BEFORE AND AFTER THE ECB MEETING

Bond yields surge after the ECB meeting



Source: Refinitiv Datastream

Source: BNP Paribas Wealth Management

THE INVESTMENT STRATEGY TEAM

FRANCE

Edmund SHING

Global Chief Investment Officer

ASIA

Prashant BHAYANI

Chief Investment Officer

Grace TAM

Chief Investment Advisor

BELGIUM

Philippe GIJSELS

Chief Investment Advisor

Alain GERARD

Senior Investment Advisor, Equities

Xavier TIMMERMANS

Senior Investment Strategy, PRB

LUXEMBOURG

Guy ERTZ

Chief Investment Advisor

Edouard DESBONNETS

Senior Investment Advisor, Fixed Income

CONNECT WITH US



[wealthmanagement.bnpparibas](https://www.wealthmanagement.bnpparibas)

DISCLAIMER

This marketing document is communicated by the Wealth Management Métier of BNP Paribas, a French Société Anonyme, Head Office 16 boulevard des Italiens, 75009 Paris, France, registered under number 662 042 449 RCS Paris, registered in France as a bank with the French Autorité de Contrôle Prudentiel et de résolution (ACPR) and regulated by the French Autorité des Marchés Financiers (AMF). As marketing material, it has not been prepared in accordance with legal and regulatory requirements aimed at ensuring the independence of investment research and is not subject to any prohibition on dealing ahead of its dissemination. It has not been submitted to the AMF or any other market authority.

This document is confidential and intended solely for the use of BNP Paribas SA, BNP Paribas Wealth Management SA or their affiliates ("BNP Paribas") and the persons to whom this document has been delivered. It may not be distributed, published, reproduced or disclosed by any recipient to any other person, nor may it be quoted or referred to in any document, without the prior consent of BNP Paribas.

This document is provided solely for information and shall not constitute an offer or solicitation in any state or jurisdiction in which such an offer or solicitation is not authorized, or to any person to whom it is unlawful to make such offer, solicitation or sale. It is not, and under no circumstances is it to be construed as, a prospectus.

Although the information provided herein may have been obtained from published or unpublished sources considered to be reliable and while all reasonable care has been taken in the preparation of this document, BNP Paribas does not make any representation or warranty, express or implied, as to its accuracy or completeness and does not accept responsibility for any inaccuracy, error or omission. BNP Paribas gives no warranty, guarantee or representation as to the expected or projected success, profitability, return, performance, result, effect, consequence or benefit (either legal, regulatory, tax, financial, accounting or otherwise) of any product or transaction. Investors should not place undue reliance on any theoretical historical information regarding such theoretical historical performance. This document may contain or refer to past performance; past performance is no guarantee for future performance.

The information contained in this document has been drafted without prior knowledge of your personal circumstances, including your financial position, risk profile and investment objectives.

Prior to entering into a transaction each investor should fully understand the financial risks, including any market risk associated with the issuer, the merits and the suitability of investing in any product and consult with his or her own legal, tax, financial and accounting advisors before making his or her investment. Investors should be in a position to fully understand the features of the transaction and, in the absence of any provision to the contrary, be financially able to bear a loss of their investment and willing to accept such risk. Investors should always keep in mind that the value of investments and any income from them may go down as well as up and that past performance should not be seen as an indication of future performance. Any investment in a product described herein is subject to the prior reading and understanding of the legal documentation concerning the product, and in particular the one which describes in details the rights and obligations of investors as well as the risks inherent to an investment in the product. Save as otherwise expressly agreed in writing, BNP Paribas is not acting as financial adviser or fiduciary of the investor in any transaction. The information, opinions and projections expressed herein reflect the opinion of their author at the time of writing; they are not to be relied upon as authoritative or taken in substitution for the exercise of judgment by anyone, and are subject to change without notice. Neither BNP Paribas nor any BNP Paribas Group entity accepts any liability whatsoever for any consequences that may arise from the use of information, opinions or projections contained herein.

As distributor of the products described herein, BNP Paribas may receive distribution fees on which you can obtain more information upon specific request. BNP Paribas, their employees or administrators may hold positions in these products or have dealings with their issuers.

By accepting this document, you agree to be bound by the foregoing limitations.

© BNP Paribas 2021. All rights reserved.

Pictures from Getty Images.



BNP PARIBAS
WEALTH MANAGEMENT

The bank
for a changing
world