

Another 50bps ECB hike, with a similar move signalled for March

The February meeting of the ECB's Governing Council saw the central bank raise rates by 50bps. This follows a similar sized move in December, which came after two consecutive 75bps hikes in interest rates in the autumn and the initial 50bps move in July. It brings the total amount of tightening to 300bps, with the key deposit rate being raised from -0.5% to 2.5%. The move was in line with markets expectations as it had been well signalled by the ECB since December.

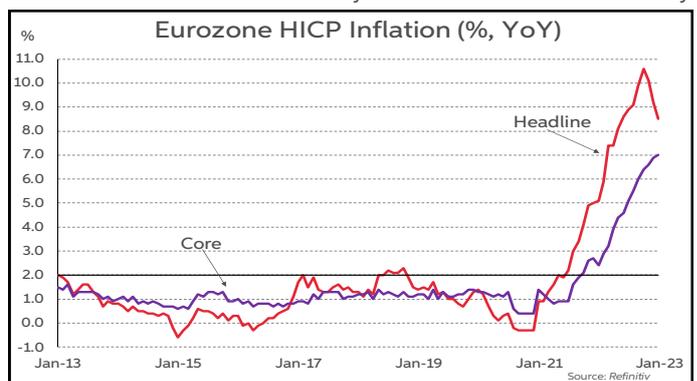
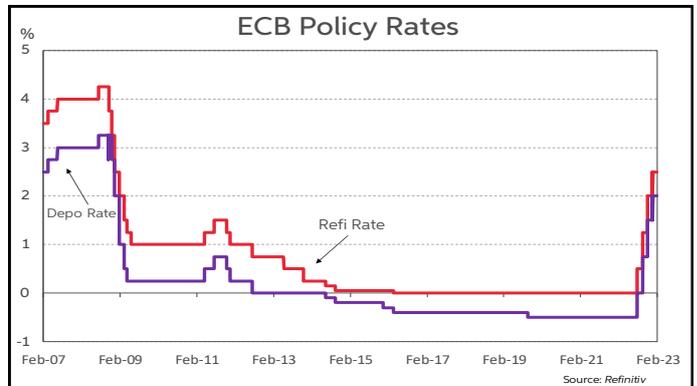
The ECB is not done yet. It indicated today that it intends to hike rates by another 50bps in March, after which it will then evaluate the subsequent path of its monetary policy. We expect to see some further rate tightening in the second quarter, possibly in the shape of one or two 25bps increases. This would be in line with futures contracts, which see rates peaking at circa 3.25-3.5% by the middle of the year. In a clear signal in this regard, the Governing Council indicated that it will stay the course in raising interest rates significantly at a steady pace to bring them to levels that are sufficiently restrictive to ensure a timely return of inflation to the 2% medium-term target.

The ECB noted that price pressures remain strong and are becoming more broad based across the economy. The headline HICP rate has declined recently, falling from 10.6% in October to 8.5% by January, reflecting lower energy prices. However, the core rate that excludes energy and unprocessed food, has continued to accelerate, reaching 7% in January. Meanwhile, a narrower core measure, excluding all food as well as energy, alcohol and tobacco, has stabilised at 5.2% in the past couple of months.

The continuing upward pressures on underlying inflation was the key factor in the signal of the ECB's intention to hike rates by 50bps again in March. It was the focus of much ECB commentary today and the trend in core inflation is likely to remain a key factor in the ECB's policy decisions in regard to interest rates during the second quarter of the year.

The ECB's latest inflation forecasts were contained in its December's macro economic projections. These show that it sees inflation averaging 6.3% in 2023, 3.4% in 2024 and 2.3% in 2025. There are downside risks to the 2023 forecast given the sharp fall in energy prices over the winter, but the ECB did not comment on this today. However, it did acknowledge that the Eurozone economy has proved more resilient than expected and should recover over the coming quarters. This suggest that the Eurozone should avoid the short, shallow recession that was previously anticipated by the ECB. GDP growth was seen expanding by a weak 0.5% in 2023 in the ECB's December macro projections, but there are now upside risks to this forecast. The ECB sees the economy picking up considerable momentum in 2024-25, forecasting growth of circa 1.9% in both years.

Given the prospect of sharply falling headline inflation in 2023, markets see the ECB moving to an easing path by end year, with close to a 25bps cut anticipated by December. Futures contracts are pricing in a further 75bps in rate cuts in 2024, taking rates down to around 2.5%. However, the ECB has commented that keeping interest rates at sufficiently restrictive levels will, over time, reduce inflation by dampening demand and also guard against the risk of a persistent upward shift in inflationary expectations. This a nod not to expect any early reversal of policy.



ECB Macroeconomic Forecasts for the Euro Area				
(%)	2022	2023	2024	2025
HICP	8.4	6.3	3.4	2.3
Real GDP	3.4	0.5	1.9	1.8

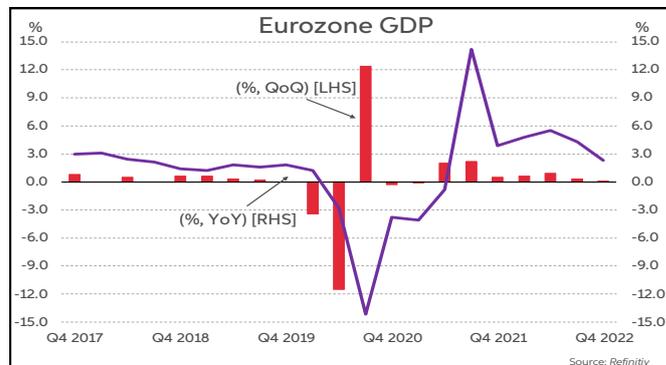
Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average \$104.6 in 2022, \$86.4 in 2023, \$79.7 in 2024 and \$76.0 in 2025
Source: ECB December 2022

The market was a bit volatile after the ECB meeting. Overall, rates are somewhat softer, with no clear guidance there will be further rate hikes in Q2 taken as a sign that we are close to the peak. Core inflation, though, is now moving centre stage.

Sluggish Eurozone growth likely in 2023

The Eurozone economy lost considerable momentum in the second half of 2022. Preliminary data show GDP grew by just 0.1% in the three months to December, having increased by 0.3% in Q3. However, the Q4 figure was boosted by a 3.5% rise in Irish GDP, which was likely driven in large part by multinational activity. Without it, Eurozone GDP would have stagnated in Q4, suggesting underlying activity weakened significantly. Indeed, the German statistics office specifically mentioned domestic demand as being a drag on GDP in Q4, while French and Spanish measures of household consumption both contracted. Overall, the Eurozone economy grew by 3.5% last year, down from 5.5% in 2021.

However, the pace of growth varied among the large Eurozone economies. In Germany, the economy contracted by 0.2% in the final quarter of 2022. Similarly, Italian GDP fell by 0.1%. In contrast, France (+0.1%) and Spain (+0.2%) recorded positive growth rates at the end of 2022. Overall, the heavily energy reliant and more export orientated German economy expanded by just 1.9% last year, much more slowly than, its French (+2.8%), Italian (+3.9%) and Spanish (+5.4%) counterparts.

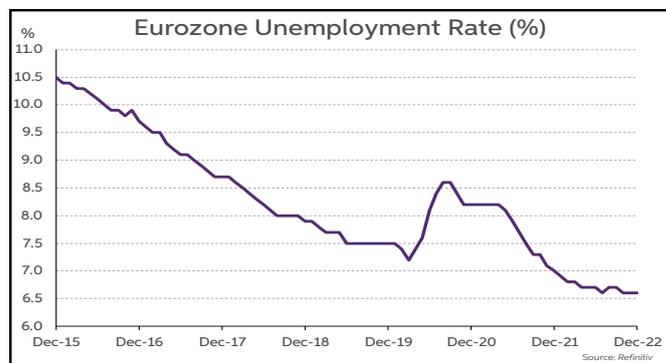


The limited amount of available survey data for January, suggest the Eurozone economy may have regained some steam at the start of this year. The services PMI moved into expansion territory for the first time since July, rising to 50.7 in January, from 49.8 in December. Meanwhile, the manufacturing index remained below 50 in January, but improved to 48.8, its highest level since August. Elsewhere, the EC sentiment indices all registered modest improvements in the month. Meanwhile, consumer confidence has been on an upward trend since September, albeit it remained at a subdued level of -20.9 in January. Nevertheless, the data are consistent with an improvement in economic conditions at the start of 2023.

In terms of inflation, headline HICP hit a peak of 10.6% in October, before easing to 9.2% in December, and to 8.5% in January. The fall in headline HICP largely reflects a sharp decline in energy prices. However, inflation has become broad based, with services price inflation hovering above 4% in recent month. Meanwhile, the annual rate of inflation for food, alcohol and tobacco accelerated to 14.1% in January, while the core rate that excludes these three components as well as energy, remained unchanged at 5.2%. The latest ECB projections from December, show headline inflation averaging 6.3% this year, and 3.4% in 2024, much higher than in its previous forecasts.

At the same time, labour market conditions remain very tight. The Eurozone unemployment rate edged lower throughout last year, falling to an all-time low of 6.6% in October, before remaining at that level during the fourth quarter. Meanwhile, employment moved above its pre-pandemic level in Q4 2021, and has continued to rise this year. It was up by 0.3% in Q3 for a year-on-year gain of 1.6%. Overall, it is estimated there are three million more people in employment now, than before the pandemic. Tight conditions are contributing to increased labour costs. The latest official data which are for Q3, shows that wages rose by 2.1% on an annual basis in the quarter, although the data remain somewhat distorted by base effects. A more timely measure of wage growth inflation for some of the large Eurozone economies, based on job postings data, indicate that wages have risen by 4.8% y/y in December, down from a peak of 5.5% in September.

Overall, the Eurozone economy proved to be more resilient than first feared in 2022. Growth slowed considerably, but the economy avoided contraction. Furthermore, the labour market remains strong, and there are tentative signs the economy regained some momentum at the start of 2023, helped by a fall in wholesale energy prices and supportive fiscal policy. However, the war in Ukraine will continue to weigh on economic activity, both directly and indirectly. Monetary policy and financial conditions are set to be tightened considerably further also.



Looking ahead, the Eurozone may face a significant challenge re-filling its gas storage facilities without Russian imports before next winter. It is likely that activity will remain sluggish in the first half of the year, but pick up some momentum in H2 as inflation falls back. **The IMF is forecasting Eurozone growth of 0.7% in 2023 and 1.4% in 2024.**

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