

# ECB July Meeting Reaction: 'Dovish hike' sends euro lower

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## 'Dovish hike' sends euro lower

The European Central Bank struck a dovish tone following its July policy meeting, unexpectedly hinting that this month's rate hike could be the last in the current cycle.

As was widely anticipated, and fully priced in by financial markets, the ECB raised rates by another 25 basis points on Thursday, the ninth straight hike. Also as expected, the bank removed its pre-commitment to additional hikes, indicating that it would adopt a data dependent approach. The guidance on policy was tweaked, however, with the bank saying that rates would be 'set at', rather than 'brought to', sufficiently restrictive levels, as had been indicated in June. This triggered an immediate knee-jerk sell-off in the euro before President Lagarde had even approached the lectern to carry out her press conference.

During the presser, Lagarde continued to talk up risks to inflation, noting that long-term inflation indicators were elevated, and needed to be monitored closely. In line with the June meeting, the Governing Council stressed that inflation had remained 'too high for too long', although policymakers appear increasingly concerned about the Euro Area growth outlook. In her press conference, Lagarde delivered a rather downbeat assessment of the bloc's economy. She noted that the near-term outlook had deteriorated, primarily due to weaker domestic demand, as high inflation and a tightening in financial conditions transmit throughout the economy.

This increased concern and emphasis on growth appears to be behind the dovish shift in the bank's rhetoric. Lagarde didn't explicitly close the door to additional rate hikes, noting that there was a 'possibility' of either another rate increase or a pause at the September meeting, and that the bank was 'open minded'. When explicitly asked, she did, however, voice a lack of confidence that more ground needed to be covered saying that the bank had started to see transmission of policy to the economy. Investors appeared to latch onto these dovish remarks, and swaps were pricing in little more than a one-in-three chance of a 25bp September hike in the immediate aftermath of the ECB's press conference.

The euro reacted in an aggressive manner, as the bank appeared to lay the groundwork for an end to tightening and investors lowered their expectations for the terminal ECB rate. EUR/USD ended Lagarde's press conference more than 1% lower, erasing its gains following Wednesday's FOMC announcement and sliding to its lowest level in around two weeks. While this was partly due to the ECB's dovishness, strong second quarter GDP data out of the US (2.4% annualised vs. 1.8% consensus) also helped the dollar on its way upwards.



Figure 1: EUR/USD (1 week)



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In our view, the ECB is keeping its options open to raise rates again at upcoming meetings, although the increased concern over the Euro Area economic outlook suggests that it may press pause sooner than we had anticipated. We still think that recent core inflation data warrants the need for at least one more hike, perhaps in September. That said, there now appears a good chance that the Council holds rates steady at the next meeting, before potentially delivering a final hike, or even ending the hiking cycle altogether, in October. As stressed by the ECB itself, this will be heavily dependent on upcoming data, particularly on inflation.

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