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Flash note
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Higher ECB terminal rate? Inflation stops moderating. Economy remains robust. Financial markets rallied. What next?

Below is an executive summary of everything you need to know about Europe and can help us to set the foundations for an investment strategy in the region.

ECB

- President Lagarde sticks with hawkish monetary policy mantra at Davos, and says "ECB will stay the course to return inflation to 2%":
    - "Inflation too high and ECB to stay the course"
    - "The bank will continue to tighten policy and bring inflation back to the 2% target". "Despite softening of Eurozone headline inflation, core readings continue to rise
- Markets remain attentive to divergent voices in the Governing Council.
    - (Hawkish) ECB chief economist Lane says "the bank must keep raising rates to fight off inflation" (Reuters and FT reported). "The bank must take rates into restrictive territory". Lane doesn't expect the low-inflation environment of the past decade to return.
    - (Dovish) Greek central bank chief Stournaras, and Italian central bank chief Visco favoured a "more tempered approach to rate hikes".
    - (Hawkish) Lexpress reported that Bundesbank chief Nagel said "the ECB is not done on fighting inflation, and further policy tightening is necessary to keep inflation expectations anchored".
    - (Mixed) Banque de France chief Villeroy added that "the ECB will probably reach peak rates by summer". Although also said "resilient economy makes rate hikes easier"
    - (Hawkish) ECB's Knot, chief at Dutch Central Bank, wants at least two more 50bps rate hikes and continued his recent hawkish rhetoric.
    - (Hawkish) ECB's Rehn, governor of Finland Central Bank, sees "grounds for significant rate hikes in Spring".
    - (Hawkish) ECB's de Cos says "the bank will continue to raise rates significantly in coming meetings". "Achieving a return to 2% inflation may require tightening policy beyond current market expectations"
- Fitch increased the forecasts for the ECB's terminal rate to 4% for the main refinancing rate, and a deposit rate at 3.5%. Fitch noted the change in guidance from October to December, who said "significant" rate rises are still ahead.

- Loss of ECB's credibility: Analysts at ING, Danske, Natixis and Pictet suggest lack of consistent ECB communication and that this has damaged ECB's credibility: "Having been behind the curve last year, ECB policymakers appear unable to convince markets of their guidance".
- ECB staff losing faith in ECB's leadership. Recent IPSO survey found that over 60% of ECB staff doubt the Governing Council's ability to protect their purchasing power. The survey showed how two-thirds of roughly 1,600 ECB staff members said their trust in President Lagarde and the rest of the ECB board had been damaged by recent developments such as high inflation and wages.

INFLATION

- Producer Prices
  - German producer price inflation eases to 21.6% yoy in December. The figure was way off the all-time high of 45% August 2022. Although the lower rate supports the view of a further slowdown in inflation in the months to come, the truth is that it is still at a too high level.
  - Eurozone December Producer Prices eased to 27.1%
- Consumer Prices stopped easing in December
  - Slovakia Dec HCPI unchanged at 15.4% YoY
  - Italy Dec CPI unchanged at 12.3% YoY
  - Austria Dec HCPI unchanged at 10.5% YoY
  - Germany Dec HCPI unchanged at 9.6% YoY
  - Portugal Dec CPI unchanged at 9.6% YoY
  - Eurozone Dec HICP Final unchanged at 9.2% YoY
  - France Dec HCPI unchanged at 6.7% YoY
  - Spain Dec HCPI slightly eased at 5.5% YoY (from 5.6% last month). But Core CPI YoY accelerated to 7% (from 6.3%)

ECONOMY (stronger than projected due to the sizeable cut in European natural gas prices after mild weather, being the warmest winter on record, which has caused gas consumption to plummet to a fraction of what it would in a normal year. As a result, gas tanks remain full, and price low).

- Eurozone flash composite PMI hit seven-month high in January on strength in services sector, posting the third consecutive gain and the largest increase since June 2020. Strength in the services sector was the highlight. One potentially troublesome aspect of the data is that the improvement in activity saw average selling prices for goods and services tick up.
- FT says Eurozone is set to avoid recession this year as economists' gloom lifts: FT reported that economists see the Eurozone avoiding a recession this year with the sharp turn in sentiment coming as the IMF indicates it will upgrade its global economic forecasts following the improvement in global economic sentiment in the past couple of weeks.

- German finance minister says country will likely face a 'very mild' recession this year. CNBC reported that German government officials are more optimistic on the prospects for Germany's economic outlook.
- German industrial heavyweights see signs that worst of crisis has passed: Bloomberg reported that German industrial heavyweights like BASF battling an unprecedented energy crunch are seeing signs the worst of the crisis has passed, but prices (energy) will need to stay lower for much longer for most companies to see a real difference.
- Europe bracing for sharp and abrupt real estate reversal: Bloomberg, citing an EBA research, reported that a big decline in EU real estate could threaten the breach of loan covenants and trigger emergency funding measures. The EBA research showed loans, bonds and other debt totaling ~€1.9T. Roughly €390B will mature this year. German house prices declined for first time in over a decade in December (-0.8% YY)

FINANCIAL MARKETS:

- Equity investors overweight Europe at 11-month high: There has been a notable increase in investors allocating cash to European equity markets and cutting exposure to Wall Street. The fall un gas prices has helped a lot in softening inflation, which in turn reduced the need for the ECB to continue applying a restrictive policy, improving the economic outlook and shifting market sentiment. This resulted in the first weekly inflow of funds into Europe in almost a year.
- Goldman and Bank of America suggest EU stocks rally in 2023 mostly done: European equities have started 2023 strongly, helped by the Chinese reopening theme and falling natural gas price, as well as signs of less negative growth outcomes for the region than previously feared. The EuroStoxx 600 rallied 9.3% this year, with strategists suggesting further gains are limited.

Best