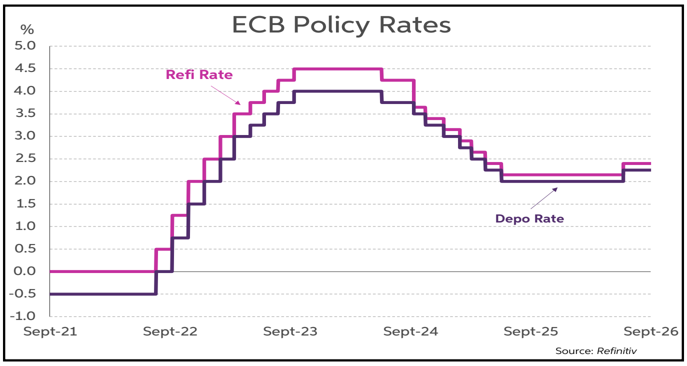
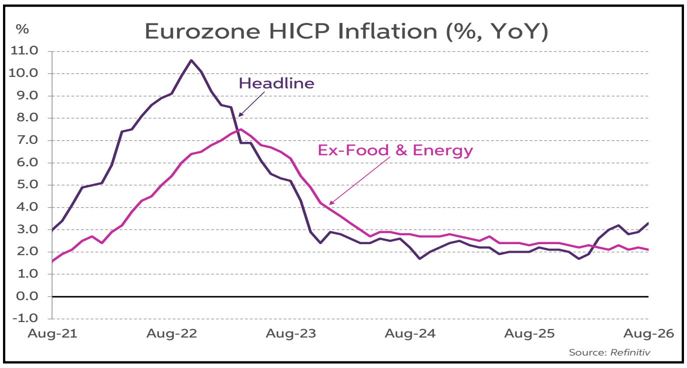
10th September 2026

ECB hikes and notes upside risks to inflation



The ECB's Governing Council meeting for September saw the central bank raise its key interest rates by 25bps. The deposit and refi rates were increased to 2.50% and 2.65%, respectively. This was very much in line with expectations and was fully priced-in. It marks the second 25bps rate hike from the ECB this year. It previously increased rates by 25bps at its June meeting and then kept rates unchanged in July. Similar to June, today's decision to hike rates was in response to concerns in achieving the inflation target, due to elevated price pressures stemming from the energy price shock from the Middle East conflict.

Today's meeting statement showed that the Governing Council remains concerned about the upside risks to inflation. Indeed it explicitly noted that it sees inflation well above target for an extended period. **The ECB's updated macro forecasts published today reflected this outlook by incorporating upward revisions to its inflation projections**. Its expectation for inflation to average 3.0% this year was unchanged, but it now anticipates it averaging 2.5% next year (was 2.3%), and 2.1% in 2028 (was 2.0%). Meanwhile, it continues to forecast that core inflation will run above the 2% target over the forecast period, averaging 2.5% this year (no change) and 2.6% in 2027 (from 2.5%), before easing slightly to 2.3% (was 2.2%) in 2028. Today's meeting statement noted that the central bank now views the "risks to the upside for inflation".



In terms of the growth outlook, the ECB revised modestly higher its baseline GDP projections, stating that this was to reflect the "greater than expected resilience" of the economy, particularly in relation to private consumption and public expenditure. For this year, it is now forecasting that GDP will average 0.9% (was 0.8%), 1.4% in 2027 (was 1.2%) and 1.5% (unchanged) for 2028. It continues to be of the view that the risks to the growth outlook are to the downside.

At the post-meeting press conference, President Lagarde repeated the ECB's mantra that it will take a "meeting-by-meeting" approach to any rate changes and that it was not pre-committing. She stated that the current policy setting was "well positioned to navigate" the uncertain backdrop arising from the conflict in the Middle East. When questioned on markets anticipating further rate hikes, she did not push back against those expectations. However, she also stated though that the ECB is not seeing much "indirect" effects on inflation and they are "still contained".

Overall, today's ECB meeting was hawkish in tone. This was reflected in the upward revisions to its inflation projections as well the reference to the "upside risks" to these forecasts. Movement in futures contracts indicate the market also shared this interpretation, with around a 10bps hardening in rate expectations. A 25bps rate increase in December is now fully priced-in, which would see the Depo rate end the year at 2.75%. Further out, the market is anticipating around 50bps of tightening over the course of 2027, which would result in the Depo rate rising to 3.25%. We acknowledge that the risks of further hikes from the ECB have increased following today's update. However, we believe that the market is too hawkish in pricing in an additional 75bps of hikes, which would likely bring rates well into restrictive territory. This would be inconsistent with the subdued growth outlook for the currency bloc as well as the ECB's assessment that indirect inflation effects are still contained. **If the conflict de-escalates and second round effects remain muted, then a further increase in rates above 2.5% may not be warranted.**

ECB Macroeconomic Forecasts for the Euro Area - Sept 2026

(%)	2025	2026	2027	2028
HICP	2.1	3.0	2.5	2.1
Real GDP	1.3	0.9	1.4	1.5

Base forecasts based on Brent oil prices avg. $89.5 in 2026, $78.0 2027, and $73.6 in 2028.

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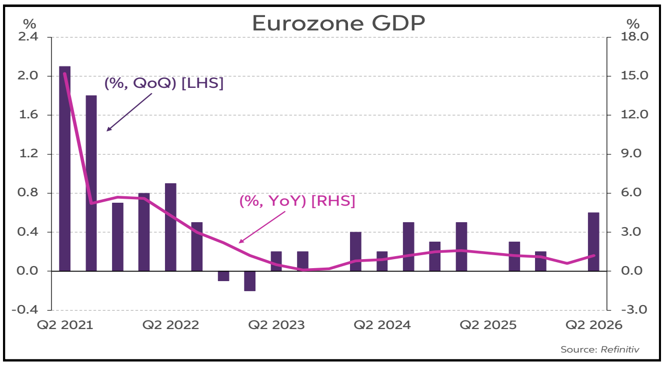
Eurozone economy unexpectedly resilient in H1

The Eurozone economy expanded by a solid 1.4% last year, up from 0.8% and 0.5% in the two years prior. So far in 2026, growth has been volatile, but overall the economy has maintained this recent momentum. GDP flatlined in Q1 before expanding by 0.6% q/q in Q2. However, the volatility was largely caused by distortions in the Irish GDP data. GDP excluding Ireland expanded by 0.3% in both quarters. Looking at the latest quarterly data in more detail, personal consumption, and exports were the main drivers of growth. Consumption expanded by 0.4% in Q2 contributing 0.2 percentage points (p.p.) to GDP. Meanwhile, exports jumped by 3.4%, adding a hefty 1.6 p.p. to the total, albeit this was offset by a rise in imports, which knocked 0.7 p.p. off growth. Although, government spending rose by 0.2% q/q, its impact on GDP was negligible, as was the marginal contraction in investment. However, a sharp rundown in inventories reduced output by around 0.5 p.p. in the quarter.

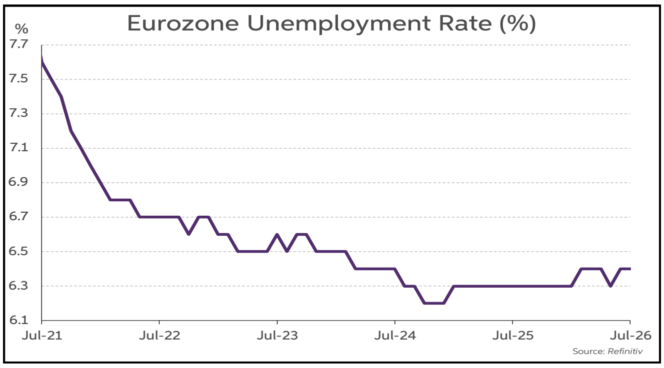


Meanwhile, the available survey data for Q3 indicate that economic conditions may have improved slightly in the quarter. Having moved into contraction territory in Q2, the services PMI returned to expansion mode in July and August. Overall, it has averaged 51.6 so far in Q3, up from 48.2 in Q2. Similarly, the manufacturing PMI has averaged 52.3 so far in Q3, up slightly from an average of 51.7 in the previous quarter. At the same time, economic sentiment has improved somewhat, albeit consumer, industrial, services and investor sentiment all remain at subdued levels. In terms of the only available hard data for Q2, retail sales contracted by 0.6% in July, following modest expansions in each of the two months prior.

In terms of the labour market, conditions remain solid. Employment expanded for a twenty first successive quarter in Q2, by 0.1% q/q and by 0.5% y/y. It means that the number of people at work has risen by 5.9% (9.8 million) since the end of Q4 2019. Meanwhile, the unemployment rate averaged 6.3% for a second consecutive year in 2025. Furthermore, it has printed at either 6.3% or 6.4% in the first seven months of 2026. Ongoing tight conditions continue to support wage growth. The Indeed wage tracker indicates that earnings rose by 3.0% y/y on average in the three months to July, compared to just 2.4% y/y during the same period in 2025.

On the inflation front, price pressures were relatively stable in the Eurozone ahead of the recent surge in energy prices. Following a gradual downtrend in the first half of 2025, inflation remained in and around the ECB's 2% target rate. Indeed, the headline rate averaged just 2.1% in 2025. Meantime, underlying inflation proved to be somewhat sticky, with the core rate averaging 2.5% last year. It should be noted though, that it printed between 2.2-2.4% throughout the final nine months of 2025. However, amid the war in the Middle East, headline inflation has increased sharply in the past six months. It rose from 1.9% to a peak of 3.3% in August. However, there has been limited evidence to date that energy price rises have let to broader inflationary pressures. Core inflation has printed in a narrow 2.1-2.3% range since the war has started, and it is currently at the bottom of that range. **The ECB is now forecasting that inflation will average 3.0% this year and 2.5% in 2027, with the core rate at 2.5% and 2.6%, respectively.**

In summary, the Eurozone economy has shown resilience so far this year, but the energy price shock remains a key downside risk. The economy has continued to grow, albeit at a modest pace. The labour market remains healthy, and looking ahead, increased fiscal spending in Germany should continue to support growth in the Eurozone's largest economy. However, the EZ continues to face challenges. Most notably, amid the energy price shock, if underlying inflation were to accelerate in a meaningful way, the ECB may have to raise rates further, bringing monetary policy into restrictive territory. More broadly, geopolitical tensions, particularly in relation to the US-Iran and the Russia-Ukraine Wars, pose major downside risks to the EU. Against this backdrop, the IMF sees GDP rising by 0.9% this year and by 1.2% next year.



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