February 6, 2023

The ECB's Interest in Rate Hikes Rates Higher Than the FOMC's

Federal Open Market Committee Chairman, Jerome Powell, announced on February 1, 2023 that the FOMC raised its policy interest rate by 25 basis points and stated that, "ongoing increases will be appropriate." On February 2, European Central Bank President Christine Legarde announced in a press conference that the ECB has raised its three key interest rates by 50 basis points, and indicated the Governing Council's intent to raise them again by 50 basis points in March. On the surface, it appears that both the FOMC and ECB will continue to raise interest rates in the next several months. However, BIA examines statements from both Mr. Powell and Ms. Legarde using our proprietary Tactical Behavior Assessment® (TBA) methodology and discover that these two policymakers may, in fact, make very different decisions about where U.S. and Euro Area interest rate paths will go. Below is what we discovered.

The FOMC is More Optimistic Than They Seem

Mr. Powell's announcement that the FOMC raised its policy interest rate by 25 basis points, and that "ongoing increases will be appropriate," also indicated that the Committee is seeing signs of disinflation taking hold. As a result, during the February 1 FOMC press conference, he is asked several questions about what he means by the vague statement "ongoing rate increases." Also, given that headline inflation has come down, he is asked why rates need to go up at all, or if they could even come down. His responses explain that disinflation "is in early stages," that there are large core sectors where inflation has not come down, and that the FOMC has "more work to do." Even so, his language surrounding how much higher rates could go shifts over the course of the press conference.

Early in the press conference, Mr. Powell is asked if the December estimate of 5 to 5.25% inflation rate is still the best guidepost. He says that, "we haven't made a decision on exactly where that would be," but goes on to give the impression that "it could be higher" depending on incoming data, and that "I don't feel a lot of certainty." He also says the Committee is concerned about the "risk of doing too little," and are "worrying about expectations [in the market] getting unanchored." However, he also states that, "we have no incentive and no desire to over-tighten," and "if we've gone too far," the FOMC has tools to rectify the situation. This implies that Mr. Powell believes there is more risk in not raising rates than in raising them too far, but when asked a follow-up question of whether the expectations for future rate increases is truly related to uncertainty, or if it is more about not wanting the market to overact to positive signs, he does not fully answer the question. He reiterates his message that there are core sectors where they have not yet seen disinflation, but fails to address to what extent market reaction is influencing policy. Instead, Mr. Powell downplays the significance of the decision saying, "we're neither optimistic nor pessimistic," and the Committee is "just saying…we're not seeing disinflation yet." This careful attempt to appear neutral concerning the FOMC's outlook, coupled with the failure to indicate whether the Committee is managing the market's expectations, suggests to BIA that the vague language about "ongoing rate increase" is, in fact, an attempt to limit expectations for a pause in rate hikes. In other words, **it is BIA's opinion that the FOMC is leaning toward a pause in rate hikes but does not want the market to internalize that expectation at this time.**

> **"The story we're telling about inflation…is basically the three things that I've just gone through a couple of times."**
>
> **- Chairman Powell**

Indeed, when asked why rate increases are still needed at all, Mr. Powell again reiterates that "the story we're telling about inflation" is that they have not seen disinflation in key sectors. However, the phrase "the story we're telling" inadvertently signals to BIA that the Committee's message is carefully crafted, and that the Committee may actually feel differently from what they are telling the public. Furthermore, Mr. Powell qualifies that the story is, "basically the three things that I've just gone through a couple of times." The qualifier "basically" signals that there is more to the story than just those "three things," and provides further behavioral evidence **that suggests to BIA that Mr. Powell's statements about policy are meant to manage market expectations.**

Mr. Powell is then asked if the FOMC discussed the possibility of pausing rate increases in the next meetings and then restarting them. Initially, he defers responding, saying that the minutes of the meeting would be released in three weeks. But when pressed he says, "I think this is not something that the Committee is thinking about or exploring in any kind of detail," and that "this is not something that the Federal Open Market Committee is on the point of deciding right now." These statements give the appearance that the FOMC is not considering a pause in rate increases, but his language — that they are not discussing the possibility "in detail," and are not "on the point of deciding right now" — **suggests to BIA that the FOMC has, in fact, seriously considered the possibility of pausing rate increases, and will make a decision on it soon**.

Finally, when asked if the statement "ongoing rate increases will be appropriate" means two more rate increases, or if one more increase and then a pause is plausible, Mr. Powell does not answer. Instead, he says, "we have inflation moving down, you know, into this somewhere in the mid-threes or maybe lower than that this year," and "I don't see us cutting rates this year…if our outlook turns true." Notably, this response is framed not in terms of the potential for future rate *increases*, but in terms of future rate *cuts.* This rules out the possibility of cutting rates, but does confirm the possibility of increasing them. Furthermore, the statement that ongoing rate increases "will be appropriate" itself falls short of saying increases are expected. Altogether, the behavioral indicators present in Mr. Powell's responses to questions about interest rate increases **lead BIA to believe that, contrary to the their implied outlook for future increases, the FOMC has seriously considered not raising rates at all in 2023.**

The ECB Can't Catch Up

Ms. Legarde also announced raises in the ECB's three key interest rates and indicated the Governing Council's intent to raise them again by 50 basis points in March. However, her statements about future rate increases are far more specific than those of Mr. Powell. She explains that the expectation for the March increase is based on current data that show underlying inflation pressure. And similarly to the FOMC press conference, Ms. Legarde is also asked questions about the potential for more future rate increases. She is asked if the rate hike in March will be followed by more increases in May, or if the March increase will be the peak. In response, Ms. Legarde emphasizes that the ECB "intend[s]" to raise rates in March, but that "intend" is a "strong word." This is a concerted effort to set public expectations for the March increase, while leaving the impression that there is an outside possibility of no increase. Furthermore, she is asked twice, and twice fails to answer, if the Governing Council expects more rate increases in May, leaving open the possibility that it does. She instead makes the case that the ECB needs to move into "restrictive territory" and stay there so that the Governing Council can be confident that once it reaches its target of 2% inflation, inflation will stay there. She also emphasizes that "we are far away today" from a steady state of inflation. These responses do not contain strong behavioral evidence to suggest to BIA that Ms. Lagardes' statements about the ECB's expectation for raising rates in March are misleading. Furthermore, her statements about potential rate increases in May do contain behavioral evidence that **lead BIA to believe Ms. Legarde suspects further increases at that time are highly probable.**

"I am not going to compare with the U.S."
- President Legarde

Other notable behavioral indicators are present in Ms. Legarde's response to a question to compare inflation development in the Euro Area with that in the U.S. She pauses before responding, then sidesteps the topic saying, "on the international front…I am not going to compare with the U.S. necessarily," then pivots to discuss the looming impact on the international economy of the reopening of China. The pause before her response signals that the question is difficult for Ms. Legarde to answer. Also, by dismissing the question, Ms. Legarde signals to BIA that such a comparison would reveal that the economic environment in the Euro Area is far more concerning that that of the U.S. Ms. Legarde is also asked to compare how far along the ECB is to the U.S., given Mr. Powell's assertion that the FOMC's policies are taking hold and disinflation in the U.S. is underway, and to comment on whether the ECB's policies have been effective. In response, she immediately insists that the ECB's policies are working on core inflation, but that underlying inflation pressures, such as energy, are still present. However, she fails to make a comparison between the effectiveness of ECB policies to FOMC policies, which signals she believes discussing such a comparison would put the ECB in an unfavorable light. As such, **these behavioral indicators strongly suggest to BIA that the ECB is likely to need to continue to raise key interest rates not only in March, but also in May and possibly even beyond.**

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