Central banks - ECB

Getting near peak rates

AUTHOR

Chiara Cremonesi
Senior Rates Strategist
chiara.cremonesi@animasgr.it

Matteo Gallone
Macroeconomist
matteo.gallone@animasgr.it

ECB's officials have recently focused in their speeches on the role of financial conditions, arguing that their recent tightening poses additional downside risks to growth. We agree with this conclusion and, in this piece, introduce our framework for tracking financial conditions in the EA.

Tighter financing conditions, coupled with a second wave of the energy shock this summer, a fiscal impulse that will become a drag in 2027 and wider sovereign spreads that increase fragmentation in the transmission of monetary policy, suggest that we are getting very near peak rates for the ECB.

Against this backdrop, we expect the ECB to remain on hold in October. A December hike remains on the table, especially if energy prices do not drop significantly from current levels, but beyond December, we expect the ECB to remain on hold in H1 2027 and adopt an easing bias in H2 2027, with the number of rate cuts it will deliver depending on the rate of convergence of inflation towards target.

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ECB to hold in October

We expect the ECB to remain on hold in October. While energy prices remain high and near the ECB's September adverse scenario, we continue to believe that the ECB staff's September core inflation forecasts are too sanguine, as evidence of pass-through is still very scarce. Meanwhile, the Governing Council rhetoric has recently softened, with most members, even the most hawkish ones (e.g. Schnabel), arguing that the second energy shock that started this summer has not yet impacted growth, while financial conditions have continued to tighten due to the rise in sovereign bond yields.

A rate hike remains on the table in December

We believe that a rate hike in December remains on the table, particularly if: 1) Energy prices do not decline significantly from current levels. 2) Growth does not decelerate significantly. 3) Core inflation remains around current levels.

Beyond December, chances are rising that the ECB will remain on hold

We believe that chances are rising that the ECB will remain on hold until H2 2027. Moreover, **we remain convinced that the ECB will adopt an easing bias in H2 2027,** for the following reasons:

1) Financial conditions are becoming a crucial variable for the ECB, and they are tightening fast

In most of the recent speeches, Governing Council members have focused on the adverse impact of tightening financial conditions on growth (**Figures 1 and 2**) and have softened their rhetoric about the need for further adjustment in monetary policy

We think that this is a very valid point, as our framework for tracking financial conditions in the EA suggests.

In this note we introduce our Financial Conditions Index for the EA, which is designed as a close, "as-in-the-paper" replication of ECB Working Paper 3193 - *"Looser, tighter, clearer: a new Financial Conditions Index for the euro area".* In that paper, the ECB builds a Macro-Finance FCI (MF-FCI) inside a single macro-finance VAR: the index is a linear combination of observable financial variables whose weights are estimated jointly with the VAR parameters, so that the resulting financial conditions factor best explains the joint dynamics of: 1) macro variables; and 2) the financial conditions factor itself.

For clarity, in our work we do not hard-code or "import" the ECB's published weights. Instead, we replicate the methodology in its entirety and re-estimate the full MF-FCI model on our dataset, including the VAR parameters and the α (weight) vector derivation, using the same penalised maximum-likelihood framework and identification choices described in the ECB paper (see the **Appendix** for full details).

This approach offers two key advantages. First, it allows us to obtain a faithful replication of the ECB framework while ensuring that the index evolves dynamically over time as new information becomes available, given that we have full control over the VAR infrastructure used for weight derivation. Second, it enables us to develop an

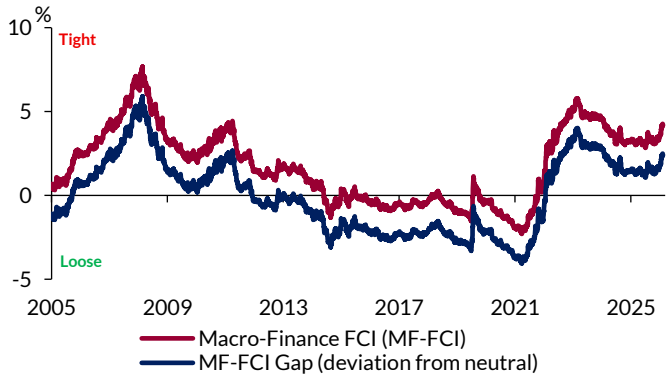
extension that estimates a Financial Conditions Impulse on Growth (FCI-G) measure, following the same intuition as the Fed FCI-G framework. Unlike a conventional FCI, this indicator explicitly incorporates the transmission lags through which changes in financial conditions are estimated to affect future economic activity.

The resulting measure allows us to quantify the estimated headwind or tailwind from financial conditions to real GDP growth over the subsequent 12 months, expressed in percentage points relative to potential growth. In other words, it provides an estimate of the cyclical contribution of financial conditions to future economic growth.

Using this framework, we observe that financial conditions have been tightening significantly since January 2026 and are now at their tightest level since Q4 2024. Most of the tightening has been driven by the rise in core yields, in particular real yields, since the end of June (**Figure 3**). At current levels, we calculate that the negative impulse to growth from financial conditions could be as high as -1% over the subsequent year (**Figure 4**).

Figure 1

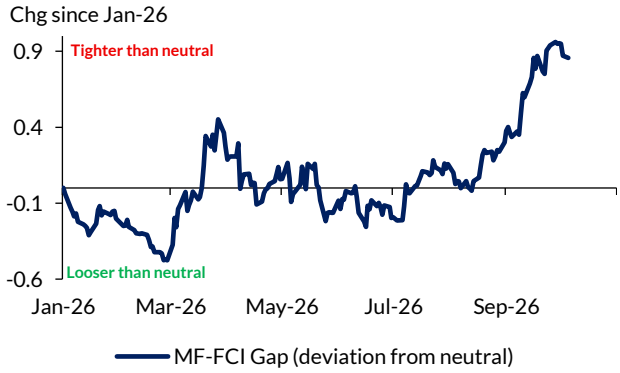
Financial conditions have tightened…



Source: Bloomberg, ANIMA Research
MF-FCI is the "raw" level index (the stance measure in rate-like units).
MF-FCI-GAP is the deviation from neutral. In other words, the VAR delivers a model-implied unconditional mean of the MF-FCI, which the ECB interprets as a neutral benchmark consistent with inflation at target and output at potential.

Figure 2

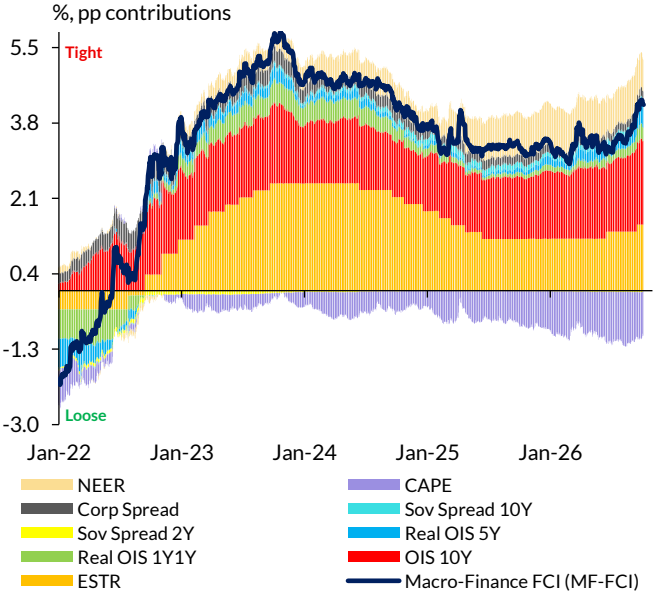
…especially compared to the start of the year



Source: Bloomberg, ANIMA Research

Figure 3

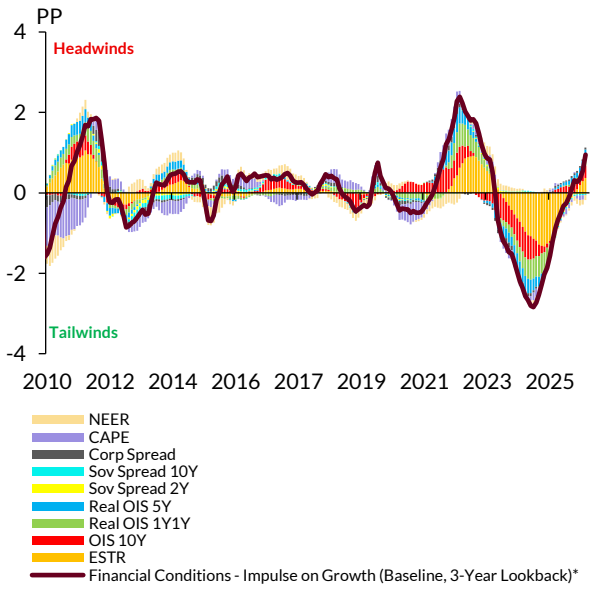
Core real yields are driving the tightening



Source: Bloomberg, ANIMA Research

Figure 4

The effect on growth is moderate but not negligible



Source: Bloomberg, ANIMA Research

2) The rise in sovereign spreads poses additional challenges

While our model for EA financial conditions tends to assign a very small role to the contribution of sovereign spreads, **a widening in sovereign spreads causes fragmentation in the transmission of monetary policy and a tightening of financing conditions in the countries where funding costs for the economy rise more pronouncedly**. Considering the recent price action in sovereign spreads, investors' sensitivity to fiscal themes, and the upcoming political elections in Italy and presidential elections in France next year, the ECB will have to be very attentive to this aspect because of its potential adverse macroeconomic impact.

Moreover, faced with rising sovereign spreads, the least controversial way for the ECB to lean against the trend would be to adopt a more dovish stance in its rhetoric about rates. The other instruments (slowing QT, activating TPI, or even OMT) would require a high degree of fragmentation, in our view, before they could be considered viable options and could be controversial in terms of their conditions for activation (TPI) or the political and legal implications of altering the current policy stance (slowing QT).

3) The role of fiscal policy

While fiscal policy remains supportive in terms of the level of public spending, **the September 2026 ECB staff projections imply a moderately negative fiscal impulse in 2027 and a broadly neutral to mildly negative impulse in 2028**. The drag reflects the expiry of RRF funding and fiscal consolidation in several member states, partly offset by continued increases in defence and infrastructure expenditure. As a result, fiscal policy is expected to subtract modestly from annual GDP growth relative to 2026, though not enough to derail the recovery.

4) The ambiguous impact of AI

According to a recent speech by Lane[1] while the impact on growth and the wealth effect of AI are positive, they are a fraction of what they are in the US and Asia. On the other hand, in the EA, AI is contributing to a rise in long-term global sovereign bond yields, which is ultimately negative for growth, via the tightening effect of financial conditions.

Against this backdrop, we believe that the EA economy is not in a cyclical position to absorb the current energy shock into wages and core inflation. For this reason, **we continue to expect the ECB not to be able to deliver the full amount of rate hikes currently priced by markets** (over 60bp by June 2027).

How many cuts in H2 2027?

It will depend on where the EA stands in terms of disinflation progress and how growth is holding up. With core inflation set to stay steady around 2.5% y/y and only declining afterwards according to our new EA inflation forecast path, we believe that the ECB will want to be reasonably sure that core inflation is heading towards target, which makes us less sure than before that it will manage to deliver two rate cuts in H2 2027**. We therefore continue to expect the ECB to adopt an easing bias in H2 2027, although the actual number of rate cuts it will deliver depends on the rate of convergence of inflation towards target.**

[1] *See: Keynote speech by Philip R. Lane - Frankfurt am Main, 5 October 2026 - Diagnostic Challenges for ECB Monetary Policy.*

Appendix

Methodology. Our Financial Conditions Index for the EA is designed as a close, "as in the paper" replication of ECB Working Paper 3193 - "Looser, tighter, clearer: a new Financial Conditions Index for the euro area". In that paper, the ECB builds a Macro-Finance FCI (MF-FCI) inside a single macro-finance VAR: the index is a linear combination of observable financial variables whose weights are estimated jointly with the VAR parameters, so that the resulting financial conditions factor best explains the joint dynamics of: 1) macro variables; and 2) the financial conditions factor itself.

For clarity, in our work we do not hard-code or "import" the ECB's published weights. Instead, we replicate the methodology in its entirety and we re-estimate the full MF-FCI model on our dataset, including the VAR parameters and the α (weight) vector derivation, using the same penalised maximum-likelihood framework and identification choices described in the ECB paper.

Data inputs and frequency handling. Consistent with the ECB baseline, our input database contains:

1) daily financial series for nine asset price variables (eSTR, 10-year OIS, 1y1y real OIS, 5y real OIS, 2-year and 10-year GDP-weighted sovereign spreads versus OIS, investment-grade corporate spreads, the CAPE equity valuation ratio, and the euro NEER);

2) monthly headline HICP;

3) quarterly real GDP (level, seasonally adjusted) to construct the output gap.

The ECB's baseline set of nine financial variables and their definitions are described in the paper and summarised in Table 2 and Appendix A.3. Following the paper, we convert daily financial variables to the monthly estimation frequency using the last available daily observation in each month (end-of-month sampling), while keeping a daily version available for producing a daily MF-FCI series.

All variables, where possible, are constructed in accordance with the ECB methodology (same data sources and same adjustments). Before September 2021, EONIA rather than eSTR is used, adjusted for the fixed EONIA-eSTR spread of 8.5 basis points.

The CAPE variable stands for the cyclically adjusted price-to-earnings ratio. We use the MSCI EMU Index and the relative price-to-earnings (PE) ratio provided by Bloomberg. The CAPE index is calculated as the MSCI EMU Index divided by the trailing 10-year moving average of earnings, where earnings are backed out from the price-to-earnings ratio. The data sources in this case differ from those used by the ECB; consequently, this variable shows some differences compared with the one used by the ECB.

Transformations of financial variables (Z block). In line with the ECB approach, transformations are intentionally kept minimal: rates/yields/spreads enter in percent (no standardisation), while equity valuation ratios and exchange rates are expressed as percentage deviations from their sample means. Operationally, we (a) compute monthly EOM values; (b) compute the CAPE and NEER sample means over the configured window; and (c) transform daily and monthly CAPE and NEER series into percentage deviations from those means before feeding them into the model.

Transformation of macro variables used by the VAR.

The monthly macro block matches the paper:

Inflation gap: year-on-year log HICP inflation minus the target, with the target set to 1.9% before July 2021 and 2.0% thereafter (reflecting the ECB's strategy review).

Output gap: constructed from quarterly real GDP interpolated to monthly frequency using Denton-Cholette temporal disaggregation, then decomposed into trend and cycle complements via the Hamilton filter (using the recommended settings of h = 24 months of look-back and p = 4 lags), and finally expressed as the log deviation of GDP from its trend (×100).

In the implementation, we explicitly added a Denton-Cholette routine and verified via a unit test that the interpolated monthly GDP re-aggregates back to the quarterly GDP within tolerance. We also added a full audit export of the GDP→log→trend/cycle→output gap "flow" so the construction can be inspected end-to-end.

Estimation window and COVID treatment. The ECB baseline estimation uses monthly data from January 2007 to December 2025 and a VAR lag order of 2. To avoid the extraordinary distortions caused by the pandemic the paper excludes March–June 2020 observations from the likelihood evaluation (while still using surrounding information for lags and structure). Our calibration step follows the same sample window, lag length, and the same COVID likelihood exclusion.

Weight estimation (α). In the ECB methodology, the MF-FCI weights (α) are estimated jointly with the VAR coefficients via penalised maximum likelihood, subject to a unit-norm constraint ($||\alpha||_2^2 = 1$). To handle multicollinearity and differences in scale and co-movement across financial variables, the paper adds a generalised ridge penalty of the form ($\alpha' C^{-1}\alpha$) and sets the penalty strength to $\lambda = 77$ in the empirical section.

We implemented the same structure (the same constraint, λ, and COVID likelihood-exclusion logic) and additionally impose a practical "orientation" convention (sign_normalise_on = eSTR) so that the index sign remains stable over time.

Hence, the marginal covariance contribution (MVC) depends on:

- the weight vector α; and
- the covariance matrix of the financial variables, $C = \text{Cov}(Z_t)$.

Accordingly, we deliver two measures of MVC to compare with our own MVC:

1. MVC implied by the paper's α, using our covariance matrix C (i.e. based on the volatility and co-movement of the underlying series).
2. MVC reported in Table 2 of the reference ECB paper.

The slight differences between our MVC output and that of the reference paper (**Figures 5 and 6**) are due to the fact that our dataset is not fully comparable with theirs. For example, there are minor differences in the construction of some time series, especially the CAPE measure. Under our dataset, CAPE's variance-covariance structure relative to the other Z variables is not the same as that used by the ECB, even if the level and path of CAPE looks similar in plots.

The reason we also provide an alternative MVC estimate [MVC (%, ECB Paper Alphas + Our Covariance)] is to show what the MVC would look like using the alpha values from the ECB paper, based on the covariance structure of our database.

Daily MF-FCI production, decomposition, and MF-FCI vs MF-FCI-GAP. After calibration, we compute the MF-FCI as the weighted sum of the transformed financial inputs (Z_t). The ECB highlights that, although the model is estimated at monthly frequency, the same coefficients can be applied to daily financial data to obtain a daily MF-FCI and a daily decomposition. We do the same: 1) compute a monthly MF-FCI on end-of-month Z values, and 2) compute a daily MF-FCI by applying the same calibrated weights to the daily Z values, also exporting each variable's daily contribution. Finally, the VAR delivers a model-implied unconditional mean of the MF-FCI, which the ECB

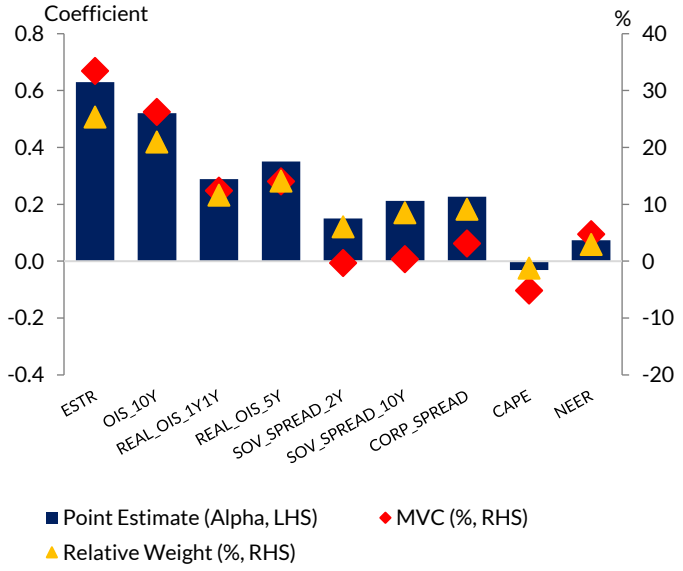
interprets as a neutral benchmark consistent with inflation at target and output at potential. In our outputs:

MF-FCI is the "raw" level index (the stance measure in rate-like units).

MF-FCI-GAP is the deviation from neutral: MF-FCI-GAP = MF-FCI − (model-implied mean of MF-FCI). Conceptually, MF-FCI-GAP > 0 indicates financial conditions that are tighter than neutral, while MF-FCI-GAP < 0 indicates financial conditions that are looser than neutral.

Figure 5

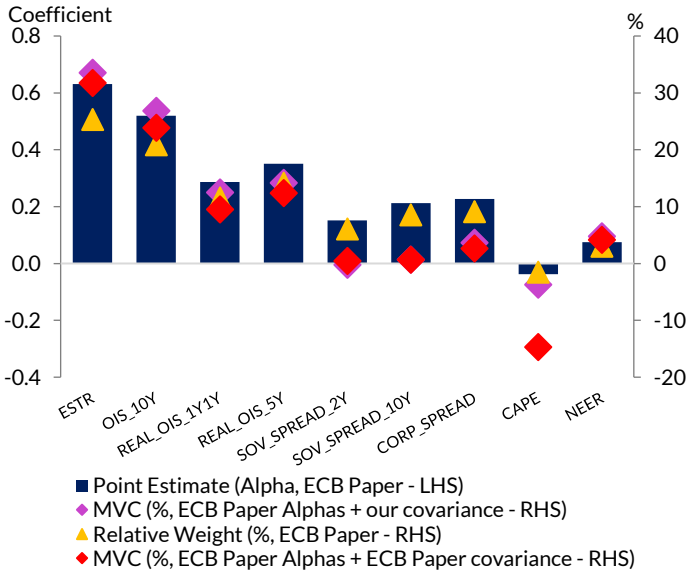
Our estimates of FCI weights



Source: ANIMA Research
Note: The blue bars show the estimated coefficients of the variables entering the Macro-Finance FCI. The yellow markers show the relative coefficients and the red diamonds show the marginal variance contribution to the overall variation of the FCI, both normalised to sum to one in absolute terms.

Figure 6

ECB estimates of FCI weights



Source: ECB, ANIMA Research
Note: The blue bars show the estimated coefficients of the variables entering the Macro-Finance FCI. The yellow markers show the relative coefficients and the red diamonds show the marginal variance contribution to the overall variation of the FCI, both normalised to sum to one in absolute terms.

ANIMA INVESTMENT RESEARCH

FABIO FOIS
Head of Investment Research & Advisory
fabio.fois@animasgr.it

CHIARA CREMONESI
Senior Rates Strategist
chiara.cremonesi@animasgr.it

COSIMO RECCHIA
Senior Equity Strategist
cosimo.recchia@animasgr.it

MATTEO GALLONE
Macroeconomist
matteo.gallone@animasgr.it

FRANCESCO PONZANO
Junior Equity Strategist
francesco.ponzano@animasgr.it

MATTIA BANIN
Junior Macro Analyst
mattia.banin@animasgr.it

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