6 December 2024

ECB Preview

A disputed 25bp rate cut

- Next week, the ECB is set to cut rates for the fourth time this year. Unlike the previous three cuts, the outcome of next week's rate decision is not given as 1) the restrictive policy stance, 2) the deteriorating growth outlook, and 3) inflation at target has opened discussions of a 50bp cut. While a 50bp cut will certainly be discussed, we judge that the ECB will ultimately deliver a 25bp rate cut, and guide that they are open to any size of rate cuts at future meetings, subject to the incoming data. A 25bp cut next week will bring the ECB's deposit rate to 3.0%. In the coming year, we expect a string of rate cuts, leading to a terminal rate of 1.5% being reached in September 2025.
- We expect a benign market reaction, even if Lagarde decides to twist guidance towards an increasing likelihood of a faster rate of normalisation.

Change guidance of policy restrictiveness

Since last year, the ECB has included a reference that it aims to keep monetary policy '*sufficiently restrictive'* for as long as necessary. Following the disinflationary process that has gained traction through 2024, the updated staff projections next week are likely to forecast inflation on target from 2025 and onwards. Thus, whether monetary policy should stay restrictive is likely going to be debated. We believe that the slightly hawkish bias in the ECB's communication is set to change as the need for a restrictive monetary policy stance in the Eurozone is no longer obvious. But the camps inside the GC are obviously divided. In a recent interview the ECB's Schnabel said that in her view the restrictive part of the monetary policy stance is already fading. At the same time, we see the dovish camp, for example Villeroy, saying that there 'won't be any reasons' for policy to remain restrictive.

A 25 or a 50bp rate cut? It is not the most important question

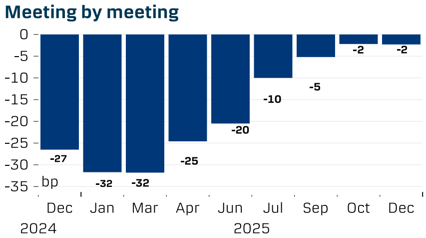
With activity indicators looking bleak heading into 2025, the case for a 50bp rate cut has strengthened, as the starting-point for financial conditions is restrictive based on most measures. However, given the ECB's sole inflation mandate, and the 'political' aspect of having a gradual rate cutting cycle, we believe it will favour a 25bp rate cut.

However, whether the ECB will deliver a 25bp rate cut or 50bp rate cut in December is not that important in isolation, as the communication around it will be key as well. There seem to be diverging views on how to cut the cake. Most recently, Schnabel's interview clearly suggested that she would opt for a 25bp rate cut, as would Vujcic, while others such as Lane, Villeroy and Centeno are more open to discussing a 50bp rate cut.

That said, rather than focusing on the rate cut next week, we should focus on where the policy rate will end in this cutting cycle, albeit we do not expect any verbal guidance on this. Markets may though interpret a 50bp cut as a signal of a lower terminal rate – and that may even be a signal that the ECB wants to send.

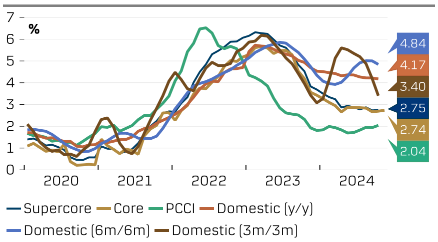
.

Markets are pricing -27 bp for the December meeting



Source: Danske Bank

Underlying inflation pressure in the euro area



Source: Eurostat, ECB, Danske Bank, Macrobond Financial

Director, ECB and Fixed Income Research
Piet Haines Christiansen
phai@danskebank.dk

Analyst, Euro Area Macro Research
Rune Thyge Johansen
rujo@danskebank.dk

Associate, FX Research
Mohamad Al-Saraf
moals@danskebank.dk

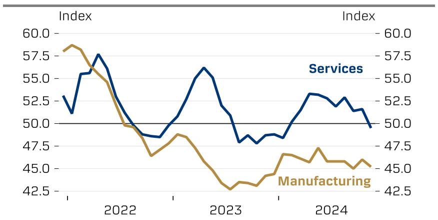
.

But as we do assume the ECB does not want a hawkish reaction from markets, leading to tighter financial conditions, we expect it to opt for a dovish 25bp cut, focusing on the communication on a potential jumbo cut.

Macro data since the October meeting has mainly given ammunition to the doves

Since the October meeting, the momentum in underlying inflation has fallen further and growth indicators have weakened. The composite PMI indicator declined sharply to 48.3 in November mainly driven by the service sector, which is now also in contractionary territory. Data indicates that the eurozone's two largest economies, Germany and France, are likely to contract in Q4 while Spain should drive aggregate euro area growth together with Portugal and Greece. The deteriorating growth indicators combined with rising political uncertainty since the October meeting have mainly given ammunition to the dovish members of the ECB. However, the hawks' last battalion, namely the labour market, continues to show resistance with the unemployment rate remaining at a record low of 6.3% in October and the national account data showing increased employment in Q3.

PMI weakening since the October meeting

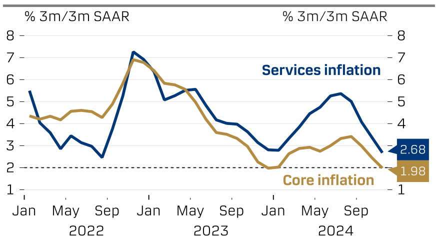


Source: S&P Global, Macrobond Financial

Underlying inflation has eased further

While headline inflation has increased from the three-year low in September, mainly reflecting base effects, the underlying momentum has continued to ease. The average month-on-month increase in seasonally adjusted core inflation has been 0.14% in the past three months, which is well in line with 2% annualised inflation. Importantly, the lower momentum in underlying inflation has been driven by service inflation where momentum is also quickly approaching the 2% target, according to the ECB's own seasonally adjusted data. Hence, inflation developments have clearly also supported the doves in the ECB. For the hawks, an argument for a cautious cutting approach is wage growth that remains elevated given the tight labour market. Negotiated wage growth increased to 5.4% y/y in Q3, albeit largely driven by one-off payments, and has averaged 4.6% so far this year, compared to 4.4% in 2023.

Momentum in underlying inflation sharply lower since last meeting



Source: ECB, Macrobond Financial

Staff projections to show lower growth and inflation

We expect the ECB staff to take note of the recent easing in the momentum of underlying inflation and incorporate this into a lower forecast for core inflation next year relative to the forecast in September. We expect core inflation to be revised down to 2.2% y/y in 2025 (from 2.1%) and headline inflation to 2.1% y/y (from 2.2%). Oil futures were 6% lower at the cut-off date for the staff projections compared to December, but gas and electricity futures were higher, so we expect only a marginal reduction in the headline forecast. We expect the growth forecast to be revised down in 2025 to 1.1% y/y from 1.3% y/y due to the continued struggles in the manufacturing sector combined with cautious consumers and a weak German economy. In contrast to the ECB's previous projections, consumers continue to have an elevated savings rate, which prevents consumption from picking up in the near term. The new staff projections will also include an additional year, albeit we do not attach significant weight to those projections given their embedded uncertainties.

We expect the staff projection to show lower growth and inflation in 2025

ECB projections December 2024	2024		2025		2026		2027	
GDP growth	0.8% (0.8%)	→	1.1% (1.3%)	↘	1.6% (1.5%)	↗	1.6%	→
HICP inflation	2.4% (2.5%)	↘	2.1% (2.2%)	↘	1.9% (1.9%)	→	2.0%	→
Core inflation	2.8% (2.9%)	↘	2.2% (2.3%)	↘	2.0% (2.0%)	→	2.0%	→

Parenthesis are the old ECB projections (from Sep 2024)

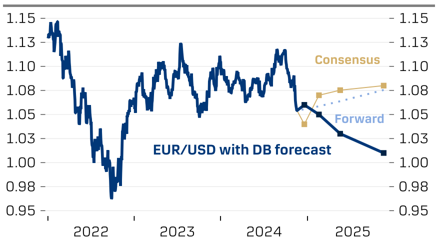
Source: Danske Bank

Limited FX market reaction on 25bp rate cut

Speculation around a 50bp cut has diminished, with markets now largely positioned for a 25bp move, with only 27bp priced in. However, the post-decision communication will be crucial, given divisions within the Governing Council that could drive a range of market responses.

We view a dovish 25bp cut, where the ECB signals flexibility to adjust the size of future cuts, as the most likely scenario. Such an outcome would likely have a limited impact on EUR/USD, and with the probability of a jumbo cut still being priced in markets. However, should the ECB indicate a preference for continuing the easing cycle in 25bp increments, market pricing could shift, potentially triggering a hawkish response and a moderate EUR/USD rally, albeit given the meeting-by-meeting approach and thereby keeping full flexibility about future monetary policy decisions, we see that as a low probability outcome. By contrast, a 50bp cut – an outcome we believe is underappreciated despite weak euro area growth and inflation – would likely prompt significant EUR depreciation, with EUR/USD potentially dropping sharply.

We remain bearish on EUR/USD



Source: Danske Bank

Looking ahead, the Fed's December meeting is likely to have a more decisive impact on EUR/USD's near-term trajectory, with Friday's US jobs report a critical input. While markets currently assign a decent probability to a Fed pause, we expect a 25bp cut. If this materialises, it should help contain further EUR/USD downside into year-end. Seasonal trends and our short-term valuation models support this view, as EUR/USD appears oversold after its sharp decline since October. We expect the pair to close the year at around 1.06.

From a strategic perspective, we maintain our bearish EUR/USD outlook, driven by the relatively stronger US growth narrative. Our 12M target remains 1.01, making parity a plausible level over the coming year. On the rates side, we note that the significant decline in rates over the past month has brought the spot level for long swap rates close to our 12-month forecast, thus offering a very limited declining profile from here, see more in *Yield Outlook - Transatlantic decoupling but not for much longer*, 28 November 2024. We do not expect a signal from the ECB to address the French spread widening to peers.

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank').

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and regulated by the Danish Financial Services Authority (Finanstilsynet). Danske Bank is authorised by the Prudential Regulation Authority in the UK. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request.

Danske Bank's research reports are prepared in accordance with the recommendations of Capital Market Denmark.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

None

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment, legal or tax advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

This research report has been prepared independently and solely on the basis of publicly available information that Danske Bank A/S considers to be reliable but Danske Bank A/S has not independently verified the contents hereof. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, completeness or reasonableness of the information, opinions and projections contained in this research report and Danske Bank A/S, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts and reflect their opinion as of the date hereof. These opinions are subject to change and Danske Bank A/S does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom (see separate disclaimer below) and retail customers in the European Economic Area as defined by Directive 2014/65/EU.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank A/S is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank A/S who have prepared this research report are not registered or qualified as research analysts with the New York Stock Exchange or Financial Industry Regulatory Authority but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Disclaimer related to distribution in the United Kingdom

In the United Kingdom, this document is for distribution only to (I) persons who have professional experience in matters relating to investments falling within article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the 'Order'); (II) high net worth entities falling within article 49(2)(a) to (d) of the Order; or (III) persons who are an elective professional client or a per se professional client under Chapter 3 of the FCA Conduct of Business Sourcebook (all such persons together being referred to as 'Relevant Persons'). In the United Kingdom, this document is directed only at Relevant Persons, and other persons should not act or rely on this document or any of its contents.

Disclaimer related to distribution in the European Economic Area

This document is being distributed to and is directed only at persons in member states of the European Economic Area ('EEA') who are 'Qualified Investors' within the meaning of Article 2(e) of the Prospectus Regulation (Regulation (EU) 2017/1129) ('Qualified Investors'). Any person in the EEA who receives this document will be deemed to have represented and agreed that it is a Qualified Investor. Any such recipient will also be deemed to have represented and agreed that it has not received this document on behalf of persons in the EEA other than Qualified Investors or persons in the UK and member states (where equivalent legislation exists) for whom the investor has authority to make decisions on a wholly discretionary basis. Danske Bank A/S will rely on the truth and accuracy of the foregoing representations and agreements. Any person in the EEA who is not a Qualified Investor should not act or rely on this document or any of its contents.

Report completed: 5 December 2024 at 15:20 CET

Report first disseminated: 6 December 2024 at 06:30 CET