Danske Bank

23 January 2025

Flash: ECB Preview

No new signals

- When the ECB meets next week, the policy decision is essentially already guided, namely another 25bp cut which brings the policy rate to 2.75%. This is a unanimous expectation among analysts and markets. With the near-term uncertainties prevailing from the Trump administration as well as continuing domestic economic resilience we do not expect new signals on the policy rate outlook. Thus we expect the three-tiered reaction function to prevail (inflation outlook, underlying inflation and strength of monetary policy transmission) and the data dependency to be reiterated.
- Markets are pricing virtually another 100bp worth of rate cuts this year. While we expect the ECB to cut more than this, we see the risk of a December repeat of an initial hawkish market reaction due to Lagarde not committing to the end point of this cutting cycle may play out again.

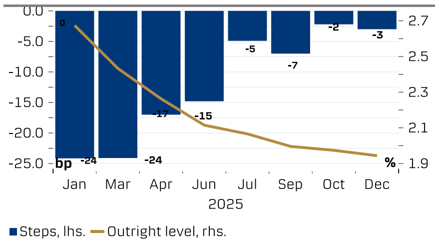
Markets price 100bp worth of rate cuts this year

The ECB's framework in recent quarters, focusing on data dependency and not data point dependency using its three-tiered reaction function, has led markets to trade its own narrative, as the ECB has chosen not to signal the policy outlook beyond the very near term. While it does not want to be *data-point* dependent, we find it difficult for the ECB not to weigh timely incoming data due to the elevated uncertainty surrounding the labour market and growth outlook. We saw it most recently in the fall last year where the weakness in European data in September / October made the ECB change the otherwise "hold guidance" to "cut guidance", and ultimately deliver a rate cut.

Under-appreciated risk as policy level approaches neutral

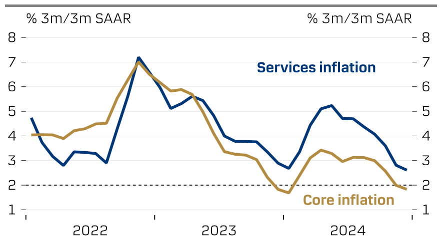
During the press conference following the December meeting, Lagarde said that they didn't discuss the neutral rate level, which means they did not discuss the end point of this cutting cycle. She did, however, say that the discussion would take place once they come closer to that neutral rate level. During that occasion she repeatedly referenced the *study* from earlier 2024 that pointed to a range of neutral real rates between -0.5% and 0%. Lagarde also said that the conventional wisdom suggests that the neutral rate is probably a little higher than before. Assuming a 2% inflation target, that means that they would only be at neutral in June this year, if they cut 25bp at each of the four upcoming meetings. This consecutive rate cutting cycle seems to be getting a wide backing, particularly by the doves for the coming 3-4 cuts of 25bp. Villeroy, Kazimir alluded to this while Vujcic said that he is not uncomfortable with the current market pricing. Knot said he is comfortable with the market pricing for the coming two meetings but needs to see further data for decisions after that. He is not convinced that they need to go into stimulative territory. While it's tangible for financial markets to discuss a yield level of where the cutting cycle ends, we find the key discussion to be had is what kind of policy stance is ultimately needed? We have only had limited guidance from GC members on this, with either guidance of a neutral stance or guidance of not being convinced to go into stimulative mode, however we expect this discussion to intensify in the GC after the March meeting.

ECB market pricing (€STR)



Source: Danske Bank

Momentum in core inflation below 2%



Source: ECB, 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

Director, FX
Jens Nærvig Pedersen
jenpe@danskebank.dk

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Front end volatility to pick up as ECB approaches neutral rate

Looking ahead to the spring 2025 meetings we identify an under-appreciated risk to front end volatility as we discussed in *COTW: The battle for April*, 17.1.2025. In short, while the following claim is difficult to validate, we still argue that once you are further away from the assumed terminal rate, you will have less volatility, and this is what we have seen in the past couple of quarters with declining volatility. However, as you approach the level of the neutral rate, front-end volatility will start to pick up again. The question now becomes, at what level / distance to neutral will volatility start to pick up again?

Assuming the current SOFR pricing vs. neutral rate pricing is any guidance, the level where volatility may pick up may be about 50bp from current levels. Coincidentally, this aligns well with our view of the January and March policy rate decisions from the ECB being rather straightforward - as, after that, we are at a 2.5% policy rate, prompting a bigger battle and divergence of views for the policy decisions. This is simply due to the probability the outcome space will not be as one-sided anymore as it will be in the next two months. As a result, we expect April will be the next key battleground for policy decisions - and markets price this as well.

Lower momentum in underlying inflation continues

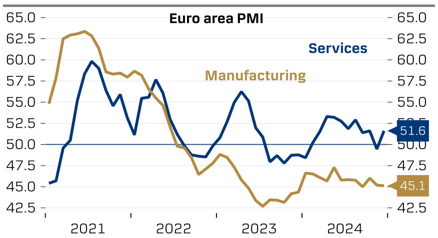
Since the December meeting, data has come out largely in line with the ECB's narrative of the economy. Growth is weak but not collapsing, the labour market is resilient, and underlying inflation continues to ease. The PMIs in December rebounded partially from the significant decline in November which likely provided some relief in the ECB. In December, the composite PMI rose to 49.6 from 48.3, signalling a stagnant but not collapsing economy, driven by a larger-than-expected bounce back in services, which increased to 51.6 from 49.5, bringing services PMI back to the same level as in October. On Friday, the January PMI will be released, which is ahead of next week's meeting, and thus will contain new information.

Headline inflation rose to 2.4% y/y from 2.2% as expected in December due to base effects on energy inflation, while the more important momentum in underlying inflation continued to move lower. Services momentum fell to 2.6% and core was below 2% for the second consecutive month at 1.8% in the 3m/3m annualised measure. Hence, December's data confirmed the narrative of weakening momentum in underlying inflation as momentum in services is coming in lower while goods remain very low. December's inflation figures resulted in the 2024Q4 average being marginally lower than the ECB staff predictions (0.1pp).

Labour market will be key for the ECB, but hard data is still strong

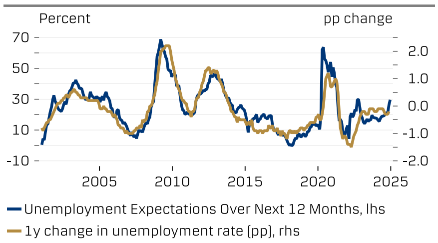
The ECB faces ongoing uncertainty regarding the labour market as survey indicators have softened in previous months. Unemployment expectations in the consumer survey jumped to a two-year high in December, and this indicator has previously led changes in the unemployment rate. However, hard data continues to show a solid labour market with rising employment in Q3 and the unemployment rate remaining at a record-low of 6.3% in November. Hence, the labour market remains very strong but forward-looking soft indicators point to risks of a deterioration.

Services PMI rebounded in December, providing some relief for the ECB



Source: S&P Global, Macrobond Financial

Unemployment expectations rose in December



Source: Eurostat, DG ECFIN, Macrobond Financial

Eventful week ahead for EUR/USD, but not because of the ECB

Next week could be another eventful one for EUR/USD. Not because of the ECB meeting since we do not expect any surprises here. (As an aside, the FOMC meeting the day before should not be a big market mover either, in our view.) But implied volatility in EUR/USD is high, because the market is anxious about what US President Trump will deliver in terms of key policies for the FX market, e.g. trade policies. He has already threatened to impose new tariffs on Canada, Mexico and China, possibly from 1 February – two days after the ECB meeting. Hence, there is a good chance that the news flow from the Trump administration will overshadow the ECB meeting, when it comes to EUR/USD. We expect EUR/USD to trade around 1.04-1.05 in the short term as we think Trump will under-deliver on some of his policy promises, but also because we think the recent US economic outperformance will fade a little.

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Expected updates

None

Date of first publication

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