02 June 2021

ECB Preview

First step to a soft exiting while keeping flexibility

- The ECB meeting on Thursday next week will focus on the financing conditions, PEPP implementation and cautiously optimistic view on demand amid weak CPI outlook. ECB is expected to raise its growth projections by 0.3pp for this year and next year.
- We expect ECB's PEPP purchase guidance to shift from 'significantly' to 'moderately' higher than at the start of the year, i.e. we expect PEPP buying to be EUR70bn/ month in Q3 versus the current net purchase pace of EUR80bn/month.
- We do not expect the meeting will alter our tactical nor strategic view on the rates (range trading & spread compression) outlook or FX (strategically stronger USD).

A balancing act – normalising, and keeping flexibility

It will be a challenging communication exercise that awaits Lagarde on Thursday next week. We expect that she and the ECB GC will convey a narrative of higher growth, with a still subdued inflation outlook yet at the same time also slow the current PEPP purchases slightly. At the current juncture, we believe it is fair to argue both for a lower but also unchanged PEPP net purchase pace given that we are still in the early phase of re-opening the European economies. Stournaras, Panetta and Villeroy indicated a preference to not taper PEPP purchases while Schnabel and Kazaks have fallen short of endorsing a similar conclusion.

Our preferred measures of *ECB financing conditions - what to watch - updated*, 21 May, are not concerning to a significant degree which also seems to be shared among various GC members. However, while financial markets have been broadly stable since the March ECB meeting, concerns about the tighter credit conditions (as also reflected in the April bank lending survey) and the risks thereof must be of concern.

We therefore expect a compromise on PEPP between going back to the Jan/Feb purchase pace (around EUR60bn/month) and keeping the current pace (around EUR80bn/month) to land around EUR70bn/month in Q3, but 15-20% lower in August due to seasonality, with the strengthening of the flexibility of the PEPP.

Transferring PEPP to APP? Not yet

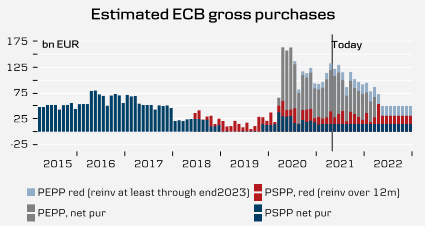
While market speculation has picked up on transferring PEPP modalities to the APP from March 2022 where the net PEPP purchases is currently expected to end, we do not expect such discussion to take place until the fall this year. Furthermore, as the PEPP is designed to address the COVID-impaired inflation and growth shortfall and PEPP's direct link to financing conditions, we do not take it as given that this will happen.

We believe that such discussions will be done on a bigger review and overall calibration of the instruments later this year, where we also expect TLTRO and tiering will be discussed.

10 June 2021

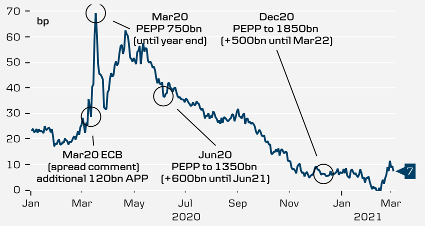
- 13:45 ECB decision
- 14:30 Press conference

Strong ECB buying even beyond March 2022



Source: Bloomberg, Reuters and ECB website

10Y euro area GDP weighted yield spread to EONIA



Note: Past performance is not a reliable indicator of current or future results
Source: Bloomberg, Macrobond, Danske Bank

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European forecasts set to be revised slightly up

With the technical assumptions little changed since March (see charts on next page), we expect the ECB new staff projections to paint a brighter economic outlook for the euro area. With the vaccination pace having picked-up in Europe during Q2 and the economic re-opening now fully underway in most euro area countries, activity has started to rebound in the services sector, while manufacturing continues to fire on all cylinders. The added external boost from the US fiscal packages - which were not yet considered in the March projections – as well the positive performance of the euro area economy in recent months should be reflected in upward revisions in the GDP forecasts for 2021 and 2022 by 0.3pp in both years and an overall balanced risk assessment, even in the near-term.

On the inflation side, things remain more mixed though. Core inflation has been on a declining trend since the start of the year and evidence of cost-push inflation from manufacturing supply bottlenecks has generally been scarce, even for goods. In light of the stronger economic momentum and tailwind from commodity price increase, we see scope for ECB's forecasts to paint a more optimistic picture of the near-term inflation outlook. That said, the medium-term outlook for core inflation will likely remain subdued around 1.4%, with HICP inflation in 2023 still falling short of the ECB's target. Service price developments especially hold the key for a turnaround in the underlying inflation pressures. Labour market developments, fiscal stimulus and possible supply constraints in service sectors after re-opening will be key to watch in that respect.

Still strong ECB buying beyond March 2022

PEPP net buying is gradually going to end as the pandemic impaired shortfall in the economic outlook is abating. ECB has taken a decision that the PEPP net buying will run at least until March 2022, and in our expectation this is going to be the final net PEPP buying. The end may only be communicated shortly before the actually end though, potentially in December this year or at the January meeting next year.

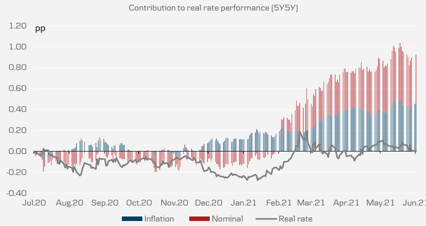
In any case, the 'stock effect' of the large balance sheet will make ECB a dominant actor in the European bond markets. Even assuming that ECB is not net buying bonds in Q2 next year, we expect gross buying of around EUR50bn/month in the public sector sphere, split between net PSPP purchases, PSPP and PEPP reinvestments (chart on front page). See more in *COTW: ECB buying set to drive free float of government bonds lower*, 29 April

As a result, the low sustainable inflation outlook combined with a continuation of strong ECB buying is expected to keep a 'lid' on rates. The EUR front end of the curve has steepened somewhat to have a first 10bp rate hike priced in already in Q2 2023, which is premature in our view and we prefer to receive such positions with a 2y forward start.

FX: Dollar to stay range bound, stronger in H2

We do not expect the ECB meeting next week to prove a major catalyst beyond simply revising growth expectations a tad higher, a theme also recently echoed by OECD. In our view, this will mean little for EUR/USD, which is already standing at elevated levels at 1.22. While we are quite some time from talking about a potential exit of pandemic and maybe even loose monetary policy in the euro area, such a discussion remains a key risk to take EUR/USD higher. In the short-term, markets will likely turn their focus towards the FOMC meeting as the direction of real dollar yields have been key in forming short-term moves in spot dollar, and notably so during 2021. We continue to forecast EUR/USD at 1.15 in 12 months.

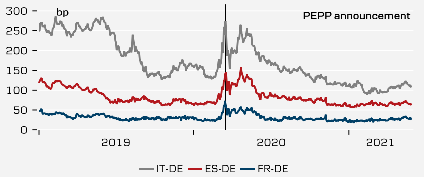
Real rates are broadly unchanged from March



Note: Past performance is not a reliable indicator of current or future results.
Note: Change since 1 Jul 20
Source: ECB, Danske Bank

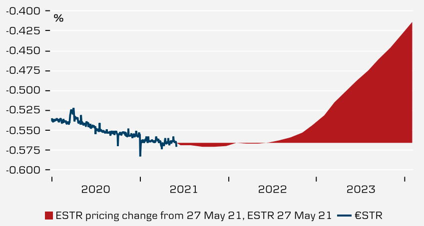
Intra-euro area spreads are still tight

Sov yield spread vs. Bunds and ASW spreads for financials and corps



Note: Past performance is not a reliable indicator of current or future results.
Source: ECB, Macrobond Financial, Danske Bank

ECB market pricing



Note: Past performance is not a reliable indicator of current or future results.
Source: ECB, Macrobond Financial, Danske Bank

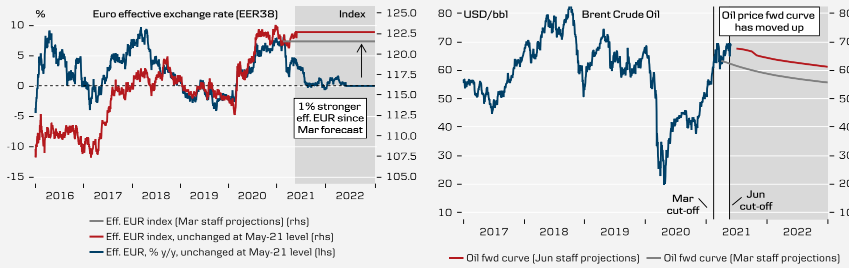
Near-term brighter growth and inflation outlook (ECB staff projection and expectation to revisions)

ECB projections June 2021	2021		2022		2023	
GDP growth	4.3% (4.0%)	↗	4.4% (4.1%)	↗	2.1% (2.1%)	→
HICP inflation	1.9% (1.5%)	↗	1.4% (1.2%)	↗	1.4% (1.4%)	→
Core inflation	1.1% (1.0%)	↗	1.2% (1.1%)	↗	1.3% (1.3%)	→

Parenthesis are the old ECB projections (from March 2021)

Source: ECB, Danske Bank

Technical forecast assumptions little changed since March



Source: ECB, Macrobond Financial, Danske Bank

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Report completed: 2 June 2021, 14:00 CET

Report first disseminated: 2 June 2021, 14:15 CET