08 December 2022

ECB Preview

A hawkish 50bp

- At next week's meeting, we expect the ECB to deliver a 50bp rate hike with a hawkish twist. Specifically, we expect the ECB to present key principles of the end to reinvestments under the APP process (in which reinvestments will almost come to a full stop) and an open-ended wording for more rate hikes to come. This will be a compromise, which we believe will be palatable to both hawks and doves.
- Nominal rates have repriced lower since the latest meeting in October by almost 40bp (10y EA GDP-weighted yield), while inflation has increased somewhat and as a result the 1y forwards have repriced back to late August levels. We expect the hawks to use the easing of financial conditions in the past weeks to argue for a more aggressive calibration, as textbook would say that the current ECB stance is not particularly restrictive.
- The European economy fared surprisingly well in Q3, but we expect the ECB to have a mild recession in its baseline staff projections. For inflation, we expect the new staff projections to only point to headline inflation at the 2% target in 2025.
- We currently expect ECB rate hikes into Q1 next year, with the deposit rate peaking at 2.75%, but with risks skewed for more hikes.

A (hawkish) compromise

In the past couple of weeks, we have seen a resurfacing of the doves in the public debate on the monetary policy calibration. Ahead of the October meeting, when all GC members were zooming in on a 75bp rate hike, we did not hear much from the doves, but that has now changed, with notably Lane and Panetta arguing for a moderation in the hiking cycle pace. However, particularly Schnabel, Holzmann and Knot have been sending hawkish signals, with notably Schnabel being very vocal on a 75bp hike. Since the October meeting, we have also noted Lagarde choosing a more upbeat wording on wages (which admittedly also Lane adopted), from 'wages are picking up' last week compared to 'wages may be picking up' in October. That means with differing views, we expect the GC to strike a compromise at next week's meeting. We expect the doves to focus on slowing the hiking pace to 50bp, with an agreement to continue to hike rates for as long as needed on a data dependent and meeting-by-meeting approach. This will be palatable to the hawks, as we expect them to get a more hawkish calibration on the end to the APP reinvestments.

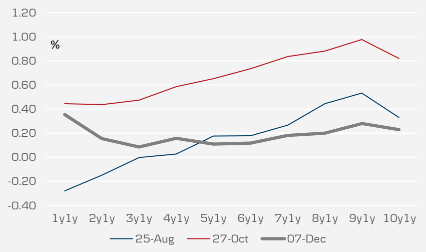
Despite recession, 'stickily' high core inflation could remain a concern for the ECB for some time yet

Economic data since the September meeting highlight the rising recession risk for the euro area economy (see *Euro Area Macro Monitor - Chilling prospects*, 6 December). Comments from various GC members suggest that a short recession this winter is increasingly becoming the consensus view, but also that a mild recession may not be enough to quell the above-target inflation pressures. Hence, we expect the new staff projections to reflect a weaker growth outlook for 2023 and 2024, with growth returning to

15 December

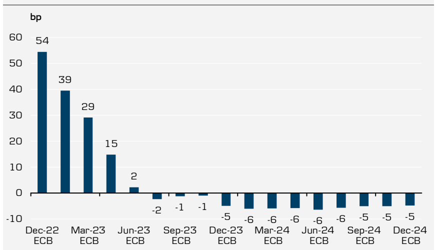
- Decision to be announced at 14:15 CET and press conference at 14:45 CET. We also expect a technical document with QT principles to be released at 15:45 CET

Real rates do not point to a restrictive monetary policy setting



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

Market pricing for rate hikes in coming meetings



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Source: Danske Bank

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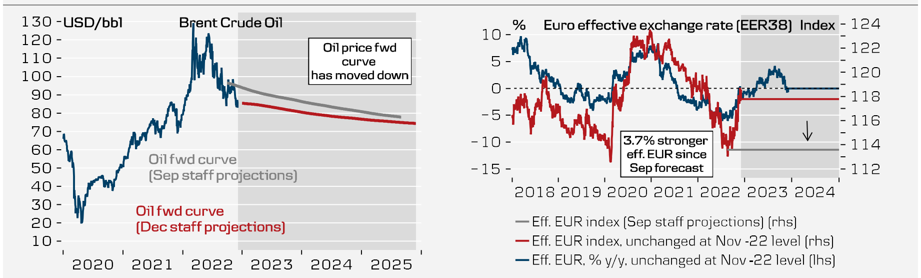
potential in 2025. We remain gloomier on the economic outlook and see a real risk of a double dip recession, as lingering energy troubles, weaker foreign demand and tighter financial conditions will weigh on the euro area growth prospects (read more in *Big Picture Euro area - Double dip recession*, 28 November).

On the face of it, the November flash HICP figures brought a welcome decline in headline inflation from 10.6% to 10.0%. However, with core inflation holding steady at 5.0%, the evidence for a similar peak in underlying inflation pressures was less clear-cut. Firms continue to pass on higher input costs to consumers and in spite of an approaching recession, we expect this process of cost-push inflation to extend into 2023 (read more in *Euro inflation notes - A 'sticky' problem*, 30 November).

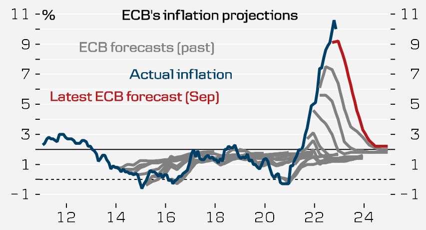
Despite lower oil prices and stronger currency feeding into forecasts, we expect staff projections again to show a notable upward revision in the inflation outlook, as inflation has continued to surprise on the upside since September and evidence of rising wage growth has become more clear (see also *Bank of Ireland wage tracker*). That said, the stabilisation in core inflation paired with the weakening growth outlook and inflation returning to the target in 2025 might be just enough evidence to slow the hiking pace to 50bp in December. However, we expect the ECB to continue to guide for further rate hikes ahead, paired with a reduction of the balance sheet (QT), as 'stickily' high core inflation could remain a concern for the ECB for some time yet.

Lower oil price and stronger euro feed into projections



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

Inflation has continued to surprise on the upside since September



Source: Eurostat, ECB, Macrobond Financial, Danske Bank

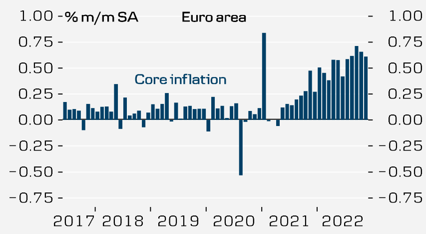
Inflation back to target in 2025

ECB projections December 2022	2022		2023		2024		2025
GDP growth	3.3% (3.1%)	↗	0.1% (0.9%)	↘	1.2% (1.9%)	↘	1.5%
HICP inflation	8.4% (8.1%)	↗	6.3% (5.5%)	↗	2.4% (2.3%)	↗	2.0%
Core inflation	3.9% (3.9%)	→	3.6% (3.4%)	↗	2.3% (2.3%)	→	1.9%

Parenthesis are the old ECB projections (from September 2022)

Source: ECB, Danske Bank

Core inflation momentum has stabilised

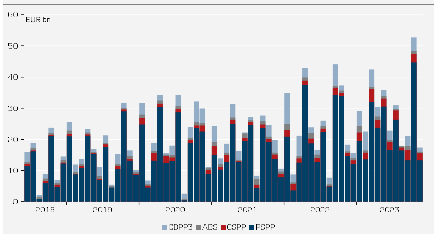


Source: Eurostat, Macrobond Financial, Danske Bank

End to reinvestments set to be aggressive but predictable

The ECB has clearly communicated that it will lay out the principles of the end to APP reinvestments, while the PEPP reinvestments are expected to continue until the end of 2024 as previously guided. The APP bond portfolio is currently standing at EUR3,256bn of which EUR2,585bn is in public sector bonds. No GC members have mentioned specific numbers or formats of how this end to APP reinvestments will be done, other than it will be a measurable and 'predictable' format. We see essentially three ways in which QE holdings can be normalised: (1) full stop to reinvestments (Riksbank-style), (2) cap to the amount of bonds that mature (Fed-style) and (3) sales of bonds (BoE-style, but that is really not an option in our view). Examining the redemption profile of the APP programme, a full stop to APP reinvestments would amount to EUR272bn of bonds between 1 March and 30 November 2022, of which EUR217bn is in the public sector bonds. If a cap is put on the APP per month and not for each programme separately, a cap of e.g. 30bn/month would equal EUR212bn (March-October 2023). Should the ECB decide to cap the amount of bonds that is not reinvested, this option comes with a flexibility to support e.g. CBPP and CSPP in months with large redemptions. However, still reinvesting a smaller amount gives

APP redemptions



Source: ECB, Macrobond Financial, Danske Bank rise to technical implementation difficulties, such as under which programme and jurisdiction it may be done in.

We expect the ECB to start its end to reinvestments on 1 March 2023 and no later than 1 April 2023, but that decision will be taken at the February meeting.

It is difficult to gauge what the market impact of QT will be in yield terms, but applying Schnabel's EUR500bn of PSPP buying roughly equates to EA yields declining 16bp and we may get some 6-7p upside. That said, the signalling value is big.

Looking into next year, the absence of ECB net purchases is set to be the biggest driver of net supply.

We do not expect further changes to the TLTRO modalities. On 9 December, the ECB will announce the amount of early repayments for the December option. We expect a number similar to the November option, i.e. around EUR300bn.

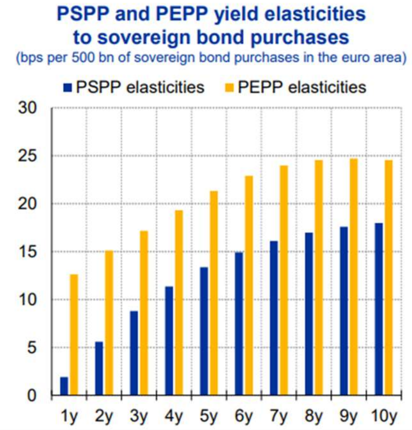
Markets are (almost) perfectly priced for a 50bp hike

Markets are currently pricing next week's ECB meeting at 54bp, which means less than a 20% probability of 75bp rate hike. We think this is fairly priced. Looking further out the front-end curve, we see that the cycle peak rate is priced at 2.8%, virtually in line with our baseline forecast of 2.75%, albeit we highlight that risks are skewed for more hikes amid 'sticky' inflation pressures.

Busy week ahead with multiple potential EURUSD drivers

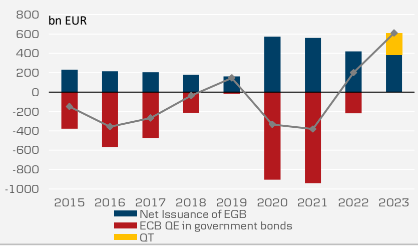
For EUR/USD, the ECB meeting will conclude a busy week that also includes US CPI and the FOMC meeting. Overall, we do not expect a 'hawkish 50bp hike' will leave a big impact on EUR/USD, but it depends on the momentum heading into the meeting. The market may feed off a hawkish ECB, if US CPI inflation drops again and the Fed comes across as dovish and sends EUR/USD to new highs. Vice versa, higher US CPI inflation may turn around momentum in EUR/USD, send it back down and leave the ECB meeting less relevant.

QT impact on euro area bond yields



Source: Schnabel 20 Sep 21, *ECB*

Net issuance of government bonds, QE purchases



Source: DMOs, Danske Bank

ECB cycle-high policy rate

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

Disclosures

This research report has been prepared by Danske Bank A/S (‘Danske Bank’). The authors of this research report are Piet P. H. Christiansen, Chief Analyst, Aila Mihr, Senior Analyst, and Jens Nærvig Pedersen, Chief Analyst.

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Expected updates

None

Date of first publication

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

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