19 October 2021

ECB Preview

The prelude to December

- Next week's ECB meeting is largely a prelude to the December meeting, where new staff projections will base the foundation for the exact calibration of its instruments.
- We expect ECB to flag risks to the outlook and as such not deviate from the current baseline and send new policy signals already now but wait for a new projections round in December. The September projections are already outdated given the recent spike in energy and slowing growth outlook. That means that we still expect ECB to repeat that they believe that the current inflation outlook is largely transitory, as Lagarde also said this weekend, but that narrative will be tested until the December meeting.
- We believe that ECB will attempt to make the meeting as uneventful as possible. From a market perspective the euro area rates have been driven by the BoE's change in tunes as well which have also raised concerns about the transitory narrative ECB is conveying. We expect significant pushbacks against the current rate hike pricing in December 22.
- What if: Markets are already testing ECB on its narrative. For ECB to 'give in' to the current market pricing (with rate hike priced for Dec22), we would need to see ECB acknowledging upside risks to underlying inflation and risk of inflation expectations being entrenched already next week as a first step. That will later open the possibility for APP and change of forward guidance in reasonable time (H1 next year) for a rate hike to materialise. In our extreme scenario (5%) we can see an ECB hike in mid-2023, see more in *COTW: What if inflation is coming. Can ECB hike in 2023?*

The fate of APP and delinking end of APP and first rate hike guidance...

PEPP is widely, if not by all, expected to end in March next year, and hence focus has changed to the 'conventional' purchase programme APP and how should it be calibrated. The devil is in the detail, but we expect that ECB can still end PEPP and send a patient / dovish signal.

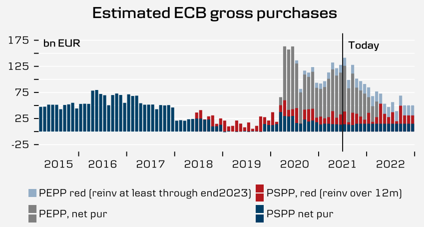
In our view, a calendar-based forward guidance to e.g. June or December 2023 combined with a 'well past the horizon of net asset purchases' on the first rate hike similar to 2016-2018 guidance is warranted – and should give markets the needed confirmation to significantly reprice ECB expectations of any normalisation (see discussion later). Such move would also be warranted in light of the strategy review outcome which showed that ECB will tolerate overshooting the 2% inflation target.

Several 'trial balloons' on the upcoming calibration have floated markets, from ECB could deviate from the capital key (in our view, this is very unlikely) to ECB increasing the focus on supra bonds as a way to mitigate the challenges with ISIN / Issuer limits (likely). As said above, the devil is in the detail on how markets will perceive it, but **firstly ECB should settle on a narrative before discussing calibration measures.** Will they continue to focus on financing conditions in its current form or will they change? We should not attach zero

28 October 2021

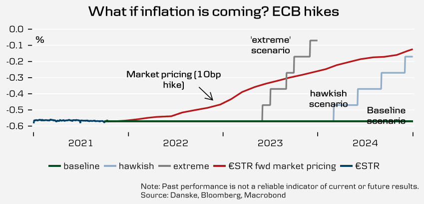
- 13:45 ECB decision
- 14:30 Press conference

Strong ECB buying even beyond March 2022



Source: Danske and ECB

Markets are very aggressively priced in the front end



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Source: Bloomberg, Macrobond, Danske Bank

Chief Strategist, ECB and Fixed Income Research
Piet Haines Christiansen
+45 45 13 20 21
phai@danskebank.com

Senior Euro Area Analyst
Aila Mihr
+45 45 12 85 35
amih@danskebank.com

Senior FX Analyst
Lars Sparresø Merklin
+45 45 12 85 18
lsm@danskebank.com

probability to any outcome, but in our view, a simple scale up from EUR20bn/month to EUR40bn/month will be the base. Some GC members have also advocated to flexibility under the APP to allow, for example, a special envelope, which could be used to respond to unexpected shocks. Some have argued for Greek bond purchases as well.

We expect a broad consensus at the meeting, but looking ahead, the divergence of views on the inflation and growth narrative will become more visible in coming weeks, and a big battle on the calibration will take place in December.

... as inflation expectations continue to rise

Inflation markets have been on a sharp rise during the past months, and 5y5y EUR inflation forward swaps touching 1.90% will clearly be noted in the ECB. The SPF, which will be released later this month, will also provide important input for ECB to take into account. At the time of writing, we do not know the updated figure, but the July release showed that analysts are revising their longer-term inflation projections as well with 65% of respondents expecting inflation at 1.5%+ in 5y time.

Market pricing is at odds with the ECB guidance

Following the repricing in the longer-end of the curve, as well as changing tunes from the BoE and Fed, where first rate hike expectations have moved significantly in, markets are now pricing a first 10bp rate hike by the ECB in December next year. This is way too aggressive and not even in our most extreme scenario we can justify that pricing given the current guidance on the sequence, see more in *COTW: What if inflation is coming. Can ECB hike in 2023?*, 15 October.

Current ECB forward guidance says that APP will 'end shortly before it starts raising the key ECB interest rates', again confirming the sequence of hiking rates

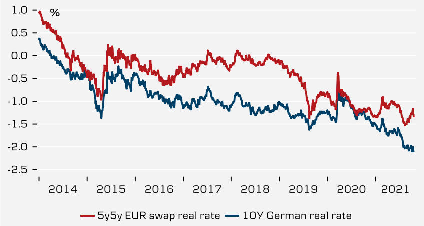
Before hiking rates, the ECB has to 1) acknowledge that inflation is not transitory, 2) remove 'at present or lower' and 3) end APP before hiking rates. And before reaching the conclusion that inflation is not just transitory, ECB has set up these three criteria on its inflation outlook, which all suggest to us that it will be patient and need further data before changing the narrative;

1. Inflation target met 'well ahead' of forecast horizon, which provides reassurance that the convergence of inflation towards the new target should be sufficiently advanced and mature at the time of policy rate lift-off.
2. Durability of inflation dynamics, which relies on the wage dynamics, and as such that inflation is not 'just' transitory
3. Progress, which means that underlying inflation should be strong enough to progress to target and also based on realized data

Slowing momentum are increasingly visible

Since the September meeting more signs have emerged that the economic momentum is turning lower in the euro area (see also *Euro Area Macro Monitor - The tide is turning*, 5 October). The slowing growth momentum is increasingly visible beyond manufacturing and supply constraints have started to weigh on demand that points to lower growth ahead. A surge in natural gas and energy prices and HICP inflation rising to the highest level since 2008 during September has further fuelled markets' fears about stagflation. Consequently, focus during the October ECB meeting will be on whether the Governing Council stays true to its 'transitory' inflation narrative or whether disagreements over the persistence of inflation are becoming more pronounced. Despite rising inflation expectations, we continue

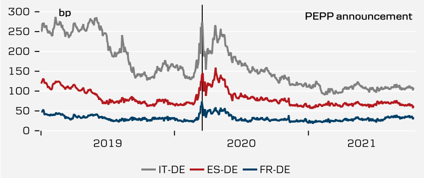
Real rates are at record low levels



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

Intra-euro area spreads are still tight

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



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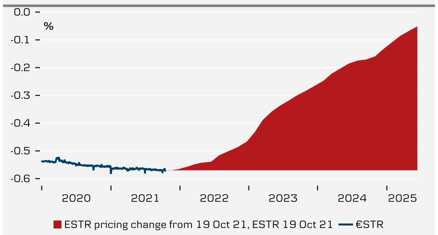
Source: ECB, Macrobond Financial, Danske Bank

ECB market pricing



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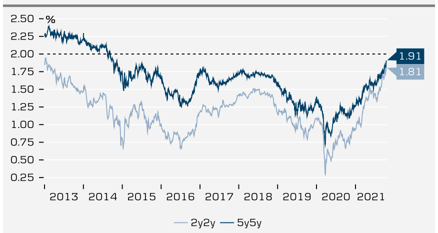
Source: ECB, Macrobond Financial, Danske Bank

Market-based inflation expectations



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

to see few signs that unions are increasing wage demands that would support the case for rising underlying inflation pressures. But the combination of slowing growth and elevated near-term inflation pressures arguably presents a tricky communication exercise from the ECB's perspective as it gears up to its next policy 're-calibration'. The ECB's Survey of Professional Forecasters will also be examined given the nature of the respondents to gauge if second-round effects are expected and the stickiness of the inflation surge.

FX: Relative interest rates are only short-term driver of EUR/USD

For EUR/USD, relative interest rate pricing between ECB and Fed appear to be a small driver and noticeably so when it is European interest rates which are moving. While ECB has been strongly repriced, this have had and should in our view continue to have a negligible but positive effect. In our view, the key driver of spot continues to be the holistic view that liquidity conditions are tightening, global manufacturing slowing and that EUR/USD is facing these headwinds from an elevated level. That said, we have repeatedly seen a simple connection where the mood of the ECB is reflected in EUR/USD on the day. Hence, if we are right in the view that Lagarde will push against the pricing in interest rates and talk against risks to the inflation outlook being for the upside, then we may very well see spot slightly lower. Conversely, learning in to the hawkish view of markets would be EUR-supportive. Our general view continues to be that EUR/USD will slowly drift lower over the coming year, targeting 1.10 in 12M.

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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 Lars Sparresø Merklin, Senior 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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