28 January 2022

ECB Preview

Inflation uncertainty and data dependency

- The Fed meeting this week has turned the ECB meeting on Thursday next week much more interesting than anticipated from a market perspective. While we do not expect the meeting to bring significant new signals to the market, attention to the elevated inflation and even more data dependence as well as the difference to Fed will be in focus.
- Since the December meeting, where ECB communicated its planned monetary policy calibration until October 2022, no data release has warranted a change in stance. We expect ECB to convey a robust, yet slowing, economic outlook and an elevated uncertainty on the inflation outlook with a confirmation of inflation expected to settle below the 2% target towards the end of the year and in 2023 and 2024.
- We expect attention to the recent rise in real rates, but given the absolute level of the metric, we do not believe this would give cause for concern at the ECB.
- We do not see ECB giving indications to follow the other major central banks in their tightening cycle. To us, it would be a surprise if ECB were to announce new TLTRO rounds at the meeting next week. We continue to expect tiering multiplier to be increased to 12 later in the year (most likely in June).
- From a near-term market reaction perspective, we remain unconvinced whether markets will buy into the ECB's wait-and-see stance and keep the very aggressive front end pricing for Dec22 (which are 21bp).

Uncertainty highlighted – but direction of travel is for tighter policy

We expect ECB to repeat the inflation and growth narrative from December, although with downplayed risks from Omicron effects and increased risks from the geopolitical tensions in Eastern Europe. That also means we expect that the risks for prolonged elevated inflation due to bottlenecks, high energy prices and wage growth outlook uncertainty will be flagged. We also expect the very negative real wage growth to be highlighted as a headwind to the economic outlook, and a concern to the eroding nature of the purchasing power. Importantly, we do not expect ECB to assess the current inflation as transitory, but as inflation shifting closer to the target while still settling below the 2% inflation target, in the baseline scenario. Despite all the above, we continue to believe that the direction of travel is for tighter policies from the ECB, but the pace is uncertain.

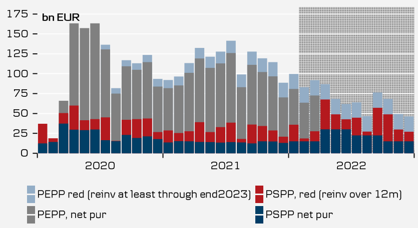
Financing conditions still easy, despite the rising real rates

Since the March meeting last year, the focus on real rates has been receiving a more prominent role. Since the start of the year, we have seen the 10y GDP weighted real yield rising above the levels seen through most of H2 last year. However, we do not expect this to be a major source of concern given the still the very low level in historical comparison.

3 February 2022

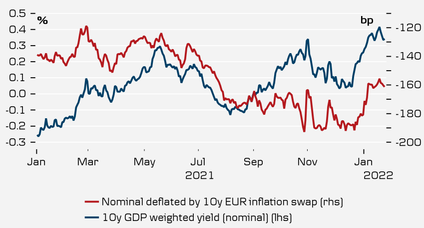
- 13:45 ECB decision
- 14:30 Press conference

Strong ECB buying even beyond March 2022 (Estimated gross purchases)



Source: Bloomberg, ECB , Danske Bank

Real rates repriced since the start of the year, but stay well below historical levels



Note: Past performance is not a reliable indicator of current or future results

Source: Bloomberg, Macrobond, Danske Bank

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All eyes on wages

Since the December meeting, incoming data supports ECB's view of an ongoing recovery in 2022, but persistently high price pressures continue to be high on ECB's worry list. Specifically, business surveys suggest the euro area economy is weathering new COVID-19 headwinds better than expected, at the same time as manufacturing activity is strengthening amid easing supply chain bottlenecks.

HICP inflation surged to yet another record high of 5.0% in December, with increasing signs of broadening core inflation pressures (January flash inflation will be published on Wednesday 2 February, ahead of the ECB meeting). An escalation of Russia-Ukraine tensions remains one of the biggest upside risks to energy prices in the near-term, that could add another 0.7-1.5pp to our baseline forecast for euro inflation of 3.3% in 2022 and create another hit to demand (read more in *Research Russia - Expect serious market disruptions if a war breaks out*, 14 January).

Despite growing divisions in the GC and uncertainty about the inflation dynamics (as visible in the December meeting minutes), there remains consensus in the Governing Council that achieving its inflation target in the medium term is unlikely to come about without dynamic wage growth. Recent *comments* from Chief Economist Lane suggest that wage growth around 3% (2% inflation, 1% productivity growth) would be consistent with that goal. So far, wage agreements do not yet point to a material uptick, with negotiated wage growth standing at 1.4% in Q3 21. However, anecdotal evidence and increasing signs of labour shortages also in Europe, leave us to expect a pick-up in wage growth in H2 22, that should keep core inflation above 1.5% also in 2023. For now, we expect ECB to remain patient and stress its data-dependency, but there is no doubt in our view, that wages will be the single most important indicator to watch this year, that could potentially trigger a faster policy normalisation. ECB President Lagarde has said last week that they do not see this risk now. ECB staff projections point to 2.9% wage growth in 2023 and 2024, close to Lane's 3% level.

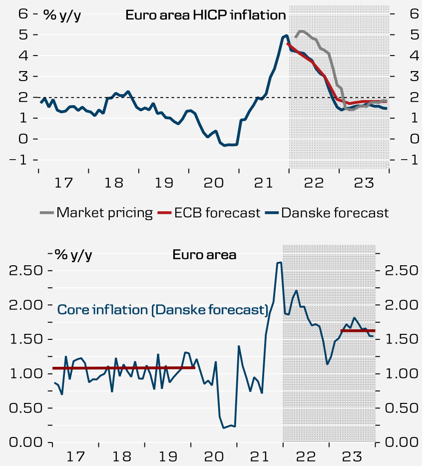
Inflation markets and front-end pricing do not speak the same language

Markets have priced in an aggressive monetary policy rate path for this year with 21bp in €STR terms, but the 2023 and 2024 with 39bp and 15bp are more balanced/on the aggressive side and conditional on 2023 respectively. We find the recent broadly unchanged front-end pricing despite long-end sell-off (disregarding the reaction from Wednesday's FOMC meeting) quite remarkable. At the same time, inflation market measures have settled around the 1.8% level in 5y5y and 2y2y inflation swap terms, which we believe is inconsistent with the call for higher policy rates. Inflation markets are pointing to a peak in fixing in February of 5.1%, and are priced for a marked drop towards the end of the year, (driven by the backwardation in oil futures) and settle below 2%.

Global central bank spillover

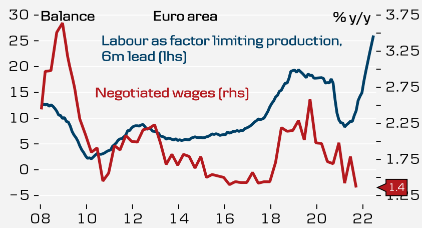
Without doubt, Lagarde will face questions in light of ECB's still divergent stance to other central banks, and notably its US counterpart, the Fed. We expect Lagarde to repeat that ECB are subject to euro area data and that ECB conduct independent monetary policy, and repeat that a rate hike this year is still 'very unlikely'. We believe that a deviation from this view will cause a sell-off and increase rate hike speculation from the ECB. On the other hand, we believe that for Lagarde to talk 2022 pricing flatter would require a significant effort to convince markets. We doubt she can change the strong momentum in front end in this regard.

Inflation worries remain...



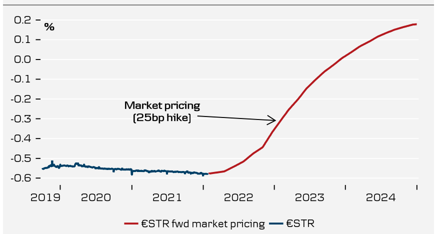
Source: Eurostat, ECB, Macrobond Financial, Danske Bank
Note: Past performance is not a reliable indicator of current or future results

... But wage pressures are the key missing ingredient



Source: EU Commission, ECB, Macrobond Financial, Danske Bank

Markets point to 25bp priced in for March 2023



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Source: Bloomberg, Macrobond, Danske Bank

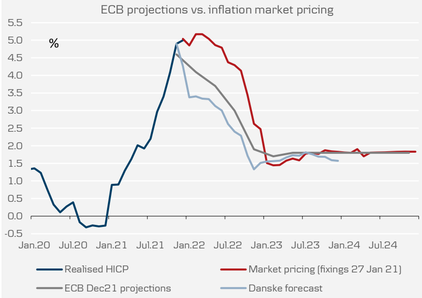
EUR/USD fade if optimism is conveyed

With EUR/USD having gapped down after the FOMC meeting, breaking a two-month range and hitting a new post-covid low of 1.1150 at the time of writing: The bar for a small uptick via ECB optimism is low.

On the ECB meeting itself, we have several times seen that if optimism is conveyed, then EUR/USD can go a tad higher (around 50pips). However, if so, we expect such move to unwind in the following week. Further, should ECB guidance be aligned with the rates market pricing we expect a similar pattern: a one-off level shift higher followed by a fade. This is likely so as the economic environment in which ECB could (but probably will not) turn hawkish is characterised by slowing growth and elevated price pressures. Given that EUR/USD reflects the holistic state of the European economy, we do not think that talks of rate hikes would do much to instil optimism on a 1M+ horizon.

Looking beyond the ECB meeting itself, our base case remains to see the EUR/USD spot towards 1.08 in 12m. The risk to this view is EU-wide fiscal easing amid an industrial production uptick as inflation fades on the back of supply chain issues being resolved. We have a low probability of this scenario happening but it is the upside risk to EUR/USD over 2022.

Market pricing suggests fixings to peak in February



Note: Past performance is not a reliable indicator of current or future results

Source: Eurostat and, Danske Bank

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Expected updates

None

Date of first publication

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