2 March 2023

ECB Preview

Higher for longer – now seen at 4%

- Underlying inflation pressures have yet to improve for the ECB to signal an end to its policy rate hikes. Since the February meeting, the economic outlook and labour market still show resilience, pushing the eventual end of ECB hiking further out.
- Accordingly we adjust our expectations for the policy path from ECB and now expect a policy peak rate of 4% (deposit rate), with hikes of 50bp in March, 50bp in May, 25bp in June and 25bp in July. We naturally remain data dependent and may adjust the call at a later stage, but for now we see the risks around our baseline rate hike expectations as broadly balanced. Our revision comes on the back of more resilient economic activity and more 'sticky' underlying inflation developments.
- We see the 50bp rate hike ECB intends to deliver at the March meeting as a 'done deal', but the key discussions at the meeting will be on the guidance for the May meeting on the back of the new staff projections.

A 'sticky' problem

The brightening euro area economic outlook since the start of the year remains a double-edged sword for the ECB. Although headline inflation has on balance surprised on the downside compared to the December staff projections thanks to lower energy prices, the same cannot be said for core inflation which reached yet another record high of 5.6% in February. Underlying inflation measures have yet to show signs of peaking and selling-price expectations in business surveys suggest firms are far from finished passing on higher input and energy costs to consumers (see charts on page 3). In our baseline, core inflation will only dip below 4.5% in August.

This is partly also due to demand holding up better than expected. Unemployment remains at rock-bottom and surveys suggest firms intend to hire more, rather than plan large scale job cuts. Chinese pent-up demand will likely boost activity in the coming months and we have revised our euro area growth outlook upwards (see *Euro macro notes - From recession to stagnation*, 2 February). But although a fully-fledged recession will likely be avoided, a strong recovery is not yet in sight either, as monetary headwinds persist and stagnation still defines the outlook.

Energy prices have fallen sharply since the December projection and hence we expect headline inflation to be revised lower. That said, with the economy and labour market holding up better than expected, 'stickily' high core inflation will remain a worry for the ECB for some time yet, requiring policy rates to stay in restrictive territory for longer.

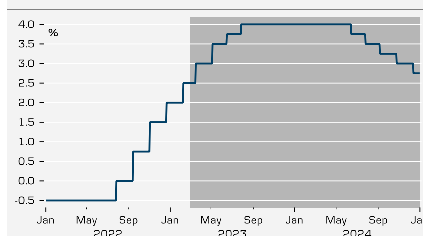
ECB focused on core inflation

The ECB has most recently been very attentive to the underlying inflation pressure building and its persistence, and as such also wages. Across the various underlying inflation measures that we (and the ECB) monitor, we only see the PCCI as having peaked, but all other underlying inflation measures are still increasing. Wages are crucial to follow in this discussion and the most recent Indeed Wage Tracker suggests wage growth around between 4.5-5% currently, which is not compatible with the 2% inflation target.

16 March 2023

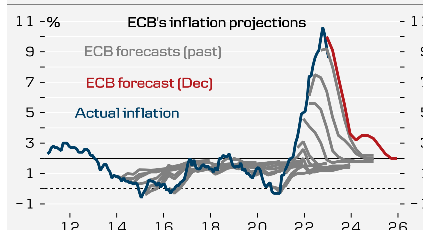
- Decision released at 14:15 CET and press conference at 14:45 CET.
- We expect the ECB deposit rate to peak at 4%, with a 50bp rate hike in both March and May followed by 25bp hike in both June and July

New ECB rate policy path



Source: Macrobond Financial, Danske Bank

Headline inflation has surprised to the downside due to lower energy prices



Sources: Eurostat, ECB, Macrobond Financial, Danske Bank

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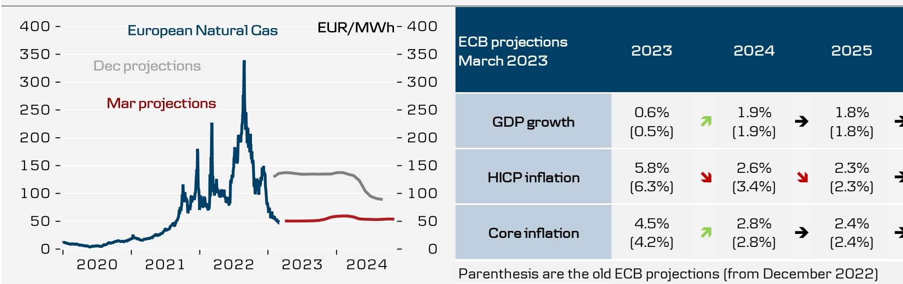
Lower oil prices and stronger euro feed into projections



ECB projections March 2023	2023		2024		2025	
GDP growth	0.6% (0.5%)	↗	1.9% (1.9%)	→	1.8% (1.8%)	→
HICP inflation	5.8% (6.3%)	↘	2.6% (3.4%)	↘	2.3% (2.3%)	→
Core inflation	4.5% (4.2%)	↗	2.8% (2.8%)	→	2.4% (2.4%)	→

Parenthesis are the old ECB projections (from December 2022)

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

Sources: ECB, Macrobond Financial, Danske Bank

Hiking until July

With the underlying inflation pressures still to show significant weakening, we have adjusted our expectations for further policy tightening. We expect the ECB's deposit rate to reach 4% in July via a 50bp hike in March and May followed by a 25bp hike in June and July. Our 4% risk scenario we discussed in late January *here* is materialising. We see the risk to our rate hike profile as broadly balanced. Markets are pricing in a peak policy rate slightly below 4%.

'In the absence of significant improvement': 50bp guided for May

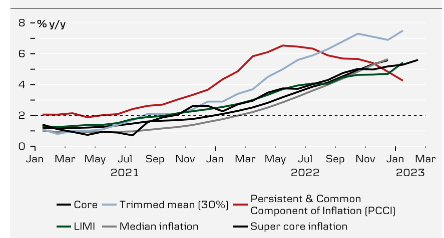
The ECB's mantra of being data dependent and adopting a meeting-by-meeting approach is set to continue. At the March meeting it seems to be a straightforward decision with a 50bp rate hike but the uncertainty about May is much greater and this is where we expect the key discussions to be focused. We believe the ECB will have to give some indications to markets of its expected rate hike size in May, without making an irrevocable commitment. We expect the guidance will be that 'in the absence of sufficient improvement in underlying inflation dynamics' the ECB will hike at a similar magnitude as in March.

Markets have repriced policy expectations significantly since the February meeting by 45bp to 3.99%. For May, markets are pricing 42bp. We believe that the communication outlined above will be a palatable compromise for the doves as well, given the data dependent approach (we have two inflation prints, two PMIs and a bank lending survey before the May meeting).

Cuts in 2024

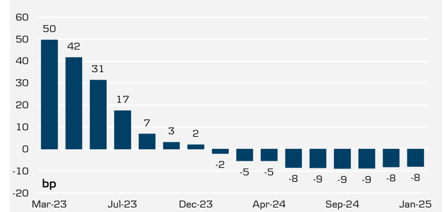
It may be early to discuss ECB rate cuts as we are still in a tightening cycle with another 150bp to be delivered before the peak, but eventually the ECB will have to cut rates again once the medium inflation outlook is in line with target. In our baseline scenario we see the ECB cutting rates despite the euro area not being in a recession. As inflation (and its expectations) is set to gradually decline following ECB tightening, the ECB will have to cut its policy rates, not to ease monetary policy but to keep an unchanged monetary policy stance. If not, the rising real rates would become gradually more restrictive for the monetary policy stance. Former ECB President Draghi discussed this approach in his 2017 Sintra speech. We expect the ECB to keep rates at the 4% level until early summer 2024 before a gradual rate cut cycle will start. Should underlying inflation pressure and wages (which are currently trailing around 4.5-5%) fall quicker than anticipated, the ECB may have to adjust its policy rates earlier. **We like to position for a flattener (more inversion) of the Sep23 vs. Sep24 Euribor which currently stands at -33bp for a target of -65bp (and stop loss at -20bp).**

Underlying inflation measures



Source: Macrobond Financial, Danske Bank

Market pricing for rate hikes



Source: Danske Bank

€STR cycle high rate

Note: Add 10bp for deposit rate level. Past performance is not a reliable indicator of current or future results.

Source: Macrobond Financial, Danske Bank

Euribor, Sep23 vs. Sep24

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

Source: Bloomberg, Macrobond Financial, Danske Bank

Market's pricing is benign, despite liquidity and credit tightening

As of March the ECB will only partially reinvest the APP redemptions. Between 1 March and the end of June the ECB will reduce its bond holdings under the APP by EUR15bn/month on average. We expect the H2 roll off to be announced at the June meeting. APP redemptions average EUR26bn from July 2023 to January 2024, hence we see scope for a complete end to APP reinvestments being announced. The recent ECB SMA (survey of monetary analysts) showed a consensus of EUR20bn/m after June. We see the market pricing as rather benign in a QT environment, given the Italian-German bond spread level of 180-185bp.

A split ECB General Council

While ECB GC members are united in fighting the inflation problem, divergent views on how to tackle inflation exist. While chief economist Lane and others argue for a more cautious approach, the hawkish camp including Schnabel argues still for a firm hand to policy tightening. We see these diverging views becoming more visible towards summer, as the trade-off between higher for longer versus very high for a shorter period has to be weighed.

FX reaction depends on the growth backdrop

In terms of the backdrop for EUR/USD we highlight that the determining factor as to whether a hawkish message from the ECB will lead to a higher or lower cross will depend on the sequential growth backdrop priced in markets on the day.

To the extent that markets price in an accelerating growth backdrop higher short-end yields should contribute to a stronger EUR. Meanwhile, if markets are pricing in a deteriorating growth outlook then a hawkish ECB message has more often than not led to a weaker EUR amid the investment case of eurozone assets getting hurt.

In our view, we are right now in a delicate tug-of-war between markets pricing renewed optimism with respect to eurozone growth short-term and markets pricing in higher global real rates and hence a worsening medium- to long-term growth outlook. Recently, we have seen eurozone assets pick up the relative outperformance from summer, which suggests some tactical topside risk to EUR/USD in the coming weeks including for the ECB meeting.

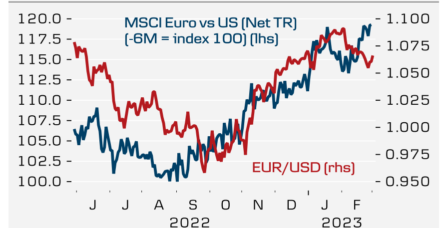
That said, we still highlight that the medium- to longer-term backdrop looks much more challenging for the single currency. To the extent markets begin to shift focus from an improved short-term outlook to the price of growth to be paid further out, then EUR/USD is likely to follow back sharply again. We maintain a 6M target on EUR/USD of 1.02 while we acknowledge some topside risk to our 1M projection of 1.06.

10y Italy vs Germany

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

Source: Bloomberg, Macrobond Financial, Danske Bank

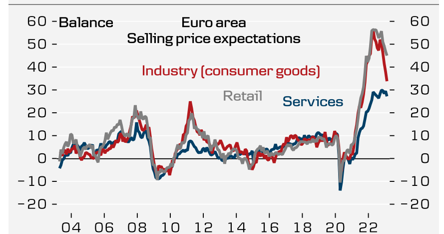
The latest renewed performance of eurozone assets poses topside risk to EUR/USD



Source: Macrobond Financial, Danske Bank

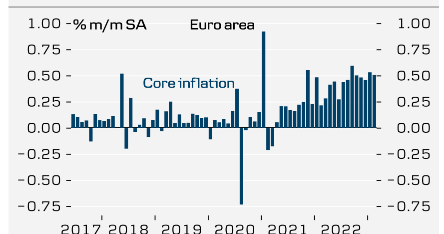
Note: Past performance is not a reliable indicator of future results.

Selling price expectations remain elevated



Source: European Commission, Macrobond Financial, Danske Bank

Core inflation momentum remains too high



Source: Eurostat, Macrobond Financial, Danske Bank

Disclosures

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None

Date of first publication

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