RESEARCH

Danske Bank

5 April 2024

ECB Preview

An intention to cut

- We expect the key takeaway from next week's ECB meeting will be an affirmation of the prevailing ECB narrative, of the ECB on route to deliver a rate cut in June. While this meeting may be considered an interim meeting, and lead to limited market reaction, we expect the ECB to deliver a clear commitment to a June rate cut, in the form of explicit guidance of an 'intention to cut by 25bp in June'. We expect no guidance will be offered beyond that point on the pace of cuts or the end level of the tightening cycle.
- Markets are pricing 1bp for next week's meeting and 23bp of cuts in June. Our baseline scenario of three cuts of 25bp this year still holds, but see the risks skewed for ECB to deliver less than that this year, due to the sticky underlying inflation.

Burden of proof is 'away from June'

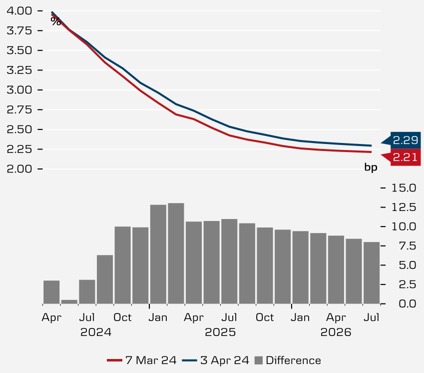
ECB president Lagarde's strong speech at the *ECB watchers conference* two weeks ago pointed to the June meeting as the pivotal one for the ECB to start dialling back its restrictive monetary policy, as in particular she said that they *'will know a bit more by April and a lot more by June*'. This narrative has seen wide support from the other GC members in recent weeks. While we do not think the specific date of the meeting when the ECB will deliver its first rate cut to be particularly important to the real economy, the consensus among virtually all GC members that a rate cut is nearby has led to market pricing being firm in calling for a rate cut in June, and a further dialling back of the restrictive monetary policy beyond June; hence, we expect firm guidance for June should not lead to a significant market impact next week. While the timing of the first rate cut being less important may even mean that the ECB could cut rates next week, the roadmap laid out by Lagarde entails a preference to wait for further information on wage growth in particular before starting to ease the current restrictive monetary policy stance.

ECB's roadmap laid out at the watchers' conference

During the March meeting, and repeated in the strong ECB watchers' *speech*, Lagarde set out the framework of the three criteria (inflation outlook, underlying inflation and strength of transmission) through the three phases of monetary policy: the tightening phase, the holding phase, and the dialling-back phase that the ECB is navigating.

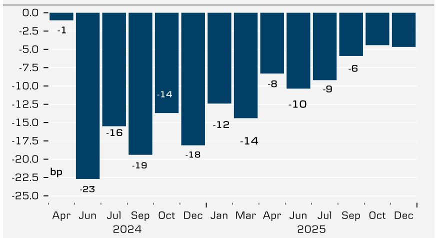
During the watchers' speech, Lagarde further laid out that we are exiting the second phase now and therefore about to enter the dialling-back phase, though the ECB needs to be confident that inflation is on track towards the target before that can happen. While she said that with the delays by which data becomes available, they can't wait to have all the relevant information, as this could entail a risk of adjusting policy too late, she nevertheless added that the ECB's forward-looking wage tracker '*is showing early signs that pressure is easing*' and guided on wages that the negotiated wage data for Q1 would only be available by the end of May (23 May). Also, the June staff projections will show whether the inflation path, which is consistent with the 2% inflation target being reached by 2025, remains valid. If those prints are sufficiently met, a June cut would follow or, in the words of Lagarde, then

ECB market pricing, since the 7 March meeting



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

ECB market pricing (€STR)



Source: ECB and Danske Bank

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'*we will be able to move into the dialling-back phase of our policy cycle and make policy less restrictive*'. In other words, following the inflation data from March released this week which was in line with the ECB's March projections, and subject to confirmation from the wage growth to be released next month, as well as new staff projections in June, the ECB would deliver a rate cut in June. Specifically, **we expect the ECB to include a sentence along the lines of 'an intention to cut rates in June by 25bp, provided that the disinflationary process continues'.** This would also end discussions about a potential 50bp rate cut, as some market participants are speculating.

Risk management, and disregarding Fed (for now)

Beyond June, we do not expect the ECB to deliver guidance on the pace of rate cuts, as the domestic price pressures are still there, so we believe a meeting-by-meeting basis is likely to continue to be emphasised. In this way, the ECB is taking a risk management approach and only providing near-term policy guidance on the nearest upcoming ECB meeting.

On the question of whether the ECB could cut rates before the Fed, we believe this discussion is overdone as both central banks are running independent monetary policies and as such the ECB could cut rates before, and faster, as also priced by markets. Our house call is still for a Fed rate cut in the spring, though the risks are weighted towards a later start. Importantly, the key question is not 'when' the central bank will deliver its first rate cut, but rather 'why'. However, imagining policies diverging for longer is more difficult, because ultimately whatever drives decisions at the Fed will spill over to Europe and affect the Eurozone as well. In the short run, the ECB could 'easily' deliver a couple of rate cuts even if the Fed stays on hold.

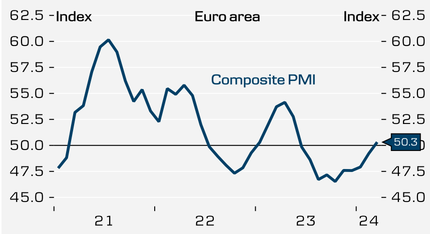
Data since last meeting should not have changed the ECB's assessment of the economic situation

Since the March meeting just four weeks ago, there has been limited new economic data, and the data that has been released should not have altered the ECB's view of the economy (see also our data monitor in the annex). In March, euro area inflation declined to 2.4% y/y, aligning with the ECB's staff projections for Q1 24. The composite PMI increased from 49.2 to 50.3, suggesting a gradual economic improvement, which is generally consistent with the March staff forecasts.

The drop in overall inflation was due to a decrease in core inflation (falling from 3.1% to 2.9%) and a reduction in food, alcohol, and tobacco inflation (falling from 3.9% to 2.7% since February). Core goods inflation remained very low, while service inflation was flat at 4.0% for the fifth consecutive month. In addition, the ECB's own seasonally adjusted series showed a 0.42% month-on-month increase in service prices. As a result, core momentum indicators like 3m/3m and 2m/2m rose in March. The strong service price pressure rules out a cut in April in our view, but we do not see this as a risk to the June rate cut.

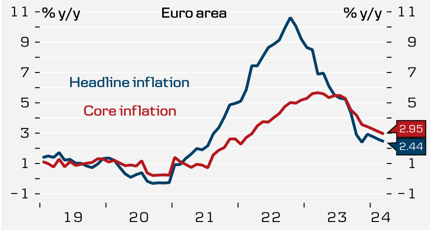
The unemployment rate stayed at 6.5% in February, and the domestic inflation indicator was also stuck at 4.5% y/y. We highlight domestic inflation as an upside risk to the outlook, but we expect the overall disinflationary process to persist in the euro area, allowing a June rate cut.

The economy is stagnating broadly in line with staff projections



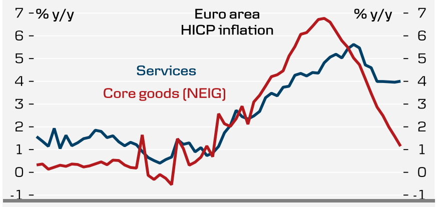
Source: S&P Global, Macrobond Financial

The disinflationary process continues

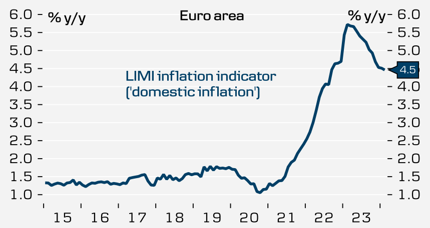


Source: Eurostat, Macrobond Financial

Sticky service inflation fuels the hawk camp in ECB



Domestic inflation remains high



Source: Eurostat, Macrobond Financial, Danske Bank

The final step before the first cut is unlikely to cause major market moves

With incoming factors not changing the ECB narrative we also expect a relatively muted market reaction to the meeting, despite Lagarde potentially acknowledging that views have been shared arguing for a rate cut already at the April meeting. Markets are pricing a roughly 10% likelihood of a 25bp rate cut at the April meeting – if that does happen, we expect EUR/USD to be significantly lower in a knee-jerk reaction. However, we find a rate cut unlikely, and hence we expect a muted market reaction.

Over the course of the year, we remain bearish on EUR/USD. We believe the US economy holds a stronger position relative to the euro area, based on factors such as relative terms of trade, real rates, and relative unit labour costs. Additionally, there are signs that underlying inflation appears more persistent in the US than the euro area, which ultimately will limit the extent of sustained USD depreciation. We view a strong USD as a necessary condition for the Fed to sustainably achieve its inflation target. We forecast EUR/USD to reach 1.07/1.05 on a 6-/12-month horizon. In the near term, we see potential upside risk to the cross as we identify arguments for a temporarily weaker USD, considering the convergence between US data surprises versus the rest of the world, including the latest improving signs in the China economy, which, all else equal, supports the topside in EUR/USD in the near future. Furthermore, given the long USD positioning, we anticipate the USD to react more significantly to, for example, negative macro surprises in the US.

Euro area data overview

Blue colour indicates less upbeat data print, red colour indicates more upbeat data print compared to other six months shown.
Thick border indicates cut-off for incoming data since last ECB meeting.

Aggregate	Last values	New values since last ECB meeting
Average augmented Z-score*	0.260	0.341

*A positive augmented Z-zcore can be interpreted as the component showing a hawkish change in its last release, and vice versa for negative Z-scores.
This augmentation is achieved by multiplying the Z-scores for unemployment, the labour force, the 10y Bund and GDP weighted rates, and the EUR/USD and effective exchange rates (real and nominal) by -1.

Inflation (%)		Sep/23	Oct/23	Nov/23	Dec/23	Jan/24	Feb/24	Mar/24	Last 12 obs
Headline (YoY)		4.3	2.9	2.4	2.9	2.7	2.6	2.4**	
Core (YoY)		4.5	4.2	3.6	3.4	3.2	3.0	2.9**	
SuperCore (YoY)		4.8	4.5	3.9	3.7	3.5	3.3		
Services (YoY)		4.6	4.5	4.0	4.0	4.0	4.0	4.0**	
LIMI (Domestic inflation, YoY)		5.0	4.9	4.7	4.5	4.5	4.5		
Headline (MoM)		0.3	0.1	-0.2	0.0	0.4	0.4	0.1**	
Core (MoM)		0.1	0.2	-0.1	0.2	0.3	0.4	0.2**	
SuperCore (MoM)		0.2	0.3	-0.2	0.3	0.3	0.3		
Services (MoM)		0.3	0.3	0.0	0.3	0.4	0.5	0.4**	
Economic Growth									
GDP[1]	... QoQ (%)	-0.1	0.0	0.0	0.0				
PMI	... Composite	47.2	46.5	47.6	47.6	47.9	49.2	50.3	
	... Manufacturing	43.4	43.1	44.2	44.4	46.6	46.5	46.1	
	... Services	48.7	47.8	48.7	48.8	48.4	50.2	51.5	
IFO	... Current	88.7	89.1	89.4	88.5	86.9	86.9	88.1	
	... Expectations	83.4	84.8	85.0	84.1	83.4	84.4	87.5	
ESI	Index	93.9	93.9	94.2	96.5	96.1	95.5	96.3	
Eurocoin	...%	-0.2	-0.7	-0.8	-0.2	-0.6	-0.3	0.2	
Consumer Confidence		-17.7	-17.9	-16.9	-15.1	-16.1	-15.5	-14.9	
Labour Market									
%	Unemployment	6.5	6.6	6.5	6.5	6.5	6.5		
QoQ (%)	Employment[1]	0.2	0.3	0.3	0.3				
	Labour Force[1]	0.4	0.2	0.2	0.2				
YoY (%)	Negotiated Wages[1]	4.7	4.5	4.5	4.5				
	Job Postings Wages	3.6	3.8	3.6	4.0	4.0	3.7		
	Comp per Employee[1]	5.1	4.6	4.6	4.6				
Labour Shortage	... Industrials[1]	21.8	19.9	19.9	19.9				
	... Services[1]	31.4	26.5	26.5	26.5				
EC Employment Expectations Indicator		103.1	103.2	102.9	103.2	102.6	102.5	102.6	
Credit									
%	BLS credit standards[1]	11.7	4.4	4.4	4.4				
YoY (%) - loan growth	Non-Financial corporations	0.2	-0.2	0.0	0.5	0.2	0.4		
	Households	0.8	0.6	0.5	0.4	0.3	0.3		
YoY (%)	Euro Area M1	-9.9	-9.9	-9.3	-8.2	-8.7	-7.9		
	Euro Area M3	-1.2	-1.0	-0.8	0.4	0.1	0.3		
Financial indicators									
% (eom)	10y Bund	2.8	2.8	2.5	2.0	2.2	2.4	2.3	
	10y GDP weighted rate	3.5	3.5	3.1	2.6	2.7	2.9	2.8	
% (eom), HICP	10y GDP wght. real rate	30.4	34.5	33.6	33.2	35.3	37.9		
% (eom), €STR	10y GDP wght. real rate	96.2	101.2	78.9	48.6	61.2	71.7		
bp (eom)	BTP-Bund Spread	193.0	192.0	172.0	168.0	157.0	143.0	141.0	
YoY(%) (eom)	Stoxx600	16.1	5.2	4.9	12.7	7.2	7.3	12.0	
	Stoxx50	25.8	12.3	10.5	19.2	11.6	15.1	17.8	
Spot rates	EER (YoY %, eom)	7.7	6.4	5.4	4.0	3.1	3.9	3.0	
	REER (YoY %, eom)	6.9	4.6	3.6	2.1	2.2	1.7	2.1	
	EURUSD (eom)	1.1	1.062	1.093	1.105	1.084	1.083	1.081	
Energy & commodities									
YoY(%) (eom)	Commodities index	10.9	-0.4	-2.4	-4.3	0.1	5.0	11.1	
	Energy index	16.5	-1.9	-3.4	-5.2	3.9	9.6	20.1	
EUR/MWh (eom)	TTF NatGas	38.1	45.4	41.0	30.5	30.1	24.8	27.1	
USD/bbl (eom)	Brent oil	95.3	87.4	82.8	77.0	81.7	83.6	87.5	

**Indicates release is flash, and not final.
Superscript with the number "1" indicates data is released in quarterly intervals, hence the border marking new releases reflects this.
Sources: ECB, Eurostat, Macrobond and Danske Bank.

Forward looking indicators

Inflation		Apr/24	May/24	Jun/24	Jul/24	Aug/24	Sep/24	Oct/24
YoY(%)	Inflation market pricing	2.5	2.7	2.6	2.5	2.0	1.9	2.0
SMA* and market pricing		Apr/24	May/24	Jun/24	Jul/24	Aug/24	Sep/24	Oct/24
%	Market priced deposit rate (€STR+10bp)	4.00		3.77	3.61		3.42	3.28
bp	- change	-0.93		-22.6	-15.4		-19.3	-13.6
	SMA DFR	4.00		3.75	3.75		3.50	3.50
	SMA TLTRO	170	113	113	113	33	33	33
EURbn	SMA PEPP	1714	1714	1714	1691	1691	1691	1669
	SMA APP	3039	3039	3039	2969	2969	2969	2888
SPF*		2024	2025	2026	Long Term		Released since last ECB meeting	
	SPF HICP	2.4	2.0	2.0	2.0		No	
YoY%	SPF HICP, Core	2.6	2.1	2.0	2.0		No	
	SPF Real GDP	0.6	1.3	1.4	1.3		No	
Latest ECB Staff Projections		Q2/2024	Q3/2024	Q4/2024	Q1/2025	Q2/2025	Q3/2025	Q4/2025
	HICP	2.4	2.2	2.2	2.2	2.1	1.9	1.9
YoY%	HICP CORE	2.5	2.5	2.5	2.3	2.2	1.9	2.0
	GDP	0.2	0.3	0.4	0.4	0.4	0.4	0.4

*SMA is latest release, coinciding with latest ECB meeting. SPF is latest release.
Blank cells under market pricing indicates lack of ECB GC meeting.
Sources: ECB, Eurostat, Macrobond and Danske Bank.

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