Danske Bank

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Flash: ECB Review

50bp and TPI but the hiking cycle is set to be short

- Today, the ECB announced its first rate hike in 11 years to fight off inflationary pressure. It hiked the three policy rates by 50bp in a unanimous decision, thereby deviating from its previous guidance of 25bp at the Sintra conference. There will be more rate hikes but the size will be set meeting by meeting and the previous guidance therefor no longer applies.
- The ECB also announced a new anti-fragmentation tool, the so-called Transmission Protection Instrument (TPI). Tomorrow's survey of professional forecasts may also show a high inflation expectation justifying the larger move.
- The ECB's assessment of growth and inflation outlook was broadly unchanged from June.
- We are gloomier on the economic outlook, which ultimately is set to take inflation expectations lower than the ECB conveys. **We no longer expect the ECB to hike policy rates in Q1 next year. We expect the ECB to hike by 50bp in September and 25bp in both October and December. We see risks slightly skewed to fewer hikes. That means that we anticipate a cycle hike of 1% on the deposit rate.**

Why larger than 25bp 'intended'?

The reason for the larger-than-previously guided hike was rising inflation risks (potentially because of further signs of de-anchoring inflation expectations in the Survey or Professional Forecasters released tomorrow) and the reinforced support provided by the Transmission Protection Instrument (TPI – more below) for effective monetary policy transmission. Today marks the end of forward guidance as well, as the ECB is now switching to a meeting-by-meeting rate-setting framework, as visibility is low. Hence, while ECB is still guiding for 'further policy rate normalisation' ahead, the size and pace of future rate hikes will depend on how the economic and inflation outlook develop, without any prior commitments or 'tying its hands'.

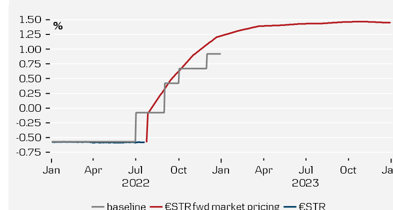
Overall, the economic assessment from the ECB has not changed much compared to June. The economy is still viewed as benefitting from reopening effects (especially in services), a strong labour market, fiscal support and pandemic savings, while there are also tentative signs that supply bottlenecks are easing. However, the outlook is clouding for H2 and beyond due to persistently high inflation and uncertainty. While growth risks remain on the downside, inflation risks are skewed to the upside. Energy prices are expected to stay high in the near term – also stoked by the EUR depreciation – and price pressures are spreading across more and more sectors, due to pipeline pressures. The ECB expects inflation to remain undesirably high for some time, but to ease up as energy prices and supply constraints eventually moderate and wage growth picks up only gradually. EUR depreciation is also adding to high inflation pressure.

We think ECB remains too upbeat on its economic outlook, while underestimating the rise in inflation pressure.

Key takeaways

- ECB hikes all three policy rates by 50bp
- No guidance for size in September (meeting-by-meeting decision)
- Broadly unchanged economic and inflation assessment, compared to June statement
- We expect ECB to hike another 100bp this year, before halting its hiking cycle

ECB to end its policy rate hikes in December this year



Source: Macrobond Financial, ECB, 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

Head of FX Research
Kristoffer Kjær Lomholt
+45 45 12 85 29
klom@danskebank.com

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Supportive factors, like post-lockdown re-openings and filled order books, are rapidly losing momentum. While an immediate European gas crisis has been averted for now, upside risks to prices still persist from a sudden Russian gas-stop and a tense global food supply situation (see also *Euro inflation notes - Food for thought*, 1 July, and *Research - A full-on gas crunch would bring Europe to its knees*, 20 July). Growth headwinds are also piling up from tightening financial conditions, a weaker Chinese growth outlook and a new political crisis in Italy (see also *Flash comment - Italy is falling back into old habits*, 20 July, and *China Macro Monitor*, 18 July).

Dealing with such a stagflationary environment presents a tricky monetary policy dilemma for the ECB, but we think today's decision confirms that for now pro-inflationary risks take precedence over the growth outlook. Hence, we also still expect the ECB to hike by another 50bp in September, but see scope for the hiking cycle to end already by year-end (Q1 23 previously) in light of the rising recession risks for H2 22.

Transmission Protection Instrument (TPI)

As a compromise for it hiking policy rates by 50bp today, the ECB announced its latest policy instrument, namely the *TPI.* The TPI is designed to 'support the effective transmission of monetary policy.' Subject to fulfilling established criteria, the ECB via NCBs will be able to buy bonds in the secondary market in countries '*experiencing a deterioration in financing conditions not warranted by country-specific fundamentals*' and the amount is not ex ante restricted. The purchases will be done in public sector securities, which also include regionals and agencies. The purchases are to be done with bonds with remaining maturity between 1 and 10 years. Private sector debt could be considered if appropriate. While Lagarde said it could act swiftly, it is still based on a GC decision in which it will rely on both fiscal and macro-economic assessment, including a debt sustainability analysis following IMF, EC and ESM etc. Importantly, ECB remains pari passu on the purchases. On the impact of the monetary policy stance, the statement is unclear in our view: '*Purchases under the TPI would be conducted such that they cause no persistent impact on the overall Eurosystem balance sheet and hence on the monetary policy stance.*' If the ECB does not intend to increase the balance sheet size, this must all things equal mean that the ECB has to sell bonds to buy in another name, for example sell German paper in order to buy e.g. BTPs.

BTPs suffering and 2023 repricing

The lack of details during the press conference on how, when, on what the TPI programme may need to be activated led to a significant disappointment for the BTPs-Bund spreads, by around 12bp since the Q&A started. The lack of clarity on the TPI instrument was thereby no longer the relief markets had hoped for.

With the ECB frontloading its hikes, the market clearly took it as a more aggressive pricing into the 2022 segment at the expense of the 2023 pricing. The Euribor Dec22 versus Euribor Dec23 slope flattened by 11bp on the more aggressive hike today. Looking ahead, we still see further flattening potential in the 2023. Therefore, we still like our Euribor Mar23 vs Euribor Mar24 flattening trade initiated three weeks ago at 42bp. We expect this to hit 0bp later this summer (currently 8bp).

BTPs suffering on TPI details

Source: Bloomberg

We still prefer to sell ECB-induced euro rallies

In FX markets, EUR/USD initially rallied close to 1.03 upon announcement before (paradoxically) ending the session below pre-ECB levels. In our view, this highlights one of our long-held views: currencies should primarily be treated as a play on the relative attractiveness of asset markets and only secondly as a play on relative rates. Higher short-end EUR rates on balance improve the carry attractiveness of investing in the single currency. Meanwhile, the larger-than-expected ECB rate hike and the signal of more front-loaded tightening also skew European asset return distributions to the left. This makes EUR-denominated assets less attractive. The lack of convincing details on the TPI-programme highlights how the ECB cannot have its cake and eat it, in the sense that the price of tightening policy across the Eurozone requires a relatively tighter stance for the economies with the lowest r*s; Italy being the case in point. In turn, this challenges the investment outlook for the EUR that still suffers heavily on a relative terms of trade and cost-adjusted-productivity basis vis-à-vis the USD. In our view, EUR/USD remains fundamentally overvalued. Hence, at this stage, we still like to sell ECB-induced EUR rallies and still pencil in EUR/USD firmly settling below parity over the coming quarters.

Flatter 2023 segment

Note: difference between Euribor Dec 22 and Euribor Dec 23 contracts
Source: Bloomberg

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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 Kristoffer Kjær Lomholt, Chief Analyst.

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None

Date of first publication

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