04 March 2021

ECB Preview

Talking or acting?

- The ECB meeting on Thursday next week will focus on the financing conditions and the PEPP implementation. We do not expect new policy decisions, but a reiteration of all options on the table while ensuring easy financing conditions.
- The main unknown is whether ECB will explicitly coin the recent rise in both nominal and real yields as an unwarranted tightening of financing conditions or fall short of reaching that conclusion and decide 'only' monitor the evolution of yields. The former should trigger increased bond buying under the existing PEPP envelope (and immediate lower rates during the press conference) while the latter will mean flexibility remains but not additional buying. We believe it is a close call (and is also subject to daily market developments) on which conclusion they will reach given the comments in recent weeks hasn't suggested major concerns for most GC members.
- We lean towards ECB concluding a continuation to monitor and remain short of conclude an unwarranted tightening. This may come at a later stage if conditions worsen 'enough'. We do not expect talking is enough to contain rates, but action is needed. We therefore see upside risks during the press conference to rates. Should ECB choose to pursue a more dovish stance, we would expect relative rates to become a further drag on EUR/USD. This would be in line with a mild easing of financial conditions while the European recovery remains weak. If not, we see EUR/USD as little changed on the day. Our long-term forecast remains 1.16 on 12M.
- We expect ECB to repeat the cautiously optimistic tune regarding the economic outlook of the euro area, with minor revisions to its staff projections (slightly lower growth and higher inflation this year). We expect Lagarde to reiterate that ECB will look through the base effects driven inflation near term.

Unwarranted tightening of financing conditions

After the rapid sell-off in European rates, led by the long end in the US, the financing conditions has tightening the past 2 weeks, with only verbal intervention from the ECB to counteract the unwarranted tightening of financing conditions. While financing conditions are overall easy (chart on right), the pace of the tightening as well as the reason thereof (US fiscal package) should have called for ECB using the flexibility within the PEPP package, notably also due to the rise in real rates (for the wrong reasons being higher nominal yields and broadly unchanged inflation expectation). However, recent communication have seen the majority of the GC members closely monitoring the evolution with only ECB's Panetta and the Greek GC member Stournaras outright calling for a pickup in purchase pace.

Holistic approach to financing conditions

In *ECB financing conditions - what to watch*, 12 February we lay out what we expect ECB is focussing when assessing the financing conditions. Updating the charts, we still conclude that financing conditions are still accommodative, but after the recent rise in yields adds a headwind with high uncertainty. Chief economist Lane last week also put a great deal of emphasis on the transmission from sovereign rates to banking lending rates, as bank

11 March 2021

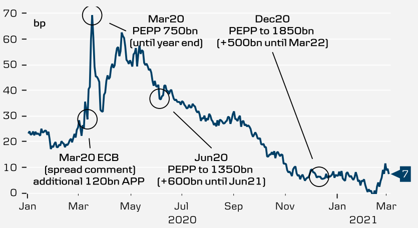
- 13:45 ECB decision
- 14:30 Press conference

ECB GC on higher rates

- Lagarde: 'Closely monitoring'
- Schnabel: 'real long-term rates… may withdraw vital policy support too early and too abruptly'
- Lane: 'maintain favourable financing conditions'.
- Weidmann: size of yield moves 'not particularly worrisome'
- Panetta: ' 'the steepening … is unwelcome and must be resisted'
- Stournaras: 'accelerate the pace of PEPP'
- Sources: ' No Need for Drastic Action to Curb Bond Yields'

Source: Bloomberg, Reuters and ECB website

10Y euro area GDP weighted yield spread to EONIA



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

Source: Bloomberg, Macrobond, Danske Bank

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lending rates strongly correlates with sovereign rates in rates up scenario.

Key questions to watch during the Q&A

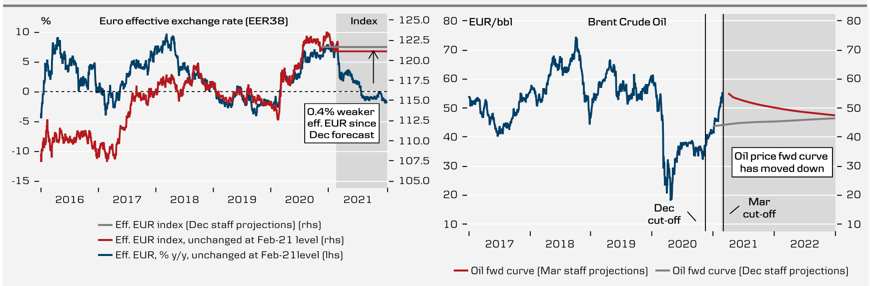
- *Holistic approach to financing conditions:* How will ECB define this and which variables to follow? In January Lagarde said that they will be 'assessing that on a regular basis'
- *Flexible PEPP implementation:* If this sell-off can't trigger higher PEPP purchases, what will? How bad should it be before ECB would step in? We will also focus on any comments about the pace of tightening.
- We do not expect preliminary results of the strategic review which is expected to be concluded by H2 21

Staff projections point to cosmetic and transitory effects

Since the January ECB meeting, euro area countries have continued to be in hard lockdown, which naturally has taken a toll on the near term economic outlook. The industry heavy sectors have performed well into the start of the year, and therefore the economic impact during the second lockdown is significantly smaller than the first lockdown. This is also illustrated by the manufacturing PMIswhich has pointed to a quite strong economic performance from the start of the year, while service and construction readings has been weak due to the lockdown. In the December ECB projection exercise, the staff foresaw a contraction of 2.2% qoq in Q4 and 0.6% growth in Q1 21. The Q4 growth wasn't as grim as the staff projected at 'only' -0.6% qoq. However, given the earlier than anticipated lockdowns, the economic recovery has been 'delayed and not derailed' as Lagarde framed it in January, and this being due to the favourable financing conditions, rollout of vaccines and easing restrictions that will still provide support to an economic recovery later this year. Therefore, the growth projections for this year is expected to be subject to a rather cosmetic to around 3.7% this year. The uncertainty will remain elevated due to the exact timing is difficult to forecast, as ECB board member Schnabel also said. We still expect risks to be assessed to be on the downside.

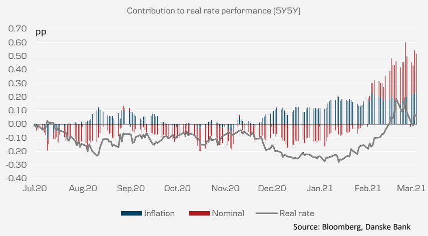
The inflation outlook arguably continues to create uncertainty for the ECB projections, as well as ours, with new weights, imputed prices and ending of temporary VAT reduction in Germany creating a high volatility in the base effects. In February core inflation fell back to 1.1%, from the January high of 1.4% after printing at of 0.2% in December. Several ECB GC members, including Lane, Schnabel and Lagarde has said that ECB will look through transitory and high volatility in the inflation dynamics near term, and still point to an sustained inflation for the decisive factor for monetary policy guidance. The underlying inflation measures has been mostly sideways in recent prints.

Technical forecast assumptions little changed since December



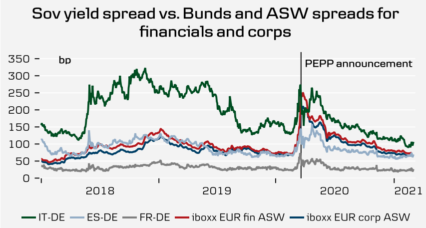
Note: Past performance is not a reliable indicator of current or future results.
Source: ECB, Macrobond Financial, Danske Bank

Real rates have risen markedly – mainly driven by rising nominal rates



Note: Past performance is not a reliable indicator of current or future results.
Note: Change since 1 Jul 20
Source: ECB, Danske Bank

Intra-euro area spreads are still tight, but somewhat wider



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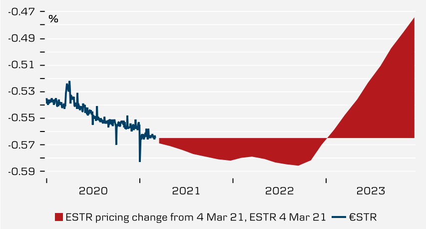
ECB market pricing



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

Revisions, cosmetic and transitory

ECB projections March 2021	2021		2022		2023	
GDP growth	3.7% (3.9%)	↘	4.2% (4.2%)	→	2.1% (2.1%)	→
HICP inflation	1.3% (1.0%)	↗	1.1% (1.1%)	→	1.4% (1.4%)	→
Core inflation	1.0% (0.8%)	↗	1.0% (1.0%)	→	1.2% (1.2%)	→

Parenthesis are the old ECB projections (from December 2020)

Note: arrow indicate changes from Dec projection
Source: ECB, Danske Bank

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