Danske Bank

04 September 2020

ECB preview

Time for inaction

10 September 2020 (CEST)

13:45 ECB decision

14:30 Press conference

- We do not expect material changes to the ECB stance at next week's meeting, hence a readiness to act given the highly uncertain economic and inflation outlook will remain.
- With no new policy signals to act as catalyst, we stay neutral on markets through the press conference. In fixed income, we continue to expect range trading driven by the offsetting factors of increased supply and large PEPP purchases.
- We expect Lagarde to be questioned on the Fed's recent AIT decision and implications for ECB's ongoing strategic review as well as the stronger EUR and its implications for the subdued inflationary outlook.

Digesting the data

The ECB meeting on Thursday next week (which also carries new staff projections) is set to be relatively uneventful for markets as the ECB still needs further data to assess the economic and inflation impact from COVID-19. According to Governing Council (GC) members Schnabel, Lane and Kazimir, the euro area recovery pace has roughly been in line with the assumptions of the ECB's baseline scenario, which foresees growth of -8.7% this year and 5.2% next year. Therefore, **we do not expect the ECB to act next week, but rather signal a readiness to act should it be needed, noting also that incoming data will be providing a better guidance for potential policy actions.**

As PEPP purchases have slowed in the past weeks (abating some of the frontloading), we have noted a slight tightening of financial conditions in the euro area, but with PEPP purchases set to increase as of this week, we expect easing conditions going forward.

Bloomberg's survey among analysts expects no new measures next week, but majority points to PEPP increase at the December meeting with a median expectation of an additional EUR350bn, heading into H2 next year.

Disagreement in the making?

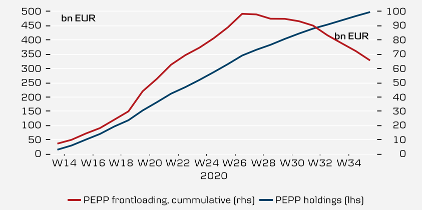
After a prolonged period with next to no ECB speakers on the wires, we have had a number of key speakers in the past week, which may point to building disagreement in the GC. Chief economist Lane continued his cautious and balanced reflections, while Schnabel and to a larger degree Weidmann pointed to ending the COVID-19 related stimuli once the crisis was over, but also reflecting on the debt burdens and sustainability of the current debt levels. We interpret that as more stimuli are not around the corner if the economy and inflation develop broadly in line with the projections and financial conditions not tighten.

Interesting Q&A

The introductory statement may prove relatively uneventful, but we expect Lagarde to be asked a number of key questions that markets will digest the next weeks.

a) **Target vs ceiling.** With the ECB's frontloading of PEPP purchases, we do not see the validity to this discussion unless the economic and inflationary outlook improves rapidly, resulting in a significant slowdown of PEPP purchases.

PEPP well ahead of schedule



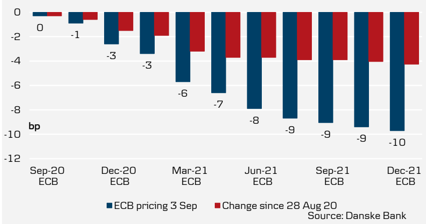
Source: ECB, Danske Bank

Euro area Financial conditions Index

Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.

Source: Bloomberg, Macrobond, Danske Bank

ECB pricing points to 10bp cut end of next year



Source: Danske Bank

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Furthermore, financial conditions are still significantly tighter than pre-March levels and we believe the ECB will be wary of not triggering tightening. If the ECB were to lower the purchase rate, we see a substantial risk of a repricing across the government bond / yield space.

b) Stronger euro. Both ECB board members Schnabel and Lane have said that they do not target the exchange rate as part of their monetary policy strategy. Lane added that it feeds into global and European forecasts and as such also the monetary policy. Front-end pricing has reacted after Lane's comment (chart on page 1). We still do not expect the ECB to cut rates.

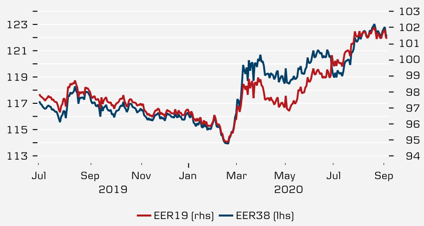
c) Low inflation print. HICP headline inflation moved into negative territory for the first time since May 2016. However, for now we think the low core inflation print will not create too many concerns at the ECB, as it is mostly due to base effects and government initiatives (German VAT cut), and inflation will likely rebound in September. We expect core inflation prints of c. 0.7% from September onwards and look for an acceleration again at the start of 2021. After the longer-dated inflation swaps rebounded to pre-coronavirus levels in August, we stay side-lined for now.

d) Fed's AIT. We expect the ECB to face questions on the Fed's average inflation target (AIT) regime and the implications for ECB's strategic review, which is restarting now. We expect Lagarde to take note of the decision and say that the ECB will not make pre-emptive conclusions of its own review. Our expectation is a confirmation of a symmetric target, formulated in a sufficient flexible way to let the ECB conduct its monetary policy without any limitations. Also, Lagarde seems keen on including climate and financial stability as work streams of the strategic review, which surely will not make it less complex to achieve the inflation target.

Escaping the exchange rate curse

The recent appreciation of the effective euro – by some 5% since the start of the year - will likely factor prominently in the GC's deliberations at the meeting. However, opinions on the impact on growth and inflation seem to diverge. Chief Economist Lane noted this week that 'the euro-dollar rate does matter' in that it 'feeds into our global and European forecasts and that in turn does feed into our monetary policy setting'. However, Isabel Schnabel indicated that she is not yet too worried about the exchange rate developments, also as a boost to global trade from a weaker dollar could offset a drag on euro area exports from the stronger euro. **While the euro appreciation fear has made a comeback among some ECB policymakers and will likely also influence the ECB's new staff projections, we remain sceptical that it will materially change the fortunes of the euro area inflation outlook (see also Euro Area Research: Escaping the exchange rate curse, 4 September).** *ECB research* has shown that the pass-through of exchange rate movement has declined in recent decades, both due to the low inflation environment and the changing composition of imports.

Broad EUR effective exchange rate has appreciated 5% since the start of the year



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

High uncertainty still reigns regarding growth and inflation outlook

GC members have pointed out that the euro area recovery pace has roughly been in line with the assumptions of the ECB's baseline scenario, which foresees growth of -8.7% this year and 5.2% next year. The noticeable rebound in economic activity in June and July should have cheered policymakers, although recent signs have emerged that the rebound might have lost some momentum during August amid flare-ups of second virus waves in some euro area countries such as Span and France (see *Euro Area Macro Monitor: Cooling down after a hot summer, 3 September*). Another positive development contributing to upside risks to its forecast has been the agreement on the EU recovery fund, which will give an important impetus for the recovery in 2021 and which previous staff projections have not factored in. The labour market impact from the crisis has so far also been more limited than assumed in June, as furlough schemes continue to shield workers. However, given that uncertainty remains high and a continued rebound in private consumption is not yet a given, **we expect ECB forecasts to err on the side of caution and refrain from a material upward revision in the growth outlook, with growth risks still seen as tilted to the downside.**

In August the HICP inflation rate dipped into sub-zero territory for the first time since May 2016. However, for now the low inflation print will likely not create too many concerns at the ECB, as seasonal factors due to postponed summer sales in France and Italy as well as government initiatives (German VAT cut) were the main culprits. **More worrying is the downtrend in service price inflation that has cooled noticeably since May and we expect ECB policymakers to pay close attention to this development in the coming months, as a potential trigger for further easing measures at a later stage.** Another noteworthy development has been the appreciation of the effective euro, by some 4% since the June staff projections were released. Mechanically, this should lower the ECB's core inflation forecast for 2021 by some 0.1pp, but a higher oil price forward curve and the June policy package pull in the other direction, supporting inflation in 2021 and 2022.

Effect of verbal intervention in FX is rarely very persistent

For EUR/USD, a key theme remains ECB's verbal intervention over recent days. However, we do note that the effect of verbal intervention in FX is rarely very persistent (see e.g. in EUR/HUF, CHF, TRY, etc.). Given that we do not expect a policy change from the ECB, we like to fade the effects of such verbal intervention. Rather, keep in mind (1) we think the FX impact on euro area inflation is low, (2) the global trend of a synchronised recovery is likely to continue and (3) that in a few weeks there is set to be further dovish action from the Fed. These points remain in favour of a renewed test of 1.20, which is also our baseline.

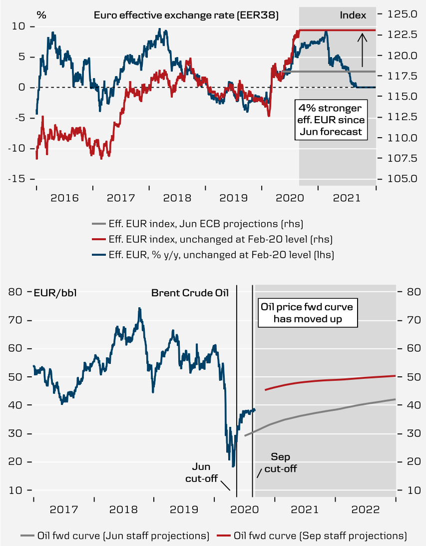
Growth and inflation outlook to take a beating

ECB projections September 2020	2020		2021		2022	
GDP growth	-8.5% (-8.7%)	↗	5.1% (5.2%)	↘	3.3% (3.3%)	→
HICP inflation	0.3% (0.3%)	→	0.8% (0.8%)	→	1.4% (1.3%)	↗
Core inflation	0.8% (0.8%)	→	0.6% (0.7%)	↘	1.0% (0.9%)	↗

Parenthesis are the old ECB projections (from June 2020)

Source: ECB, Danske Bank

Stronger EUR to weigh on ECB's inflation outlook



Source: ECB, Macrobond Financial, Danske Bank

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None.

Date of first publication

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