14 July 2022

ECB Preview

We have lift off

- **Stagflation risks are building in the euro area, sharpening the policy dilemma for ECB. With inflation still taking precedence over the clouding growth outlook, we expect ECB to go ahead with its intention to hike all three policy rates by 25bp in July.**
- **The pace of further rate increases will depend on how the economy evolves, but we do not anticipate any guidance for the Q4 monetary policy outlook at the July meeting. As visibility remains low, we expect increased market volatility to persist in the near-term, but still see ECB as priced too aggressively by the market for 2023, especially with the Federal Reserve priced for a 50bp rate *cut* in 2023. Currently markets are pricing in a tightening of 141bp in 2022 from ECB and another 43bp in 2023. Any frontloading ECB hikes is unlikely to support EUR/USD in our view.**
- **Designing a credible anti-fragmentation tool is key, for markets not to call the bluff on ECB and send Italian yields sharply higher again. We expect the new instrument to be implemented in a flexible manner, with focus on shorter maturities, but without a pre-set intervention amount or timeframe. We also expect purchases to be sterilized in order not to interfere with the monetary policy stance, but we see only a small probability of ECB outright selling bonds.**

21 July 2022

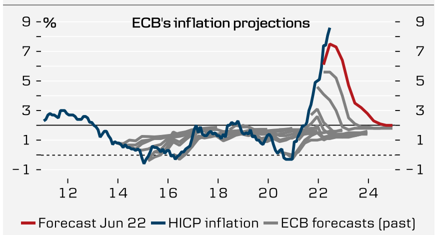
- 14:15 ECB decision
- 14:45 Press conference

Inflation risks take precedence over clouding growth outlook

Stagflation risks are building in the euro area, as business surveys point to a further sharp slowdown in the growth momentum at the end of Q2 (read more in *Euro Area Macro Monitor - Energy troubles*, 7 July). A positive side-effect of weaker demand are signs of easing cost pressures on prices and an approaching peak in commodities inflation. Yet, euro area inflation reached a new record high of 8.6% in June and even if pricing power in industry and services should have reached its peak, 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). While German inflation eased somewhat in June, we think the setback will prove temporary and expire with the government relief measures in September. Once again, ECB's staff forecasts from June look too optimistic on the growth outlook and have underestimated the rise in inflation pressures.

Calibrating the right monetary policy stance in a stagflationary environment presents ECB with a tricky dilemma. However, comments from Governing Council (GC) members suggest that for now inflationary risks still take precedence over the clouding growth outlook. The June meeting minutes showed a clear concern that inflation is becoming entrenched and more persistent. We consequently expect ECB to go ahead with its pre-signalled intention to hike all three policy rates by 25bp in July (deposit rate -0.25%, MRO rate 0.25%, MLF rate 0.5%). While some 'hawks' have floated the idea of a larger (i.e. 50bp) hike in July, we think there is currently no consensus in the GC to start the hiking cycle with such a move, especially as inflation expectations have broadly fallen back to target amid rising recession worries. One of the most outspoken hawks, Austrian Governor Holzmann, will also have no voting rights at the July/September meetings due to rotation.

ECB has again underestimated inflation pressures



Sources: Eurostat, ECB, Macrobond Financial, Danske Bank

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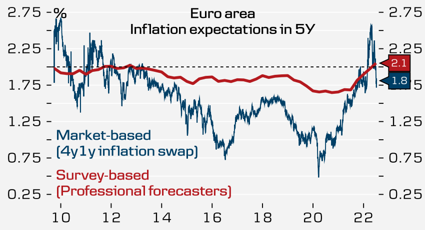
The pace of further rate increases will depend on how the economy evolves. However, in the absence of any material improvement in the inflation dynamics (which we do not expect), a 50bp hike in September seems the base case. Beyond that, we think a sequence of gradual hikes until Q1 23 will follow, but much will depend on how successful ECB can navigate the rising recession risks. As visibility remains low, ECB is keen to avoid tying its hands too much beyond the very short-term, in line with the mantra of optionality, data-dependence and flexibility. Hence, we doubt that we will get any guidance for the Q4 monetary policy at the July meeting and we will likely have to wait for September, when more data and new staff projections are available.

The flipside of ECB's optionality and gradualism strategy is an environment of increased market volatility. Caught between mounting recession concerns and high inflation pressures, market speculation has intensified about the size of rate hikes. So far, markets are pricing 30bp for July, i.e. still a 20% probability of a 50bp rate hike. Beyond that, 141bp are priced by year-end and with only four meetings in H2 this year, markets expect at least one of the meetings to end with a 50bp rate hike. A further 43bp are priced for 2023 and compared to the Federal Reserve, ECB pricing in 2023 remains too aggressive in our view, as we doubt ECB can continue its hiking cycle if the US (and global economy) start falling into recession.

Inflation expectations have fallen back amid rising recession worries



Source: ECB, Bloomberg, Macrobond Financial, Danske Bank

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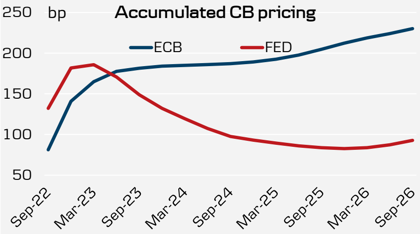
ECB pricing beyond 2022 remains too aggressive



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Source: Bloomberg, Macrobond, Danske Bank

Preserving monetary policy transmission

Apart from comments on the ECB's hiking cycle, focus during the meeting will be on the new anti-fragmentation tool. The quick rise in government bond yields - especially for Italy – triggered an emergency ECB meeting on 15 June. While flexible PEPP reinvestments remain the first line of defence to avoid Italian public borrowing costs spiralling out of control, the GC decided to accelerate work on a new anti-fragmentation tool to ensure proper monetary policy transmission in all jurisdictions.

Media reports referred to the tool as 'Transmission Protection Mechanism'. In *COTW: The devil is in the detail - how to structure an anti-fragmentation tool*, 24 June, we discussed how we anticipate this tool to be designed. We believe the anti-fragmentation tool will primarily work through a confidence channel and expect ECB to find inspiration from its previous bond buying programmes:

- **Necessary conditions (NGEU inspired):** we believe there will be loose 'conditions' attached to a new programme, which could resemble those needed for receiving NGEU funds, although not as stringent or "stigmatising" as for the OMT/ ESM programme.
- **Sufficient conditions (SMP inspired):** As with the SMP programme, we expect a vague definition of what constitutes fragmentation, which allows ECB to implement purchases in a flexible manner, without specifying the amount of intervention or timeframe.
- **Sterilisation of purchases (SMP inspired):** ECB has to sterilise any additional bond purchases under the new tool in order not to create additional inflationary pressures. We see two options for sterilisation: 1) selling certificates of deposit on a rolling basis, or 2) providing a term deposit facility (as used for SMP with 1 week operations of limited amounts at the MRO rate at most). We see only a small probability of ECB outright selling bonds in order to finance new purchases, as it erodes central bank equity and raises legal and political questions (read more in *ECB sterilisation primer - In a new anti-fragmentation tool*, 29 June).

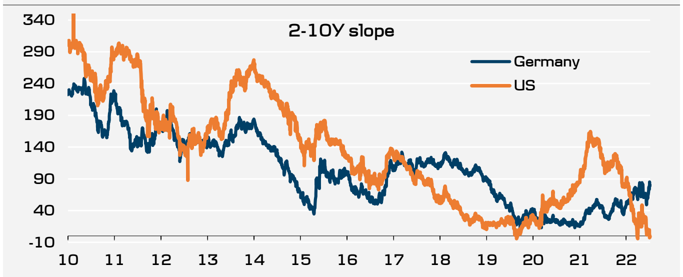
- **Maturities (OMT inspired):** To address monetary transmission risks, we expect a focus on shorter dated bonds and potentially an implicit intra-euro area spread target (which will not be made public). Specifically, we expect a sub-3y target (similar to OMT, which targeted the 1-3y segment).
- **No pre-determined capital key guidance (PEPP inspired)**, as it may not be all countries that have monetary transmission problems.
- **Unlimited in time and size (APP inspired):** ECB needs to show commitment to use its potentially unlimited balance sheet for an unlimited amount of time, if markets should see the anti-fragmentation tool as credible. However, in the end it should be a backstop facility that is only used to 'bridge' dysfunctionality and not address structural issues, which remain to be solved in the realm of economic and fiscal policy.

The anti-fragmentation tool will complement ECB's policy normalisation process, ensuring that policy rates can go as high as necessary, without causing any undue tightening of financial conditions in some countries. It will be important that the design of the new instrument is strong and credible, while also allowing room for spread differences that reflect countries' economic fundamentals. In the best case, it may not even have to be activated, similar to OMT in 2012. On the other hand, any delays in the announcement of specifics on the tool, will be met with an adverse market reaction in our view, that could send Italian yields skywards again.

Flatter curves and still wide German ASW-spreads

In our view, the initial market reaction to the ECB meeting in terms of the outright yield level will be determined by the communication on inflation rather than growth. Given the comments from ECB hawks, that monetary policy should be tightened faster than is currently priced, we could initially see a negative reaction with higher yields. Furthermore, given the risk of frontloading rate hikes, as seen in the US and from other global central banks, we expect a flatter curve between 2Y and 10Y (US 2-10Y curve is now inverted).

Slope of German yield curve has decoupled from US curve



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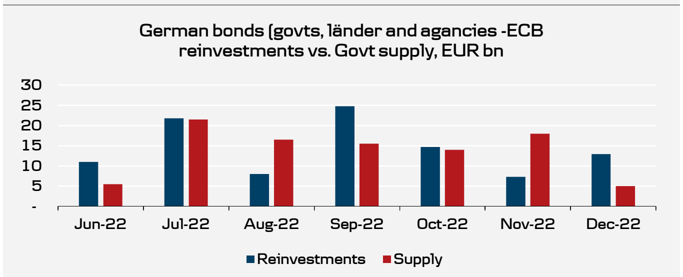
Source: Danske Bank

ECB reinvestments will absorb entire German gross supply



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Source: Danske Bank

The anti-fragmentation tool should keep the 10Y BTPS-Bund spread in a tight range. However, unless ECB adds a facility to the Transmission Protection Mechanism, where it can sell e.g. Bunds and buy BTPS, **we expect German ASW-spreads to remain elevated**. The funding/repo rate will still be very negative and ECB reinvestments will absorb the entire gross supply of German government bonds for the rest of the year (see chart above). Overall, we expect swap spreads to stay elevated due to:

- Solid paying in swaps in order to hedge rising rates and tighter monetary policy
- Negative net supply of German government bonds after ECB reinvestments

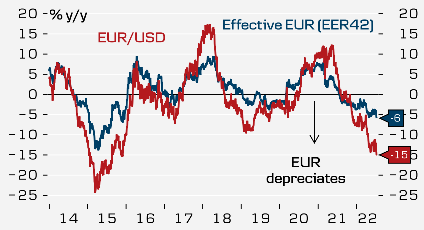
- Funding gap of some 100bp as Euribor fixings rise and short-dated repo rates decline
- Positive yield on Schatz, which is AAA-rated, liquid and does not have the same credit risk as the periphery

Frontloading ECB hikes unlikely to support EUR/USD

The weaker EUR (15% against the USD this year, 6% against a broader basket of trading partner currencies) has added to ECB's long list of worries, stoking imported inflation even further. However, we expect Lagarde to reiterate that while they are monitoring developments, ECB is not targeting the exchange rate.

These days, frontloading rate hikes by ECB is unlikely to materially support EUR over USD. Indeed, we have recently seen many central banks hiking interest rates, where the FX response has been muted or a signal to sell the domestic currency – also in the case where hikes were in excess of market pricing. This is probably because hikes are not a reflection of increased productivity lifting natural real rates, but rather a global policy shift intended to curb demand (though with substantial differences in timing between regions). As such, we continue to see scope for a stronger USD as rising global interest rates add to the safe haven appeal of the dollar (see also *FX Strategy - ECB fighting gravity in "reverse currency war"*, 22 April).

Effective EUR has depreciated by 6%



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Source: ECB, Macrobond Financial, Danske Bank

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