19 October 2022

ECB Preview

Focus on the technicalities

- Next week's ECB meeting is set to bring another 75bp rate hike in all three policy rates. We expect Lagarde to say that the probability of the ECB staff's downside risk scenario from the September projection exercise is becoming more likely, but fall short of giving new significant policy signals. We expect the ECB to continue to hike its policy rates until early next year, with the risk of potential further hikes if fiscal initiatives support the growth outlook in such a way that inflation remains too high over the medium-term.
- Markets will focus on the risk of the ECB ending its APP reinvestments, which will complement the liquidity tightening that will take place as TLTROs mature next year. We do not expect the ECB to present a roadmap on how to end reinvestments at this meeting, but we expect the ECB to announce a change in its reserve remuneration system, which may initially cause some market jitters. We expect the ECB to calibrate the new system in such a way that the market relevant policy rate will continue to be the deposit rate, but we acknowledge risks to short-end credit spreads.

Navigating the 'tug of war' between fiscal easing and monetary tightening

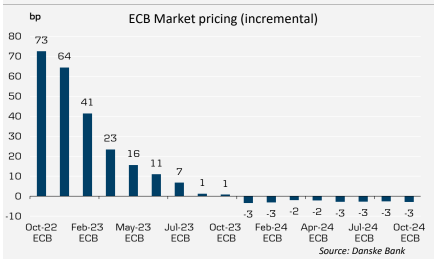
Since the September meeting, the outlook for the Eurozone economy has clouded further. A worsening energy crisis is weighing on competitiveness and domestic demand and business surveys, such as PMIs and consumer confidence, have further declined into recessionary territory. However, hard data has so far outperformed soft indicators, as a healthy order backlog and easing supply constraints continue to support industrial activity and a strong labour market is holding a hand under consumer spending. Our baseline remains that a recession will take hold in H2 22 and **we expect the ECB to acknowledge that the probability of its downside scenario (negative growth of -0.9% instead of 0.9% next year) has increased.**

Navigating the 'tug of war' of monetary tightening amid easing fiscal policies creates increasing headaches for the ECB. Underlining the risks of fiscal expansion at a time of rapidly rising interest rates, Banque de France governor Villeroy recently warned that: "If you have a monetary policy with an anti-inflationary stance and there are doubts about whether your fiscal policy will fuel inflation, then you really risk nurturing a vicious loop." While high inflation keeps pressure on the ECB to front-load more rate hikes (HICP and core inflation rose yet again to record highs of 9.9% and 4.8%, respectively, in September), governments are coming up with ever more creative ways to shield consumers and firms from the adverse repercussions of the energy crisis. Since the September meeting, Germany announced a large aid package (see *Germany's energy package: stoking or quenching the fire?*, 11 October) and discussions about another round of EU-wide borrowing are ongoing.

27 October

- Decision released at 14:15 CET and press conference at 14:45 CET.
- Inflation expectations still anchored but too high. Economic outlook weakening and risks of downside scenario increasing.
- Another 75bp frontloaded rate hike delivered. Further rate hikes in upcoming meetings, but size dependent on incoming data.
- No end to reinvestment plan, but changes to reserve remuneration schemes.

Market pricing for rate hikes in coming meetings



Source: ECB, Eurostat, Macrobond Financial, Danske Bank

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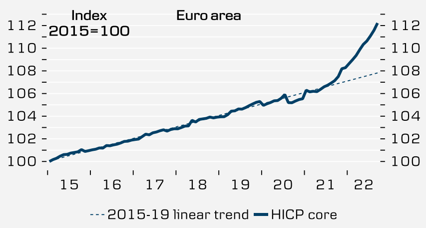
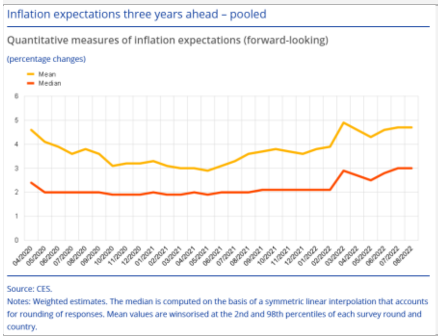
No slowdown in core inflation in sight



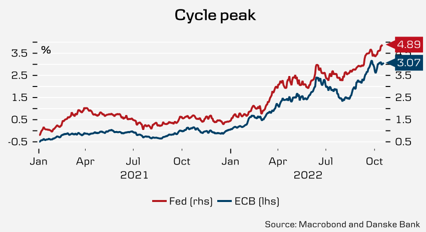
Source: Eurostat, Macrobond Financial, Danske Bank

Inflation expectations stable, but still too high



Source: ECB

Markets have reassessed expectations for peak policy rates in a hiking cycle



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

Despite tentative signs of moderating inflation pressures in non-essential items, such as package holidays, a renewed rise in firms selling price expectations suggests that the weakening demand environment has yet to slow core inflation on a broad scale. **Heterogeneous country developments, reflecting differing public support measures to limit energy price increases, further complicate the job of finding the right policy calibration for the ECB** (see *Euro inflation notes - Energy variations*, 10 October). A ray of light is that consumer inflation expectations were stable in August (see *here*). But they probably remain too high for the ECB to signal a slowdown in the hiking pace anytime soon.

At the ECB meeting, the GC will likely use the Survey of Professional forecasters as an important input in their decision making. We believe that a high release (the report is released on the day following the ECB meeting) will increase the probability for another hike of 75bp in December, while a broadly unchanged reading from the July release will likely signal a less than 75bp rate hike.

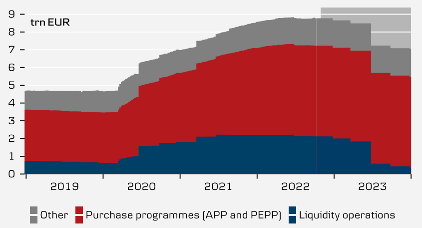
Markets are set for a 75bp rate hike

Markets have significantly repriced the outlook for ECB rate hikes since the 8 September meeting by 85bp to the cycle high peak in rates, which leaves markets now pricing the policy rate to reach 3% in summer next year (we define cycle high as peak rate level within the coming five years). This is naturally in stark contrast to one month ago, due to the recent fiscal initiatives and spill over from the UK fiscal packages. The cycle peak has remained stable at around 3% in the past week. ECB sources said last week that the ECB GC members are sceptical of ECB staff estimations of the deposit facility rate at 2.25% and reduced balance sheet is enough to get inflation in line. We expect Lagarde to repeat her guidance of the ECB to hike until early next year.

Ending APP reinvestment discussions started but no decision

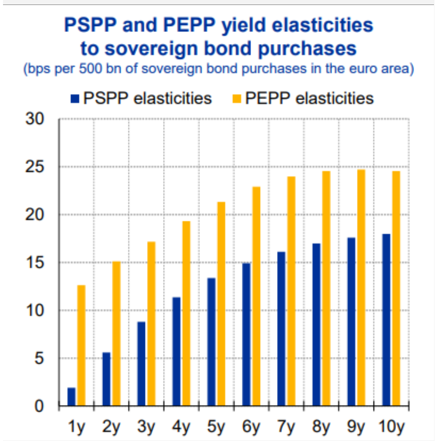
The ECB QT theme has featured prominently in markets these days, not least since the non-monetary policy meeting in Cyprus at the start of the month. We highlight though that balance sheet normalisation will take place next year as EUR1.5trn of TLTRO funds will mature by the end of next year. Any QT discussion will come on top of these already tighter financial conditions. News sources said that the hawks are looking for early 2023/Q2 23 to start bond holding normalisation, yet Villeroy said that an end to full APP reinvestment could come from the end of this year. Nagel said they should begin rolling off the bond holdings soon. Looking into the redemptions of the PSPP portfolio, we see that in the coming 12 months the potential roll-off is rather insignificant volumes as on average only

ECB balance sheet normalisation



Source: Macrobond, Danske Bank

QT impact on Eurozone bond yields



Source: Schnabel 20 Sep 21, *ECB*

EUR21bn/month mature (around EUR5bn/month in the rest of the APP). We do not see the outright sale of bond holdings as a risk right now as ECB APP holdings are spread across the maturity spectrum of its purchases up to 31 years. That provides a gradual roll-off of the holdings, contrary to the UK. This fact has also been pointed to by several GC members including the traditional hawks such as Knot.

It is difficult to gauge what the market impact of QT will be in yield terms; however, applying Schnabel's EUR500bn of PSPP buying roughly equates to EA yields declining 16bp, and we may get only 8bp – and that is even when we stretch the assumptions. That said, the signalling value is big. And the lessons from the UK show that there is no point in pursuing price stability if we do not have financial stability, so the GC needs to carefully weigh whether to take such a decision. We remain unconvinced that the ECB will eventually embark on an end to APP purchases though, but we acknowledge that this is the next natural step in its tightening narrative.

As for next week, we expect the APP reinvestment language to have changed, given that it refers to the time of the first rate hike, which seems increasingly outdated. We do not expect a change, where the ECB would give clear indication, even between the lines, of when the ECB expects QT to commence. Next week, peripheral spreads have a risk of initial underperformance.

Changing the reserve remuneration of ECB liquidity

At the September ECB meeting, President Lagarde said that an overall review of the remuneration mechanisms will be conducted 'in due course'. **We expect a decision to be taken next week**, but likely only to take effect after the December TLTRO repayment option, thereby giving banks the option of repaying the TLTRO funds under the current modalities. In some sense, we see it as a 'now or never' situation for the ECB to announce a change to the reserve remuneration, because the main "problem" for the ECB is the TLTRO calibration. We already know that EUR1.2trn will mature in June 2023 and another EUR300bn through H2 23, so for the ECB to make it 'worth it', we expect the ECB to make an announcement next week. The exact calibration is difficult to predict. We looked at various options at how the ECB could design a new reserve remuneration system *here*. **Importantly, we do not expect €STR to be materially impacted, but there are risks for the credit component in rates markets to underperform, as liquidity and credit conditions will tighten**. Similar to the 2019 introduction of the tiering system, we remain confident that the ECB will calibrate a reserve remuneration system in such a way that the deposit rate remains the policy relevant rate, in order to get the monetary policy tightening that is needed.

While the easiest way to address this would be to change the TLTRO modalities, there is a risk of litigation issues according to ECB source stories. We do not expect the ECB to resort to this option, but we expect that the ECB will net the TLTRO funds and the deposit holdings, so that banks will not be remunerated on the TLTRO related funds, but only after the TLTRO voluntary early repayment option in December.

We see upside risks to FRAOIS and slightly less repo squeeze on the back of this change.

Higher ECB policy rates not supportive for the EUR/USD

In our view, FX markets will continue to focus on the negative effects of higher policy rates on 1) housing, 2) consumer demand, and 3) the general investment case for Europe (where inflationary tailwinds appear stronger than in the US). Therefore, although the ECB is likely to continue to raise interest rates, we do not view this as supportive of EUR/USD spot and there is by now a great deal of events in FX which suggest the above line of thought is consistent with how it is traded. In terms of the communication from the ECB, the verbal emphasis on downside risks for growth will likely be a negative factor for the EUR. These considerations also appear in line with general indicators of demand that have declined, whereas indicators of inflation remain elevated. As such, we continue to see EUR/USD spot fixing below parity and our 12M forecast is 0.93 as we see more room to price-in stagflation in European assets, noticeably in FX.

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Ad hoc.

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