26 January 2023

ECB Preview

Set for another 50bp rate hike

- For next week's ECB meeting, another 50bp rate hike has been well telegraphed and fully priced by markets. We expect the ECB to continue to sound very hawkish and signal that further rate hikes are coming, in particular giving guidance for another 50bp hike in March. The ECB surprised on the hawkish side in December, which immediately tightened financial conditions, but during January financial conditions reversed back to pre-December levels. Consequently, we expect Lagarde to give a strong reminder to markets to tighten financial conditions.
- Since the December meeting, the economic outlook has brightened, but this is a double-edged sword for the ECB. While headline inflation declined in December and is expected to head lower throughout most of the year, the stickiness of underlying inflation remains a headache for the ECB.
- On the technical side, the ECB said at the December meeting that it will publish the technical details of the reduction in the APP portfolio.

Resilient economy is a double-edged sword for the ECB

Since the December meeting, the economic outlook has brightened. Thanks to the effects of expansionary fiscal policies and easing supply bottlenecks, economic activity remained fairly resilient and energy crisis fears have abated with natural gas prices returning to their pre-war levels. In January we even saw the euro area PMI composite returning to marginally expansionary territory. However, for the ECB the brightening growth outlook is a double-edged sword. Chinese pent-up demand has the potential to boost activity during the spring and summer, but it could also worsen the inflationary trade-off, as Europe and China will increasingly compete on a still tight global energy market (*Euro macro notes - The China connection: short-term boost, long-term worry*, 12 January).

While markets have focused on the decline in headline inflation that could materialise faster than forecast by the ECB in December considering the lower energy market prices, core inflation is still rising. For the time being, lower energy prices and base effects as well as government interventions are pushing down headline inflation. However, with a resilient labour market and still elevated selling price expectations, high core inflation is set to remain a worry for the ECB for some time. In a positive development, consumer inflation expectations and high-frequency wage growth measures have eased a bit lately, but they remain at too elevated levels to be consistent with market expectations of (core) inflation already returning to the 2% target by the end of this year. We also see the potential for an upside surprise in the January HICP figures released next week (see *Euro inflation notes – January surprises*, 25 January), adding to the risk of more ECB hikes to come.

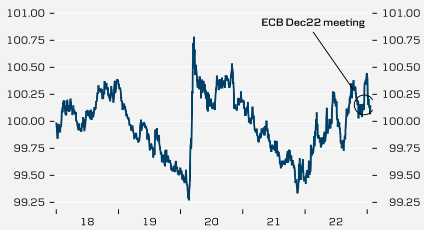
A 50bp hike is the easy decision, communication is difficult

The decision next week to hike 50bp has been very well telegraphed to markets and hence markets have exactly 50bp priced for the meeting. Therefore markets' focus will be on the

2 February

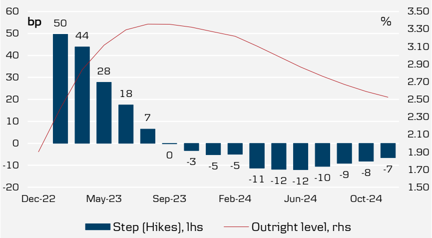
- Decision to be released at 14:15 CET and press conference at 14:45 CET. A technical document with QT principles is due for release at 15:45 CET.

Euro area Financial Conditions Index



Note: Effective exchange rate, stock prices and government yields are used to construct this index.
Source: Macrobond Financial, Danske Bank

Market pricing for rate hikes in coming meetings



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

Director, ECB and Fixed Income Research
Piet Haines Christiansen
+45 45 14 15 18
phai@danskebank.dk

Senior Euro Area Analyst
Aila Mihr
+45 45 14 15 11
amih@danskebank.dk

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

guidance for hikes beyond that. As headline inflation has come lower and will continue through the year, the doves are likely to argue for signals to slow the hiking pace, like what Bloomberg's ECB *sources* story suggested last week. However, with underlying inflation expected to stay sticky for longer and only return to 2% in 2024, we expect the hawks and Lagarde to send hawkish signals for further tightening to come. Since the December meeting, the peak of policy rate hikes has come higher by 51bp to 3.3% (in €STR terms, hence c.3.4% in deposit rate equivalent). This is broadly in line with our anticipation of 50bp next week, followed by another 50bp in March and 25bp in May, which will bring the deposit rate to 3.25%. We still see risks skewed to more than the 3.25% as in our baseline scenario.

Diverging views and a split GC as ECB is approaching the end of its tightening cycle

Recent comments from ECB members show that the Governing Council (GC) is split on its current guidance beyond the February meeting. While Lagarde, Schnabel and Knot have signalled further tightening through significant rate hikes, chief economist Lane has suggested a more cautious approach to the pace of tightening beyond the near term. One of the most dovish GC members, Stournaras, has suggested an even more cautious approach to tightening than the rest of the GC comments suggest. That said, most GC members still lean to the hawkish side – and the ECB accounts from December also indicated that some GC members did not see the hawkish communication and a 50bp hike to be able to make up for a 75bp rate hike.

Therefore, we expect Lagarde to provide guidance for at least one more hike of 50bp in March and signal a slowdown in the rate hike pace only after the March meeting. It is important for the ECB to clearly communicate this following the sources story last week about some GC members pondering a 25bp rate hike and with that view gathering support. Markets are currently pricing a 50bp rate hike in March with more than 80% probability.

With regard to the financial conditions, Lagarde needs to repeat her hawkish message from December, as financial conditions have reverted to their pre-December levels at which point Lagarde also said that it was incompatible with inflation returning to the target. Real 1y forward rates are also broadly back at the pre-ECB December meeting levels in the sub 5y area.

Looking towards the summer, there have not been comments from any GC member suggesting a rate hike cycle that could go beyond the summer, hence the final rate hike is guided for June. However, we do acknowledge a risk of the tightening going even beyond that on the back of a strong labour market, significant wage growth and China reopening as discussed above. The latter was also a risk that Lagarde mentioned in a panel participation last week in Davos.

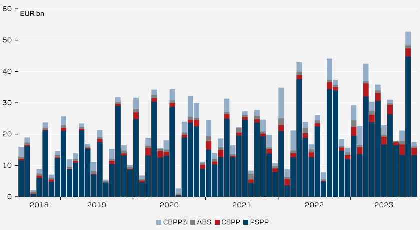
End to full APP reinvestments starting in March

In December, the ECB announced that from March it will stop its full reinvestments under the APP programme. The ECB will allow for on average EUR15bn/m from March until June, which corresponds to roughly 50% of the bonds maturing under the APP during that period. The pace for H2 23 is yet to be decided. Next week, bond markets will focus on how the reinvestments will be implemented. We expect the ECB to attempt to make the QT process as 'boring' as possible, i.e. as a mechanical process running in the background of its prime monetary policy setting via rates like the Fed's QT. We therefore expect the ECB to do a broadly proportionate implementation of the APP reinvestments across asset classes and jurisdictions. Further, we expect the ECB to reinvest the maturing bonds in the

€STR cycle high rate

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

APP redemptions

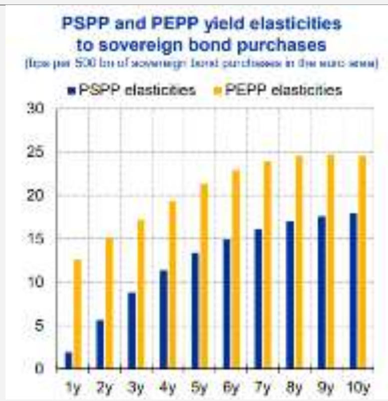


Source: ECB, Macrobond Financial, Danske Bank

10y Italy vs Germany has tightened markedly since the December meeting

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

QT impact on euro area bond yields



Source: Schnabel 20 Sep 21, *ECB*

weighted average maturity (WAM) of the asset class / portfolio where the given bond falls due, therefore not actively shortening the WAM of the APP portfolio. The exception to this view is that we expect the ECB to favour green bonds relative to conventional ones, which the December *ECB accounts* also noted. Recall that the end to the full reinvestments is still only concerning the APP programme and not the PEPP programme. We expect the current guidance of PEPP reinvestments to continue until the end of 2024 to remain unchanged.

Markets will continue to discuss QT, but it may not be a big driver beyond the immediate impact

The ECB balance sheet normalisation (both via TLTROs and QT) has been very well flagged and is widely anticipated by market participants. So, while we may see an initial market impact upon announcement next week, we believe markets will cope well with the tightening of liquidity conditions and balance sheet reduction, despite the additional issuance that needs to be absorbed by markets (from EUR200bn in 2022 to c.EUR600bn in 2023). Looking beyond the most immediate reaction to the announcement, we still see markets relaxed given the spread tightening between the 10y Italian and German bond yield to levels seen before summer last year.

In our December preview we highlighted the market impact of QT in yield terms and while it is difficult, we shared Schnabel's EUR500bn of PSPP buying equates to euro area yields declining 16bp, see *ECB Preview - A hawkish 50bp*, 8 December 2022.

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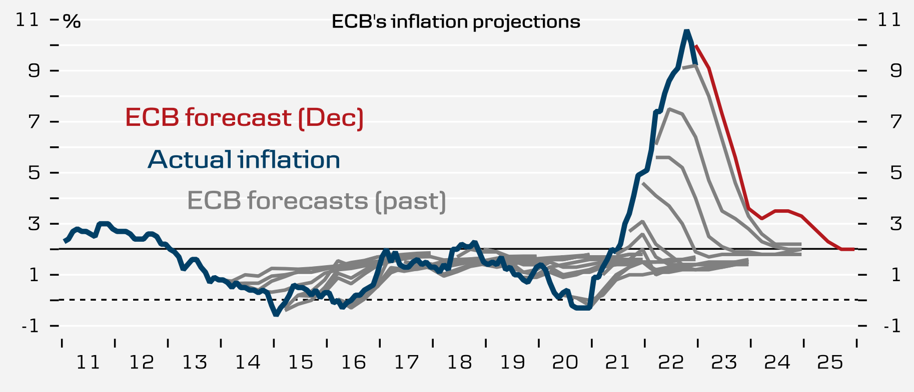
On balance a firm hawkish message from the ECB should contribute to a stronger EUR upon announcement. Meanwhile, we emphasise that an important condition for this call is that the global investment environment remains characterised by growth optimism (reduced pessimism) on Thursday. If that is not the case, we have previously seen hawkish ECB messages weaken the single currency instead on the day, as it hurts the investment case outlook for EUR-denominated assets.

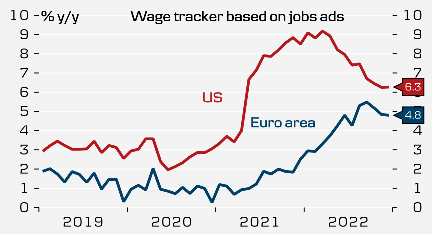
EUR/USD has bounced sharply higher over the past months in a move that we primarily attribute to the overperformance of euro area assets (China, natural gas prices, financials etc.) and the general easing of global financial conditions. Tactically our conviction on the direction of EUR/USD is not high, albeit our 1M forecast of 1.09 remains reasonable in our view. Meanwhile, we remain convinced that EUR/USD strategically is a sell on rallies as we still believe the cross is fundamentally overvalued on a 1-3Y horizon and as we think a stronger USD plays an important role in fighting the second wave of higher global inflation pressures.

Headline inflation has started to surprise on the downside since December



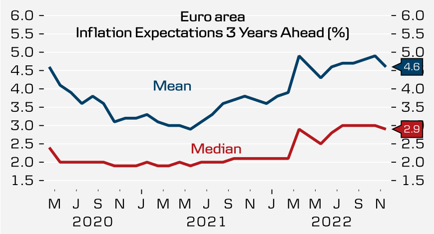
Source: ECB, Eurostat, Macrobond Financial, Danske Bank

Tentative signs of peaking wage growth, but at too elevated levels



Indeed Hiring Lab, Bank of Ireland, BLS, Macrobond Financial, Danske Bank

Consumer inflation expectations have eased



Source: ECB, Macrobond Financial, Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Piet P. H. Christiansen, Director, Aila Mihr, Associate, and Kristoffer Kjær Lomholt, Director.

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