9 June 2022

Flash: ECB Review

Ready for lift-off - confirmed!

- At today's ECB meeting today, the ECB decided to end the net purchases under the APP programme on 1 July and announce that they 'intend' to hike policy rates by 25bp in July. For September they remain data dependent, but they essentially communicated that they will have to see an improvement of the inflation dynamics in order not to hike 50bp rate hike. Beyond that a sequence of gradual hikes will follow.
- As a result of ECB's guidance, we change our expectation for the size of the September rate hike to 50bp, but otherwise our call remains unchanged of 25bp in the other meetings between July this year and March 2023.
- Risks are still skewed for more than one 50bp rate hikes, but with the current very uncertain outlook we expect the economic outlook will dampen the medium inflation pressure, paving the way for 'only' 25bp hike.

25bp lift off in July followed by 50bp in September

With Lagarde's *blog* two and a half weeks ago, the ECB GC took the 'easy' decision to confirm that net asset purchases are coming to a halt in 1 July, and announced its intensions to hike 25bp. Looking ahead ECB said that they will remain data dependent and considering the medium inflation outlook before decision on the size of a rate hike. However, the burden of proof is reversed for not to hike 50bp at the September meeting as they say that '*If the medium-term inflation outlook persists or deteriorates, a larger increment will be appropriate at the September meeting.*' As a result we also pencil in a 50bp rate hike in our projections. We also highlight that with inflation expectations still to peak (markets price the September HICP headline inflation at 9.3%), there is a risk of a sequence of 50bp rate hikes, into Q4 as well. However, given the very uncertain environment we believe that ECB will weigh the predictability and gradualism thereby choosing 25bp rate hikes.

Spreads remain vulnerable and curves flatter

Lagarde only confirmed the usage of existing policy instruments and that they can deploy a new tool if warranted. This lead to peripheral bonds suffering quite a lot with BTPs-Bund spread widening at 10bp on the day at the time of writing (212bp). At the same time, with the front loading of hikes and ECB determination to fight inflation, the curves flattened with the short end coming significantly higher.

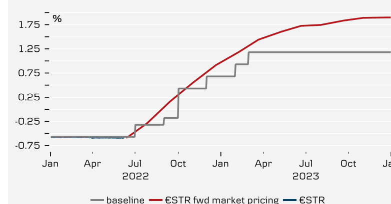
Markets price two hikes of 50bp as a minimum

As for this year, the market now price 148bp of policy rate hikes by year end. This would require two hikes of 25bp and two hikes of 50bp to be validate this pricing. This compares to 137bp at the start of the day for the Dec ECB €STR. We do not find it attractive from a risk reward perspective to enter new positions now. Looking into 2023, we remain sceptic about the 98bp that are currently priced.

Key take away

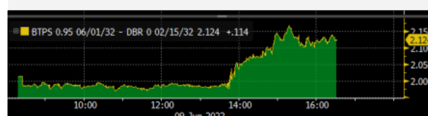
- APP ending 1 July
- 'Intends' to hike rate 25bp in July. Open for more in September.
- No details on fragmentation

ECB to hike policy rates in July



Source: Macrobond, ECB , Danske Bank

Spreads widened markedly by 11bp on ECB announcement



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

Source: Bloomberg, Danske Bank

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With ECB's meeting behind us, the markets will remain sensitive to potential sources stories, which may indicate differences in views on the size of rate hikes at the September meetings and onwards. While the decision today was unanimous, we believe that the ambiguity in interpreting the September/beyond to be a source of volatility going forward.

Inflation problem calls for action

As expected, the new ECB staff projections painted a more gloomy near-term growth outlook combined with significant upward revisions in inflation pressures. The Ukraine war, supply issues and real income erosion continue to weigh on confidence and dampen growth in the near-term, but once current headwinds abate, economic activity is expected to pick up again thanks to a strong labour market, fiscal support and pandemic savings, with GDP growth averaging 2.1% in both 2023/24.

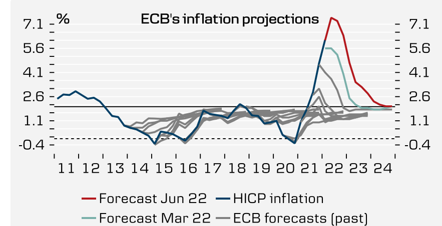
ECB acknowledges that high inflation is a major challenge, especially as inflation pressures have broadened and intensified and wage growth has started to pick up. Although moderating energy costs, easing supply disruptions and monetary policy normalisation will lead to a decline in inflation rates, both core (2.3%) and headline (2.1%) inflation are now expected to remain above target at the end of the forecast horizon in 2024. The risk around the inflation outlook remain primarily on the upside, also as inflation expectations still stand above target.

We agree with ECB's risk assessment, but find it a bit puzzling that monetary policy normalisation is expected to help cool inflation, while at the same time seemingly not doing much damage to growth. Hence, we think ECB continues to underestimate near-term inflation pressures and also expect a more subdued growth outlook with an increasing recession risk for 2023 (read more in *Big Picture: A (mild) recession in western economies seems unavoidable*, 3 June).

Inflation still above target in 2024

ECB projections June 2022	2022		2023		2024	
GDP growth	2.8% (3.7%)	↘	2.1% (2.8%)	↘	2.1% (1.6%)	↗
HICP inflation	6.8% (5.1%)	↗	3.5% (2.1%)	↗	2.1% (1.9%)	↗
Core inflation	3.3% (2.6%)	↗	2.8% (1.8%)	↗	2.3% (1.9%)	↗

Parenthesis are the old ECB projections (from March 2022)



Sources: Eurostat, ECB, Macrobond Financial, Danske Bank

EURUSD heading towards parity in 12m

For EUR/USD, ECB is provided some well-sought after clarity as to the entire likely policy path in to and including Q4. Further, this guidance appear quite in line with the market's view. We are seeing a mild widening of credit spreads (higher Italian rates vs Germany) and during the press conference, and EUR/USD unwound some of the initial strength – likely due to the credit/risk aversion channel. This is well in line with the observation that FX strength upon hawkish central banks has faded rather fast and we have recently seen that in SEK, AUD and Eastern Europe. Also, EUR strength on ECB guidance has faded multiple events in the last 3-6 months. In our view, this ECB meeting confirms our view that rate hikes are a global phenomenon intended to make markets rotate towards less risky positions and a lower EUR/USD spot is part of such a rotation. For Europe, widening spreads is also crucial to why EUR/USD heads south as we price in higher rates. Looking ahead, we continue to see EUR/USD towards 1.00 in 12m.

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None

Date of first publication

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