15 December 2022

Flash: ECB Review

Hawkish 50bp – more hikes to come

- At today's ECB meeting, the ECB delivered a 50bp rate hike in all three policy rates as widely anticipated, so now the ECB deposit rate is at 2%. The ECB also announced that the end to full APP reinvestments would start in March 2023, which was more specific than the presentation of key principles expected. The ECB guided that from March 2023 to June 2023, its securities holdings will decline by EUR15bn per month on average. The pace beyond that is still to be determined.
- Lagarde highlighted the data dependent and meeting by meeting approach, but at the same time also gave a firm guidance that today's 50bp rate hike will not be a single 50bp rate hike and that more will follow.
- While we expected an open-ended wording of more rate hikes to come, we were surprised by the significant hawkish guidance Lagarde gave today. In our preview, we had already pointed to the risk to our forecast for longer/more than our baseline and as a result of today's meeting **we revise our ECB call and add another 50bp to the peak cycle rate to 3.25%, so our new call is for 50bp in February (unchanged), 50bp in March (+25bp) and 25bp in May (new)**. We remain open to further rate hikes in June next year.

Lagarde in full hawkish mode and slowing the rate hike pace is not an ECB pivot

Lagarde was very hawkish during the press conference today. While she highlighted a lot of risks surrounded the outlook she did not provide many dovish arguments. We thought the most dovish was her view that during the policy discussions, some wanted a less hawkish calibration and some wanted to be more hawkish. While we had expected the ECB to communicate an open-ended wording about the number of rate hikes the ECB would ultimately deliver, the fact that she guided markets to price in more rate hikes was a surprise to us as she previously had refrained from commenting on market pricing. This brings back memories of Draghi's tenure. She said that the current market pricing feeding into the staff's models do not provide sufficient tightening for inflation to fall in line with the target and therefore more tightening is needed. Furthermore, she made it very clear that this is not a pivot from the ECB.

The decision statement also said that, 'by the end of 2023, we will also review our operational framework for steering short-term interest rates, which will provide information regarding the endpoint of the balance sheet normalisation process.', but there were no questions during the press conference on what this might entail.

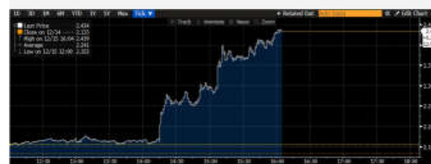
End to full reinvestments in March – details announced in Feb

Markets were somewhat surprised that the ECB's announcement to end its full APP reinvestments from March was made today, as expectations were only for key principles to be presented today. The ECB announced that the securities holdings would decline by EUR15bn per month on average from March 2023 to June 2023 and the pace beyond this is still to be determined. This amounts to EUR60bn of EUR131bn, i.e. 45% of the bonds maturing. The rest will be reinvested, but how will only be published in February.

New call

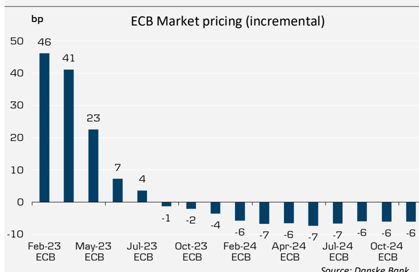
- 50bp in February (unchanged), 50bp in March (+25bp) and 25bp in May (new). That means ECB policy rate hike to peak at 3.25%.

2y German yields rise 29bp on the day



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

Market pricing for rate hikes in coming meetings



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

Chief Strategist, 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

Chief Analyst, FX
Kristoffer Kjær Lomholt
+45 45 12 85 29
klom@danskebank.dk

Amid 'sticky' core inflation and rising wages, ECB has more ground to cover

New ECB staff projections showed the inflation outlook revised markedly higher in 2023/24, and a 'mild and short-lived' recession in Q4 22/Q1 23 is now included in the baseline, owing to the energy crisis, high uncertainty, weakening global activity and tighter financing conditions. The higher core outlook, with inflation rates still above target in 2025, was an important reason for the relatively hawkish wording on the rates outlook. We remain more gloomy on the economic outlook (the ECB acknowledges 'downside risks') and see a real risk of a double dip recession for the euro area, as lingering energy troubles, weaker foreign demand and tighter financial conditions will weigh on the euro area growth prospects (read more in *Big Picture Euro area - Double dip recession*, 28 November). Inflation risks remain on the upside and we agree with the ECB that 'sticky' core inflation could remain a concern for some time yet (read more in *Euro inflation notes - A 'sticky' problem*, 30 November). Evidence of rising wage growth has become clearer amid the robust labour market and staff projections assume wages growing at rates well above historical averages during 2023/24. At the same time, fiscal measures are expected to mitigate the downturn, but also prolong inflation pressures over the medium term.

Markets repriced the cycle high rate 30bp higher today

At the start of the day, markets priced the ECB deposit rate to peak at 2.8%, but after the very hawkish communication, this now points to 3.10%, i.e. 30bp higher in the front end. Looking ahead, markets price 45bp for February and 38bp for March.

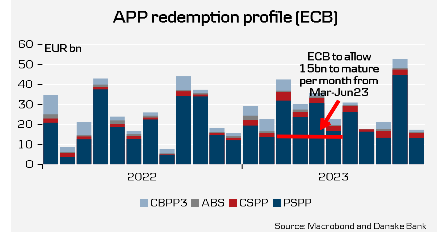
The bond market also sold off markedly in a bearish flattening move. 2y Germany is up 22bp on the day while the 30y point is 'just' up 5bp at the time of writing. Bund asw spread tightened 6bp on the announcement, but has somewhat rewidened half of that back to now stand at 62.8bp.

Busy week ahead with multiple potential EURUSD drivers

The hawkish ECB message – not least at the Lagarde press conference – combined with weak US retail sales brought a sharp EUR-USD spread tightening in today's session, which in turn has sent EUR/USD close to a full big figure higher. At the time of writing EUR/USD spot has erased part of the day's gains yet remains close to the 1.064 mark. Looking ahead it is a tough balancing act for FX markets. On the one hand, higher EUR rates is a clear boost to the carry-attractiveness of the EUR. On the other hand, higher real rates is set to hit Eurozone growth, which is already suffering from the last year's negative terms-of-trade shock. This will hurt the investment case of Eurozone assets making the EUR look less attractive compared to peers.

In the near term, our bearish case for EUR/USD is under pressure. However, we still think EUR/USD is a sell-on-rallies rather than a buy-on-dips. Our adjusted MEVA-model estimates has EUR/USD close to 0.90 as fair (based on terms of trade, unit labour costs and real rates) and unless global growth prospects accelerate next year we think it will remain difficult for EUR/USD to persistently leave the gravity force of parity.

APP redemption profile

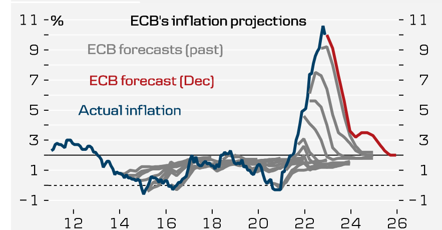


Sources: Macrobond Financial, Danske Bank

Inflation still above target in 2025, with wages growing above historical averages

ECB projections December 2022	2022	2023	2024	2025
GDP growth	3.4% (3.1%)	0.5% (0.9%)	1.9% (1.9%)	1.8%
HICP inflation	8.4% (8.1%)	6.3% (5.5%)	3.4% (2.3%)	2.3%
Core inflation	3.9% (3.9%)	4.2% (3.4%)	2.8% (2.3%)	2.4%
Wage growth (Comp. pr. employee)	4.5% (4.0%)	5.2% (4.8%)	4.5% (4.0%)	3.9%

Parenthesis are the old ECB projections (from September 2022)



Sources: Eurostat, ECB, Macrobond Financial, Danske Bank

ECB cycle high policy rate

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

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, Chief Analyst, Aila Mihr, Senior Analyst, and Jens Nærvig Pedersen, Chief Analyst.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Authorised and regulated by the Danish Financial Services Authority (Finanstilsynet). Deemed authorised by the Prudential Regulation Authority. Subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details of the Temporary Permissions Regime, which allows EEA-based firms to operate in the UK for a limited period while seeking full authorisation, are available on the Financial Conduct Authority's website.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

None

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment, legal or tax advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

This research report has been prepared independently and solely on the basis of publicly available information that Danske Bank A/S considers to be reliable but Danske Bank A/S has not independently verified the contents hereof. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, completeness or reasonableness of the information, opinions and projections contained in this research report and Danske Bank A/S, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts and reflect their opinion as of the date hereof. These opinions are subject to change and Danske Bank A/S does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom (see separate disclaimer below) and retail customers in the European Economic Area as defined by Directive 2014/65/EU.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank A/S's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank A/S is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank A/S who have prepared this research report are not registered or qualified as research analysts with the New York Stock Exchange or Financial Industry Regulatory Authority but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Disclaimer related to distribution in the United Kingdom

In the United Kingdom, this document is for distribution only to (I) persons who have professional experience in matters relating to investments falling within article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the 'Order'); (II) high net worth entities falling within article 49(2)(a) to (d) of the Order; or (III) persons who are an elective professional client or a per se professional client under Chapter 3 of the FCA Conduct of Business Sourcebook (all such persons together being referred to as 'Relevant Persons'). In the United Kingdom, this document is directed only at Relevant Persons, and other persons should not act or rely on this document or any of its contents.

Disclaimer related to distribution in the European Economic Area

This document is being distributed to and is directed only at persons in member states of the European Economic Area ('EEA') who are 'Qualified Investors' within the meaning of Article 2(e) of the Prospectus Regulation (Regulation (EU) 2017/1129) ('Qualified Investors'). Any person in the EEA who receives this document will be deemed to have represented and agreed that it is a Qualified Investor. Any such recipient will also be deemed to have represented and agreed that it has not received this document on behalf of persons in the EEA other than Qualified Investors or persons in the UK and member states (where equivalent legislation exists) for whom the investor has authority to make decisions on a wholly discretionary basis. Danske Bank A/S will rely on the truth and accuracy of the foregoing representations and agreements. Any person in the EEA who is not a Qualified Investor should not act or rely on this document or any of its contents.

Report completed: 15 December 2022, 16:49 CET

Report first disseminated: 15 December 2022, 17:40 CET