15 June 2023

Flash: ECB Review

'Very likely' to hike again in July

- The ECB meeting today was according to expectations with its 25bp rate hike and a formal decision to end the APP reinvestments from July. The staff projections were revised higher for both underlying and headline inflation across the horizon with importantly the 2025 projection at 2.2%, above the ECB's target.
- ECB is 'very likely' to hike again in July. Lagarde didn't provide guidance for the rate path beyond that but reconfirmed the mantra of a known destination, but unknown journey.
- Markets repriced the peak policy higher by 4bp today and now price a peak of 3.90%. EUR/USD rose towards the 1.0900 mark on the back of the hawkish announcement and press conference.
- We continue to expect ECB to hike to 4% by September, and we reiterate our view that the burden of proof will reverse after July when we get two new inflation prints and new staff projections ahead of a September meeting.

Harmonious discussion and too high inflation

Lagarde delivered a press conference in line with expectation, as she guided for further tightening. The tight labour market and upward revision to the staff inflation projections across the horizon on higher wage projections was referenced multiple times. Upside risks to the inflation outlook were still noted, in particular driven by the strength of the labour market and the recent strong wage growth. Lagarde said that it was a harmonious discussion and the decision was based on a 'very very broad consensus'. The change to the staff projections was accompanied by the almost unchanged wording in the statement: '*Inflation has been coming down but is projected to remain too high for too long.*'

Further tightening is on its way and Lagarde repeated her mantra of a known destination (inflation at the 2% target) while the journey to get there is unknown. So far the 2.2% inflation average in 2025 looks too high, hence policy rates need to stay restrictive for 'as long as needed'. Asked directly during the press conference, Lagarde said that they have neither finished their hiking journey and have more ground to cover nor are they thinking about a pause.

While monetary policy transmission has started to kick in, the lag to the real economy and the strength of the transmission still remains uncertain.

Strong labour market conditions feeding through

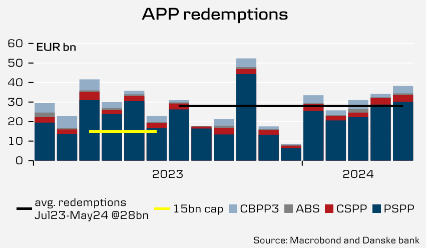
Lagarde generally characterised the economic situation as a largely stagnated economy in recent months and that growth is likely to remain weak in the short run, but also that it is expected to pick up later this year, not least due to lower inflation. She also highlighted the two-speed economy, which is currently driven by services.

The new staff projections showed markedly upward adjustments to the inflation outlook for the coming years. Core inflation is now expected to be 3% in 2024 (vs 2.5% in March), while the outlook for both headline and core inflation in 2025 inched up to 2.2% (from

ECB peak policy rate vs. deposit rate

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

APP redemptions



Source: Macrobond and Danske Bank

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2.1%) and 2.3% (from 2.2%) respectively. The 2025 revisions can be generally attributed to the staff's higher assumptions regarding wage development, aligning with the strong labour market data coming out from the euro area in recent months. The projection for compensation per employee was revised up from 3.6% to 3.9% in 2025, distancing it further from Chief Economist Philip Lane's previous (rough) estimate of 3% being the level corresponding to the inflation target. While there was a slight downward revision in the short-term growth outlook, partly influenced by the downward revisions in Q1, the quarterly trajectory furthermore still points towards growth above trend in the years ahead. Overall, the new projections reinforce the notion that further tightening is likely, despite recent signs of some softening in service inflation and sentiment indicators. On the risk assessment, Lagarde leaned towards the upside factors for inflation, while the outcome space seems more balanced for growth.

Ending APP reinvestments from 1 July - confirmed

As already 'pre-announced' at the May meeting, ECB officially confirmed that APP reinvestments will come to a complete halt from July. The updated redemption profile for APP shows that from July 2023 to May 2024, the average monthly redemptions will be EUR28.3bn/m, although with significant seasonal patterns, in particular in H2 this year. This is almost double the EUR15bn/m cap currently applied. Together with the TLTRO repayment, this should lead to a significant reduction in excess liquidity by year-end of about EUR700-800bn (to around EUR3.3-3.4trn), starting with at least EUR477bn maturing on 28 June. The TLTRO early repayment figure is due tomorrow, which looks set to see a higher repayment than the EUR477bn. There was no change to the guidance for PEPP reinvestments.

Front-end led sell-off

The initial market reaction to the hawkish guidance and staff projections led to a bearish flattening of the EUR curves, where markets sent 2y German yields 12bp higher on the day, although now it has retraced slightly to be 7bp up on the day. The APP announcement was as expected and we don't judge this to have led to the flattening of the curves.

Broad EUR appreciation in FX – we remain bearish on the EUR/USD

EUR/USD rose towards the 1.0900 mark on the back of the hawkish announcement and press conference. The EUR was generally appreciating in the G10 space expect against scandies.

As we move into H2, we still look for a broadly higher USD, and in general expect near-term USD strength. We think that as long as sticky inflation remains a concern globally, we would expect the EUR/USD to remain soft. Although not our base case, sticky inflation means a "harder landing" may be necessary at some point for central banks to avoid entrenched inflation. However, we think there have been disinflationary tendencies in underlying inflation as of late – mostly in the US, where we do not expect more rate hikes from the Fed. As we expect two more 25bp hikes from the ECB, carry on being short EUR/USD will likely decline from here, but we expect this effect to be dominated by stronger US fundamentals. In other words, while higher EUR rates, all else being equal, increase the attractiveness of the EUR, we think the euro area economy is sensitive to the cumulative monetary policy tightening, which is yet to fully hit the economy. In sum, we still find the outlook for the US economy less gloomy relative to the euro area, which should weigh on the EUR/USD in H2. We expect the EUR/USD to decline towards 1.06/1.03 on a 6M/12M horizon.

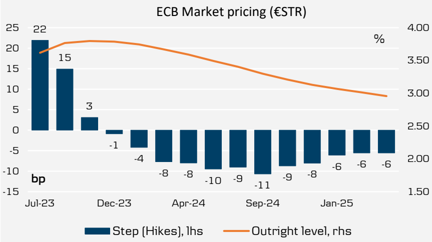
Changes to staff projections

ECB projections June 2023	2023		2024		2025	
GDP growth	0.9% (1.0%)	↘	1.5% (1.6%)	↘	1.6% (1.6%)	→
HICP inflation	5.4% (5.3%)	↗	3.0% (2.9%)	↗	2.2% (2.1%)	↗
Core inflation	5.1% (4.6%)	↗	3.0% (2.5%)	↗	2.3% (2.2%)	↗

Parenthesis are the old ECB projections (from March 2023)

Source: Danske Bank

Market pricing for rate hikes



Source: Danske Bank

TLTRO operations

(bn EUR)	Start (settlement)	Maturity	Original amount (bn EUR)	Currently outstanding (bn EUR)	% early voluntary repayment, of original size	Danske repayment projection
TLTRO3.4	24-Jun-20	28-Jun-23	1308	477	64	550
TLTRO3.5	30-Sep-20	27-Sep-23	174	84	52	100
TLTRO3.6	16-Dec-20	20-Dec-23	50	46	10	70
TLTRO3.7	24-Mar-21	27-Mar-24	331	284	14	200
TLTRO3.8	24-Jun-21	26-Jun-24	110	73	33	70
TLTRO3.9	29-Sep-21	25-Sep-24	98	91	7	80
TLTRO3.10	22-Dec-21	18-Dec-24	52	44	16	29
Total			2,123	1,098		

Source: ECB and Danske Bank

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None

Date of first publication

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