2 June 2022

ECB Preview

Ready for lift-off

- Next week's ECB meeting is set to be the formal end of ECB net asset purchases and a clear signal to hike rates in July, although without a specific guidance of the size of the first rate hike. We expect ECB net purchases to end on the 1 July, thereby in line with previous guidance for Q3.
- With inflation pressures continuing to build and the economic backdrop still supported by services, we do not expect the inflation problem to solve itself in the near future. On the other hand, inflation expectations should gradually decline to the 2% mark in late 2024/early 2025, which leaves a narrow window for ECB to hike between now and the coming 12m.
- Market focus will be on the discussion if a 50bp hike is possible, and if so when, as well as to any hints about tools that ECB may take to address fragmentation. **We expect ECB to hike 25bp each meeting until Mar23, but risks are clearly skewed for a 50bp rate hike in H2 this year (July or Sep most likely).**

The classical indicators indicate lift-off

While the near term uncertainties from the pandemic and the Russian aggression on Ukraine have receded, ECB is still faced with the longer-lasting implications of higher energy and food prices, higher inflation expectations than a year ago and building wage pressures. In the past months, the traditional ECB indicators for financing conditions have still shown benign signs. For example, the bank lending rates is still a relatively low levels (and no material intra-euro area difference observed), and the EGB spread widening have been gradual. Furthermore, the real yields have moved around 30bp higher in an 'orderly' fashion.

Last week, President Lagarde posted a *blog post* which essentially was an inter-meeting decision to announce an end to the APP purchases in early Q3 and announce that ECB would no longer have a negative interest policy in place by the end of Q3. There was no pledge or forward guidance for Q4 or beyond given the elevated uncertainty.

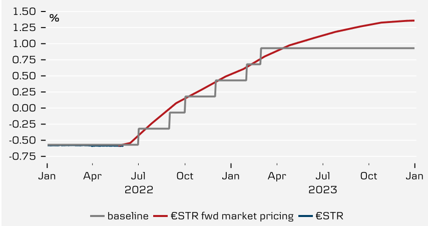
As a result of the continued strong inflation pressures, with core inflation set to peak after the summer, we see an urgent need for ECB to hike rates. To us, given the clear inflation mandate, there are no economic argument of why ECB should not hike rates already next week, but their forward guidance and sequencing prevents them from doing so. For July and until March 2023, our expectation is for 25bp rate hikes, but we do acknowledge the risk of a 50bp hike happening along the way. However, as ECB prefers to be an anchor of stability, we believe they will opt for 'only' 25bp, but remain open to discussing a 50bp rate hike. We do not anticipate any commitment on rate hike size next week.

On top of the tightening from rate hikes, the euro area markets will also see tightening from the lack of duration extraction (no new net asset purchases), TLTROs (LT) and the end of tiering.

9 June 2022

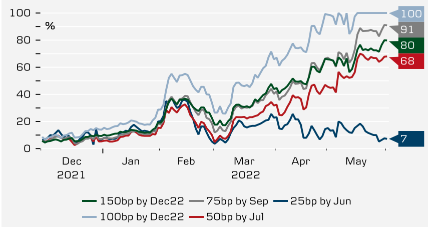
- 13:45 ECB decision
- 14:30 Press conference

ECB expected to revise QE bond buying



Source: Macrobond, ECB , Danske Bank

Probability of ECB hikes in given meeting and size



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

Source: Bloomberg, Macrobond, Danske Bank

Chief Strategist, ECB and Fixed Income Research
Piet Haines Christiansen
+45 45 13 20 21
phai@danskebank.com

Senior Euro Area Analyst
Aila Mihr
+45 45 12 85 35
amih@danskebank.com

Senior FX Analyst
Lars Sparresø Merklin
+45 45 12 85 18
lsm@danskebank.com

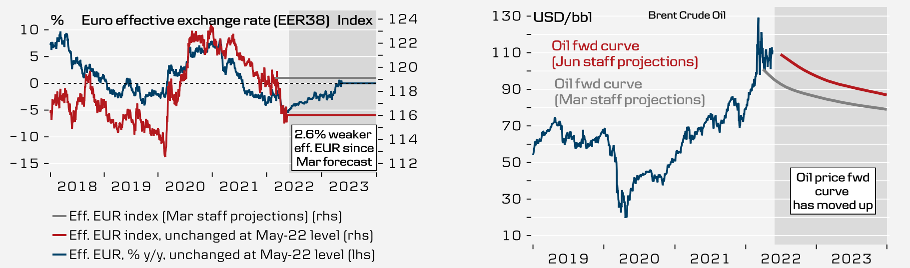
Our additional rate hike expectations for this year and into next year is due to the continuation of inflation pressures building (peak not observed yet). While we do expect ECB to pause after Q1 next year, we do acknowledge an uncertain outlook with risks of additional hikes should it be needed, however, our balance of risk is for more than 100bp this year rather than 100bp cumulative next year.

ECB has an inflation problem

Since March, inflation has continued to surprise on the upside and we again expect to see a marked upward revision in the ECB's inflation outlook, also due to technical assumptions from higher oil prices and a weaker currency. Especially, underlying inflation pressures have been broadening with core inflation standing at 3.8% in May. Rising input costs are still working their way through the consumer pricing chain and alternative inflation measures all stand above 2%. Service price inflation has yet to see any negative effects of weaker demand and with the Ukraine war and Chinese lockdowns, supply chain pressures will keep NEIG inflation elevated well into 2023 in our view. Although negotiated wage growth picked up to 2.8% in Q1 22 (from 1.6% in Q4 21) partly due to one-off payments in Germany, the continued building of underlying inflation pressures leaves little room for complacency from ECB, especially as inflation expectations (both consumer survey and market-based) have still stand above the 2% goal.

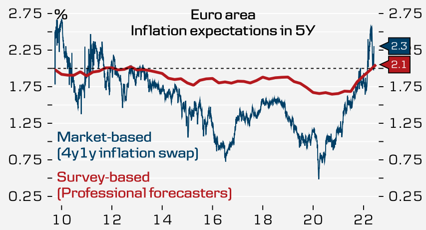
Looking ahead, we expect the new forecast to show abating inflation pressures during 2023, with negative energy base effects kicking in, and core inflation broadly back at target by the end of the forecast horizon. That said, ECB will likely stress that inflation risks remain firmly skewed to the upside, not only in the near-term, but also in 2023/24 from Europe's green transition and housing inflation. In contrast to the inflation outlook, the growth projection will likely paint a more gloomy picture. Although the euro area economy has so far avoided falling into recession thanks to a strong rebound in services activity, the list of external headwinds is growing from renewed supply disruptions, tightening global financial conditions, possible cuts to Russian energy imports as well as more cautious consumers. While we see an increasing recession risk for the euro area in H2 23, we expect ECB's projections to show a continued moderate recovery until the end of the forecast horizon.

Weaker currency and higher oil prices point to higher inflation outlook



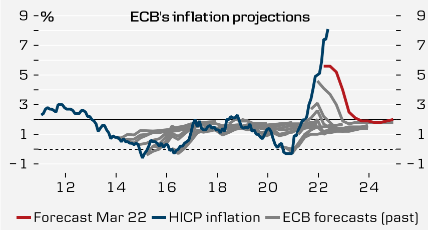
Source: ECB, Macrobond Financial, Danske Bank

Inflation expectations showing signs of de-anchoring



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

Inflation continued to surprise on the upside



Sources: Eurostat, ECB, Macrobond Financial, Danske Bank

Our expectations to ECB revisions of staff projections: Inflation back to target in 2024

ECB projections June 2022	2022		2023		2024	
GDP growth	2.7% (3.7%)	↘	2.4% (2.8%)	↘	1.6% (1.6%)	→
HICP inflation	6.5% (5.1%)	↗	2.7% (2.1%)	↗	2.1% (1.9%)	↗
Core inflation	3.3% (2.6%)	↗	2.5% (1.8%)	↗	2.1% (1.9%)	↗

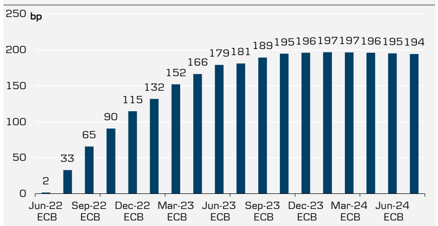
Parenthesis are the old ECB projections (from March 2022)

Source: ECB, Danske Bank

No guidance on rate hike size – at least one 50bp needed to validate market pricing for 2022

Market speculation have intensified about the size of the rate hikes, in particular in light of the mounting inflation pressure. So far, markets are pricing 120bp by year-end and with only four meetings in H2 this year, at least one of the meetings should end with a 50bp rate hike. We clearly see risks skewed to a 50bp hike coming, however, we doubt that ECB will feel similar urgency as they weigh in the stability / predictability argument.

Market pricing for



Source: Danske Bank

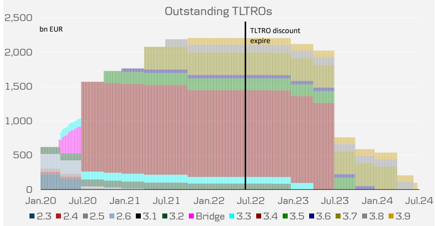
Fragmentation is not a risk

We believe that Lagarde will face a series of questions about fragmentation risk and the potential of a new bond buying tool. However, in line with her previous answers we expect Lagarde to repeat her view of ECB standing ready to deploy a new instrument should it be needed, without any guidance on how a tool could be structured.

Liquidity, tiering end to complement the rate hikes

Looking into H2 of the year, we expect significant focus on the tighter liquidity conditions, as described in *COTW: Introducing ECB 'LT': QT in liquidity*. Later this month, the 50bp TLTRO discount expires which we believe will trigger for significant repayments. We expect between EUR400-500bn and further repayment by the end of the year, which would leave excess liquidity around lower EUR800bn than the current EUR4.5trn. At the same time as ECB exits negative interest rate policies, we also expect an end to the tiering system that is currently in place.

Maturity profile of TLTRO operations

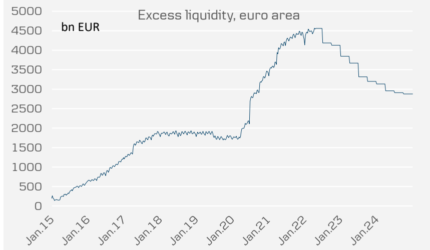


Source: ECB, Danske Bank

Hawkish ECB unlikely to help EUR/USD at the meeting

In our view, the ECB's stance has been well communicated ahead of the meeting, including the release of Lagarde's blog post. As such, the market is well ahead of the view that rate hikes are likely at most, if not all, meetings going in to H2 and excess liquidity will fall. At present, we view it hard for ECB to surprise on the hawkish side versus those market expectations. If any, we might see some pushback against recession risks and/or confidence in inflation turning around 'sooner than later.' Both may well give a bit of downside to EUR/USD spot at the meeting, maybe in the scope of some 50-100pips given EUR/USD has seen a short-term uptick to 1.07 recently. We continue to forecast EUR/USD towards 1.00 over the coming 12M.

Excess liquidity peaks now



Source: ECB, 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, Chief Analyst, Aila Mihr, Senior Analyst, and Lars Sparresø Merklin, Senior Analyst.

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Expected updates

None

Date of first publication

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