8 April 2022

ECB Preview

Lagarde to bring September into play – we revise our ECB call

- We revise our ECB call slightly after the recent Governing Council (GC) comments, hawkish minutes and inflation surprises. We now look for a 25bp rate hike in both September and December 2022. Beyond that, we do not look for a prolonged hiking cycle into 2023 at the current stage as inflation falls back to target and Fed tightening will also have contributed to a significant tightening of financing conditions globally – thereby worsening the economic outlook.
- Yet another challenging meeting awaits next week, with ECB facing an increasingly uncertain economic outlook. The economic backdrop since the last meeting has moved further towards a stagflationary scenario in the euro area, with weakening growth, higher uncertainty, lower confidence and higher inflation. However, the increasing risk of unanchored inflation expectations and second round effects on wages will keep the pressure on ECB to proceed with its policy normalisation despite rising recession risks in our view.
- While we expect the statement to re-confirm the decisions taken at the March meeting just 4 weeks ago, with its guidance to end APP during Q3 and the first hike to come 'some time' after the end of net asset purchases, we believe the press conference will be the most interesting part, where we expect Lagarde to repeat the gradual, flexibility and optionality mantra. While we do not expect Lagarde to directly mention a September rate hike as a possibility, similar to other voices in the GC, we believe she will keep the door open as a way to respond to high inflation pressures.
- **We expect markets to buy in to** September hike in play (current 31bp priced for September) and thereby we also believe that risks are skewed towards a hawkish market reaction, notably in the 2022 segment of the curve, where there are currently 66bp priced (€STR terms).

Caught in the stagflation trap

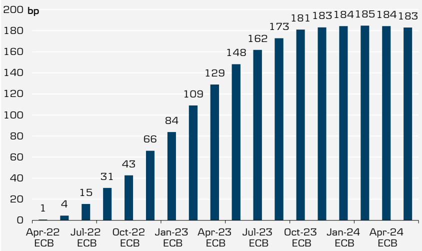
The first euro area data releases after Russia's invasion of Ukraine made for an ugly reading, with consumer and business confidence falling back to levels last seen during the early days of the pandemic (see also *Euro Area Macro Monitor - Caught in the stagflation trap*, 5 April). While government support measures (*estimated* to amount to 0.4% of GDP by ECB), will probably cushion the economic fallout, the loss in *purchasing power* already amounted to 3.5% of euro area GDP at the end of 2021. Since households cannot easily reduce their consumption of food and energy in response to rising prices, a marked slowdown in private consumption growth likely lies ahead. The manufacturing sector is also faced with increasing supply disruptions and a possible Russian energy embargo idling production, increasing the risk of a recession as already indicated by our growth tracker (see chart).

At the same time, inflation pressures continue to build at an unrelenting pace. HICP and core inflation rose to new record highs of 7.5% and 3.0% during March and with cost-push inflation still working its way through pricing chains, we doubt that we have seen the inflation peak yet.

14 April 2022

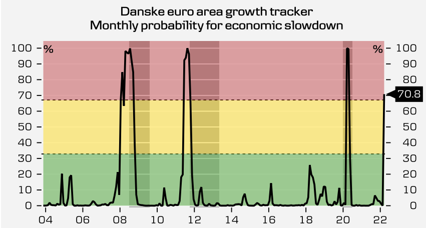
- 13:45 ECB decision
- 14:30 Press conference

Markets price 66bp of ECB hikes in 2022



Source: Bloomberg, ECB , Danske Bank

Recession risks are on the rise



Note: Shaded area indicates historical recessions
Source: EViews, Macrobond Financial, Danske Bank

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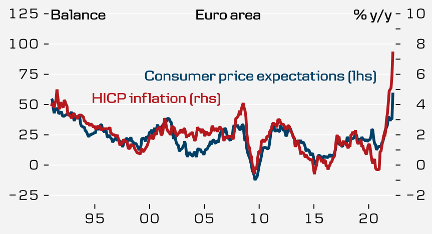
The stagflationary dynamics clearly present a policy dilemma for ECB, with its baseline economic projections from March looking increasingly outdated as the economy is evolving more along the severe scenario, which ECB published as an alternative scenario to the March projections, and which foresees growth of 2.3% this year and inflation averaging 7.1%. As consumer price expectations are adapting higher, we see an increasing risk of second round effects and higher wage growth materializing in late-2022/23 (read more in *Euro inflation notes - The wage conundrum*, 1 April).

Minutes – further steps towards monetary policy normalisation are needed

These concerns about second round effects and unanchored inflation expectations also seem to gain traction in the GC as the March minutes showed, with the hawks becoming increasingly vocal about the risk of a wage-price spiral if monetary policy did not act in a timely manner. The minutes show that the ECB do not see stagflation, but call it slowflation. Already in March, a large number of GC members thought that the persistently high inflation rates called for further steps towards monetary policy normalisation, as the three forward guidance conditions for interest rates increases had either already been met or were very close to being met. Similarly to the Fed, the uncertain economic outlook following Russia's invasion of Ukraine was the main factor leading the GC to refrain from a more accelerated policy tightening at the current stage, with lingering doubts about the role of temporary, pandemic-related factors and the indirect effects of higher energy prices.

Consumer inflation expectations are adapting higher



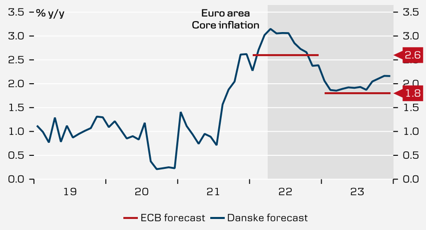
Source: Eurostat, EU Commission, Macrobond Financial, Danske Bank

Slightly revised call – September hike coming into play

In light of the increasingly broadening inflation pressures, with core inflation predicted to stay around 3% in the coming months and headline inflation lingering in 7%- territory until year-end, we are revising our ECB call slightly and now expect ECB to hike by 25bp in September and December 2022 (i.e. advancing the hiking start by one quarter)

Beyond that, we do not look for a prolonged hiking cycle into 2023 at the current stage. As the chart on the right shows, we see inflation being broadly in line with ECB's target in 2023 and Fed's expected tightening will also have contributed to a significant tightening of financing conditions globally –thereby also worsening the economic outlook. But if anything, risks remained skewed towards more monetary tightening in our view.

Core inflation to fall back to target in 2023



Source: ECB, Eurostat, Macrobond Financial, Danske Bank

Given that the first rate hike is expected to come in September and ending the NIRP in December, we do not foresee any changes to the tiering multiplier. In fact, we expect it to be phased out once the deposit rate hits 0%.

Given the rapidly increasing inflation, we acknowledge a risk of a July hike, should ECB feel the imminent tightening pressure, similar to the Fed.

Hawks have the upper hand right now – but next policy change to come only in June

The recent inflation dynamics have put ECB in an uncomfortable positioning amid slowing growth and high inflation. Most recently, we have seen the hawks, such as Knot, Wunsch, Muller, Kazimir and Holzmann all calling for an earlier end to the APP, which could mean that the last net purchase would take place in June this year, despite the current guidance of a Q3 end. The hawks have already explicitly mentioned the September meeting as a possibility to adjust policy rates – which is now our baseline. While Schnabel argued along tightening lines, she refrained from putting explicit time reference to the potential lift off dates, but given her influential voice in the GC she will also support the more hawkish camp.

That said, we expect next week's meeting still to be broadly a confirmation of the March statement, with bigger communication changes postponed until the June meeting, when new staff projections will also shed more light on the uncertain economic outlook. While the official decision is expected to be broadly unchanged, **we expect Lagarde to keep the door open for a potential rate hike after summer, while she will continue to repeat the flexibility, optionality and data dependency. We believe markets will react to this, speculating about a potential rate hike in July.**

The important role of ECB reinvestments

As ECB net purchases are coming to an end in June, the market will increasingly rely on the reinvestment flow coming from the APP and PEPP. In the coming 12M we estimate that reinvestments will amount to EUR38bn / month, split between the APP of EUR21bn and PEPP of EUR17bn. Last week, ECB chief economist Lane said that the PEPP reinvestments could be redirected, if pandemic-related fragmentation was the cause. It is yet to be seen how firm ECB will be on this, but should it decide to end reinvestments early, this would leave notably the periphery exposed.

Upside risks to the EURUSD on the day, but downside risks persists

It seems likely that ECB is moving towards a more hawkish stance. For EUR/USD, if this is indeed confirmed at the upcoming meeting then we may see some upside risk to spot on the day. However, looking beyond the event of the ECB meeting itself, downside risk to EUR/USD spot will likely persist as spreads widen further in Europe (vs. Germany) and the economy continues its slowdown. As such, spikes in EUR/USD are an opportunity for those with USD-expenses (purchase USD via forwards) and are likely to be transitory in nature, in our view. We continue to forecast 1.05 in 12M.

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Ad hoc.

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Report completed: 8 April 2022, 6:45 CET

Report first disseminated: 8 April 2022, 7:00 CET