8 June 2023

ECB Preview

Looking beyond next week

- The ECB meeting next week will be a peculiar one, with a risk of no market reaction. On the one hand, the decision has already been well telegraphed (25bp hike and APP reinvestments to end from 1 July) and on the other hand guidance (with new staff projections) is likely a 'one-sided' risk for markets. Hawkish tunes from Lagarde on the back staff projections is at risk of being largely disregarded by markets.
- ECB's stance and market pricing are more harmonious for policy hikes than what we have seen during the past year and after the June meeting we find it challenging for markets to price in more than 40bp of additional until we get close to the July meeting.
- We continue to expect ECB to hike to 4% by September, but risks may be slightly skewed to 3.75% in July as the burden of proof have been reversed. We expect ECB to guide for further tightening although providing a non-committal statement as they stay data dependent.

Still focus on the "sticky" inflation narrative

The euro area economy is still characterised by resilience driven by the service economy, as "hard" data still lag the signals from the weakening sentiment indicators. Although slightly receding in May, the composite PMI indicators still points toward a growth level around 0.3%qoq, which is insufficient to markedly dampen inflationary pressures to bring it in line with ECB's target. The outlook continue to be characterised by a two-speed economy, where manufacturing activity is subdued yet the services sector – which account for more than 70% of the economy – is still recording buoyant activity supported by a variety of factors. Accumulated savings from the pandemic period is still remarkably high (estimated c. EUR700bn by end of Q4 22), and real income (and real wage growth) is recovering on the back of lower energy prices and strong job creation. Furthermore, building wage pressure is evident across most of the region as new collective wage agreements are being settled. The latest signs of abating service inflation in May will give rise to some "cautious optimism" among the doves, but the "sticky inflation" narrative will most likely remain the main in focus. We still observe that the underlying inflation is printing at very elevated levels and the disinflationary developments for May gives rise to realign the key question from inflation slowing to the pace of the slowdown and the new steady state. For this, we still see inflation pressures being assessed to be too high for too long.

Stronger wage dynamics driving the medium-term inflation

The ECB staff projections will be closely watched on the back of recent developments. Commodity prices has continued to fall throughout Q2, and especially gas prices is well below the assumption in the March projection round. However, inflation prints during spring have generally come in stronger than anticipated in March, and that will drive a marginal upward revision to the 2023 inflation forecast. For the 2024 and 2025 outlook, the inflation will still be supported by a strong labour market and still building wage pressures across the region. Wage indicators for Q1 has risen markedly as the

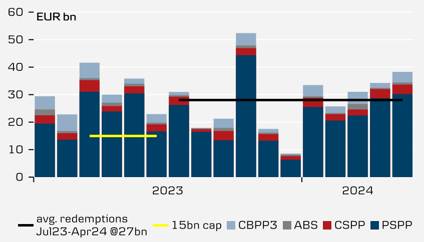
15 June 2023

- Decision released at 14:15 CET and press conference at 14:45 CET.
- Staff projections document released at 15:45

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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compensation per employee rose 5.2% in Q1 while the negotiated wages rose 4.3%, which is well above Chief Economic Lanes previous (rough) estimate of 3% being the level corresponding to the inflation target as he referenced multiple times last year. The strong wage data for Q1 feeds directly into the inflation trajectory in the staff projections, which previously saw inflation reaching 2% in the second half of 2025.

We see the risk of an even longer convergence time could be the conclusion in the June projections, although if the projection exercise would result in 2% target being reached on average in 2025, this would constitute an important input to the guidance for further tightening.

From headline to underlying, and back to headline?

The inflation narrative have changed significantly during the past years and until recently the focus have clearly been on the underlying inflation pressure which was way too high for ECB to accept. The May developments of the disinflation impulse commencing is naturally welcoming news, but also a feature and not a bug of getting inflation down to the 2% target. Looking at the various underlying metrics we monitor we still see a too strong inflation pressure.

Beyond the June meeting

The June decision well telegraphed of a 25bp and a formal decision to end the APP reinvestments from July. Therefore focus turns to what will happen for the meetings from July onwards. Markets are already pricing the July hike close to a ‘done deal’ of 20bp. We do not exclude that with the large drop in headline inflation expected during the summer due to base effects could lead to a pause in September if focus on headline inflation returns.

Between the July and the September meeting, we will see two inflation prints (July and August). Also the September meeting will have new staff projections. That said, with the strong service economy, strong underlying inflation and not least the wage pressure from the still growing employment we still see a September hike in our baseline.

Looking ahead, the change in the narrative from when the inflation would peak to inflation declining (on the disinflation impulse from May), we see the burden of proof have been reversed, which will become even more important after the July meeting. That means that now ECB now has to ‘justify’ to keep hiking rates on the back of too strong data, which is in contrast to previously when the (underlying) inflation was still on the rise the burden of proof was so that they would have to ‘justify’ not hiking. That said, with the strength in the economy, and inflation at a too high level, we see a data dependent approach still warranting continued tightening after summer.

Ending APP reinvestments from 1 July

At the May ECB meeting, ECB said that they ‘expect’ the APP reinvestments to come to a complete halt as of July. While this is formally not a decision to discontinue APP reinvestments, we see this as a ‘done deal’. Looking at the APP holding reduction from 1 March until end of May, this has been fully in line with the EUR15bn/m. The reduction has primarily been in the PSPP programme as expected as this is 79% of the APP holdings. Compared to the stock share at end February, we see that the reduction has been larger in the PSPP (+3pp) and the ABS (+4pp) while less in the CSPP (-5pp) and CBPP (-2pp). The updated redemption profile for APP shows that from 1 July to May 2024, the average amount of redemptions will be EUR28.3bn/m, although with significant seasonal patterns, in particular in H2 this year. Together with the TLTRO repayment, this will lead to a

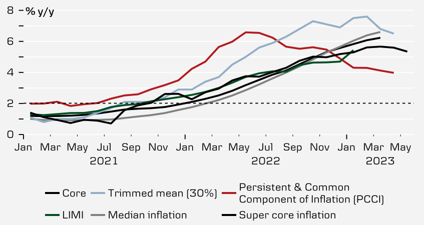
Expected changes to staff projections

ECB projections June 2023	2023		2024		2025
GDP growth	0.9% (1.0%)	↘	1.3% (1.6%)	↘	1.5% (1.6%)
HICP inflation	5.5% (5.3%)	↗	2.6% (2.9%)	↘	2.1% (2.1%)
Core inflation	4.9% (4.5%)	↗	2.9% (2.8%)	↗	2.3% (2.4%)

Parenthesis are the old ECB projections (from March 2023)

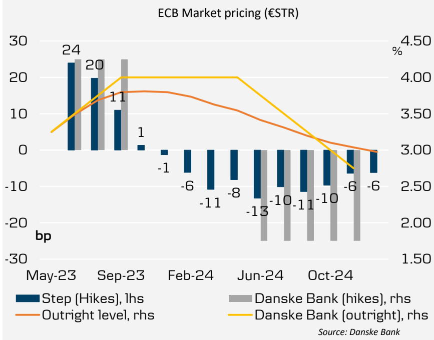
Source: Danske Bank

Underlying inflation measures



Source: Macrobond Financial, Danske Bank

Market pricing for rate hikes



Source: Danske Bank

EUR700-800bn reduction in excess liquidity (to around 3.3trn) from the 28 June maturity of the TLTRO and until year end.

FX reaction could give a temporary boost to the EUR/USD given that the Fed will pause the day before

A 25bp rate hike will likely not have a substantial effect on the EUR/USD, although it could pose upside risks to the EUR/USD in the very near-term depending on the rhetoric on the subsequent press conference and the sequential growth outlook priced by markets.

During the past month, there have been three main driving forces of the EUR/USD; the relative outperformance of the US economy, weaker-than-expected data from China, which likely have spilled over to the euro area, and the debt ceiling situation. The resilience of the US economy has put upward pressure on US yields implying a widening of interest rates differentials between the US and the euro area, which recently has been a headwind for the cross. Furthermore, the strong outperformance in euro area risk assets have faded the past month, which also has weighed on the cross.

Going forward, we think the USD momentum could continue, and we keep our long-held bearish stance on the EUR/USD. The tightening of USD liquidity, as Treasury Department replenishes its cash balance by issuing T-bills, could add further support to the USD, although much of is already priced. In H2, we think fundamentals will be the main driver of the EUR/USD. More specifically, we think relative growth differentials favour the US economy. Even though carry on being short EUR/USD incrementally looks to decline from here, and will likely reach lowest level since 2020 in H2, we think this effect will be dominated by fundamentals. Hence, we expect the EUR/USD to head lower below 1.06 in H2 based on relative terms of trade, real rates and relative unit labour costs.

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Expected updates

None

Date of first publication

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