17 October 2023

ECB Preview

Keeping a tightening bias with optionality

- Next week, ECB is widely set to be on hold in terms of policy rate changes for the first time since June last year. Since the September meeting, inflation and growth data have been broadly in line with expectations and taking into account the clear guidance from ECB, no changes should be expected at the upcoming meeting.
- We expect Lagarde to acknowledge a discussion on advancing the PEPP reinvestments during the Q&A part of the press conference, thereby signalling a tightening bias, albeit with some optionality still in its communication.
- Markets are pricing ECB policy rates largely unchanged for the coming six months, before a very slow and gradual rate cutting cycle commence from Q2 next year. Rate cuts of 89bp are being priced between April 2024 and April 2025.

Working the duration channel given limited data releases since September

Following the ECB meeting in September, there appears to be a wide consensus in the Governing Council (GC) that additional rate hikes from the ECB is not in the cards, as long as data comes in broadly according to the ECB projections as they presented in September. And since then, the 'tier1' being the September PMI and inflation data, have not shown a significant deviation from anticipations. Therefore, we expect ECB to repeat its guidance from the September meeting on being on hold in terms of rate policy path. That means that the monetary policy outlook will primarily be focused on the duration channel of keeping the current policy stance instead of adding additional tightening via the rate path.

However, some hawkish GC members such as Schnabel, Knot and Wunsch have said that should data surprise on the upside, a further rate hike could be on the table. We see the December meeting as the most likely candidate for additional rate hikes should they come, although from current viewpoint we find that unlikely. However, we cannot completely rule it out should October and November inflation surprise on the upside. By the time of the ECB meeting next week, we will have received another PMI print as well as the result of the ECB's bank lending survey. ECB will also be aware of the Survey of Professional Forecasters result, what usually features prominently. We doubt that those releases will alter the outlook significantly for ECB to send clear policy signals about imminent changes at next week's meeting.

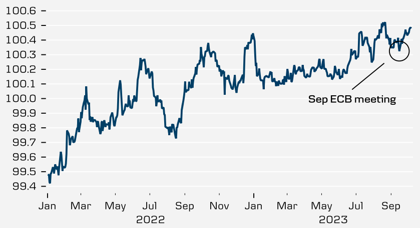
Data still support soft-landing

The incoming data since the September meeting shows that the euro area economy is still cooling at a pace that is comfortable for ECB as inflation is coming down and the unemployment rate remains at historic lows of 6.4%. The September PMIs confirmed the contractionary trend, with the composite PMI coming in at 47.1. The continued drag mostly attributes to the manufacturing sector, whereas the service PMI edged higher to 48.4 from 47.9 in August – though remaining in contractionary territory. We still have the 'soft

ECB meeting 26 October

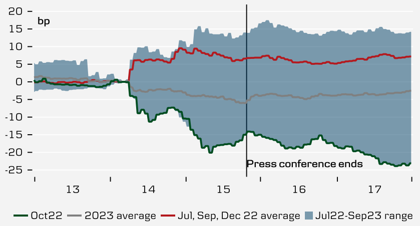
- Decision statement at 14:15 CET. Press conference to follow from 14:45 CET.
- No policy rate changes, but keeping optionality to rate changes
- PEPP reinvestments to be discussed

Tighter Financial conditions since the last GC meeting



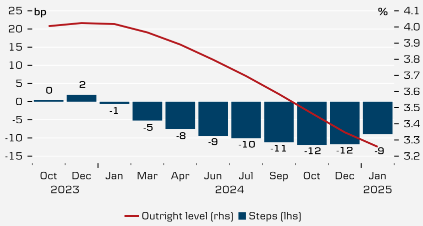
Source: ECB, Bloomberg and Danske Bank

Change in 10Y Bund yield since ECB decision at 14:15 CET



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

ECB market pricing



Source: ECB, Bloomberg and Danske Bank

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landing' as our base case and believe that the pace of the current slowdown will prevail in the coming months due to persisting monetary headwinds and waning demand. We see that ECB generally share this narrative. Yet, the risk is that we suddenly will see a sharp contraction if energy prices increase more than expected over the winter or financial conditions quickly tightens. This would (again) challenge the ECB reaction function.

Inflation is falling but 'last mile' will be the hardest

Headline inflation posted a 2-year low in September cooling to 4.3% y/y from 5.2% y/y in August, while core inflation printed at 4.5% compared to 5.3% in August. The declines were mostly attributed to fading base effects from energy as well from indirectly via various government subsidies provided last year affecting both energy and core services inflation on a yoy basis. These base effects will drive inflation further down over the coming months, but a return to 2 percent is not in sight before 2025 according to the staff projections. Several GC members, including Lane and Knot have expressed satisfaction with a gradual convergence to 2% by 2025. Still, the month-on-month change in inflation also declined in September and shows encouraging signs especially in core inflation. The underlying price pressure persists albeit the trend is declining in line with signals from PMI output prices. That said, it is still too early to declare victory over inflation as the 'last mile' of bringing inflation back to ECB's 2-percent target will be tough to overcome as both Schnabel and *de Guindos* noted. Further wage increases from the strong labour market, higher than expected energy prices, sticky service price inflation, and the risk of food price increases from the upcoming 'El Niño' provides upside risks to the inflation outlook.

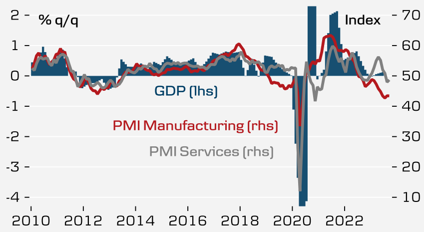
Focus on the monetary policy transmission

Monetary policy affects the economy with a lag as it takes time for the policy rate to be transmitted to consumers and companies via banks and financial markets. Changes to monetary policy usually only takes full effect on inflation after a year. Thus, we have yet to see the full impact of the past ECB interest hikes on the euro area economy. Most recently, ECB's Lane said yesterday that people with fixed rate mortgages are yet to be impacted by the rate hikes. As the ECB have opted to work with the 'patience' argument it will now be crucial to follow the speed of the monetary policy transmission to predict ECBs next move. If the speed is low, we should be more patient, and if the speed is high the first rate cut could come earlier. The minutes from the September meeting showed a large discussion about the speed of the transmission. Overall, the GC assessed that there was ample evidence of a stronger than expected transmission. The Bank Lending Survey out next week will add to this discussion through updated data on changes in lending standards and credit demand. Thus during the upcoming meeting we will closely follow any comments about monetary policy transmission.

Keeping a tightening bias

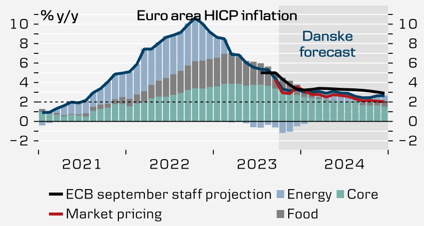
In *COTW: Avoiding an Oct22 repeat*, we discussed that the market reaction to this year's ECB meeting has on average ended with 10y Bund yields 3bp lower on the day (chart on front page). With ECB now on hold the communication has to transition to a situation where ECB may tighten policies further should data warrant so. If not, we may end with easier financial conditions, which we find to be unwanted by the ECB at this stage. For markets to adopt the tightening bias as a credible scenario, we see a need for ECB to bring the balance sheet normalisation into play. This could be done specifically via a low-hanging fruit of advancing the end to full PEPP reinvestments. We do not expect a decision at the upcoming meeting, but only in December. However, we expect some GC members have

The economy is cooling as desired



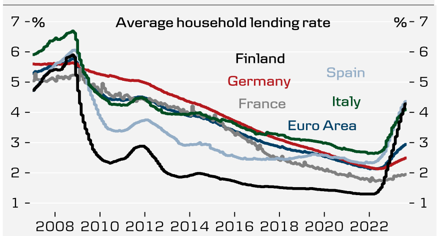
S&P Global, Eurostat, Macrobond Financial

Sticky core inflation makes 'last mile' tough



ECB, Bloomberg, Eurostat, Danske Bank, Macrobond Financial

Different monetary policy transmission across countries



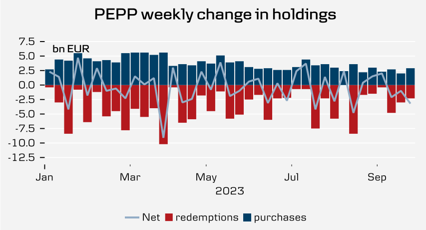
Source: ECB, Macrobond and Danske Bank brought this up during the meeting, and this is something that Lagarde will acknowledge as well.

Overall, since the latest ECB meeting, we have seen real rates significantly higher as the higher for longer / higher 'forever' narrative have been traded in markets. We expect ECB to largely be satisfied with the tightening of financial conditions as well as the higher real rates as the transmission to the real economy will work faster thereby dampening demand with this setting.

Advancing the end of full PEPP reinvestments

In our baseline, the ECB will advance the end of full PEPP reinvestments to January 2024, with an announcement to be made at the December meeting. However, we do not expect ECB to 'pull the plug' in one go but rather do it in a similar way to the initial wind-down of the APP holdings, where it said an average reduction of EUR15bn per month in Q2, i.e. a smoothening in of the end to PEPP reinvestments. Given the first line of defence (flexible reinvestments) and TPI, we expect the ECB will set a target for the eventual reduction within a certain time frame, which could be set as the year as a whole / specific period or an average per month, hence an 'envelope-styled' end to PEPP reinvestments. We think this will be a feasible compromise to be struck between the doves and the hawks, as it maintains the potential to use flexible reinvestments and the TPI, should it be needed. The 'envelope'-style package was also used at the 12 March 2020 meeting, where the ECB announced an additional envelope of bond purchases by the end of that year.

PEPP reinvestments currently average EUR18bn/month



Source: Macrobond and Danske Bank

We anticipate a relatively subdued FX reaction

Since there have been limited data releases since the last ECB meeting in September, we do not expect significant changes from the ECB's perspective. Therefore, we anticipate a rather muted market response. For EUR/USD, the Fed meeting on 1 November is likely to be more crucial.

In summary, we maintain our strategic case for a lower EUR/USD. Our rationale remains grounded in relative terms of trade, real interest rates, and relative unit labour costs. Consequently, our projection for the cross remains at 1.06/1.03 over the next 6 to 12 months. However, in the near-term, we see the potential for USD weakness due to less positive economic surprises from the US.

Disclosures

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Expected updates

None

Date of first publication

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