18 January 2024

ECB Preview

Stocktaking

- Next week's ECB meeting is set to see few, if any, new policy signals, given the limited new information that has been released since the December meeting. We expect President Lagarde to confirm that the next policy rate change is most likely a cut, which may happen in summer. It remains to be seen whether the June meeting will be singled out as the key meeting to watch, similar to Lane's comments this weekend. We expect Lagarde to repeat the three key criteria for setting the policy rates, which should point to the new staff projections in March as key.
- Markets are pricing the first ECB policy rate cut for April, and a total of 135bp through to the end of 2024. The policy rates are priced to trough at 2% in two years' time.

Still too early for ECB to declare victory over inflation

Since the latest governing council meeting mid-December, we have received one additional inflation print. Headline inflation picked up to 2.9% y/y in December from 2.4% in November driven by energy base effects, while core inflation continued to fall to 3.4% y/y from 3.6%. For Q4 23, headline inflation came in at 2.7% y/y, which was lower than the December ECB staff projections of 2.8% y/y. Similarly, core inflation came in 0.1 pp lower than the projection of 3.8% y/y in Q4. Philip Lane has downplayed the importance of this downside surprise probably because it was small and some to extent expected, as the ECB was aware of the November print at the December policy meeting, but the print came in after the cut-off date for the December staff projections. Hence, we do not think the ECB has changed its overall assessment of inflation since the last policy meeting.

In the bigger picture, the disinflation process continues as also noted in the continued easing of most underlying inflation indicators. For example, the 3m/3m seasonally adjusted annualized core inflation was significantly lower than 2% at just 1.4%. The service inflation momentum is still above 2% though, which is important given the service price momentum moving in tandem with a tight labour market (the November unemployment rate declined to an all-time low of 6.4%) and the many wage negotiations schedules for Q1 24 underscore that it is still too early to declare victory over inflation. Most recently there has been a stabilisation in the 3m average of the job portal Indeed's wage listings. The ECB will likely share this assessment and wait for more data prints before it starts talking about easing.

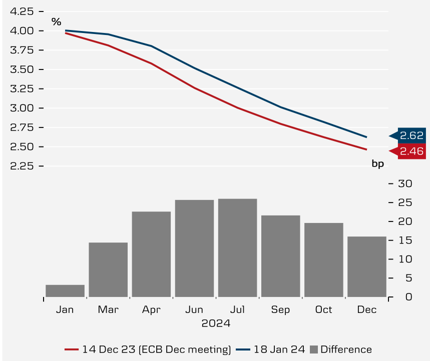
Growth ended 2023 on a weak footing, and likely to stay weak near term

Growth ended the year in contractionary territory as manufacturing PMI remained at 44.4 (November: 44.2) and service PMI came in at 48.8 (November: 48.7). The weak manufacturing activity was visible in the November industrial production figures that declined 0.3% m/m and in industry-heavy Germany that saw Q4 GDP growth at -0.3% q/q. While the current growth momentum is weak, it is not collapsing and thus the ECB will not use this as an argument for easing policy as it (and we) forecasts a gradual rebound

ECB meeting 25 January

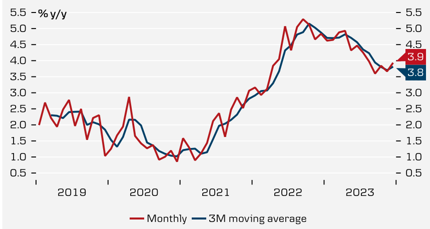
- Decision statement at 14:15 CET
- Press conference at 14:45 CET

Markets repricing ECB expectations slightly higher since the December ECB meeting



Source: ECB, Bloomberg, Danske Bank

Stabilisation/ pickup in wage dynamics



Source: Indeed, Macrobond Financial, Danske Bank

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in activity through 2024. Rising real wages and a strong labour market in combination with leading indicators showing a turn in the global manufacturing cycle will support growth in 2024 so the euro area avoids a recession.

Note though, that 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. The ECB will also be aware of the Survey of Professional Forecasters result, which usually features prominently and will be released the day after the ECB meeting. We doubt that those releases will alter the outlook significantly for the ECB to send clear policy signals about imminent changes at next week's meeting.

ECB pushback on market pricing

While the ECB will not commit to saying that a rate cut is imminent, we expect it to acknowledge that the next step is a rate cut and that this is likely to be discussed following a successful confirmation of no second-round effects. That judgement will come on the back of the wage growth figures, most likely by the end of April.

In recent days, a string of ECB officials has been pushing back on the current market pricing. Most aggressively, Holzmann said that markets should not assume that the ECB will cut rates this year, while other hawks such as Nagel have been less aggressive. During the weekend, Lane said that June seems key given that we will have the important Q1 wage data by then. On Tuesday, the moderate Villeroy said that the ECB should cut this year but would not comment on a specific timing of the first rate cut. Following the push-back from ECB GC members in recent days, markets are now pricing the first rate cut of 20bp in April and cumulative 48bp by June. We continue to like our expectation of the first rate cut in June.

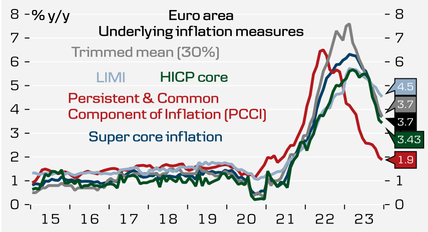
Limited lasting market impact on FX and rates

As new data has been sparse since the December meeting, we anticipate a rather uneventful meeting in January in terms of lasting market impact both on the FX and the rates side. The limited macro data available has broadly aligned with the staff projections from that time, subject to the incoming data as noted above

We maintain our strategic case for a lower EUR/USD based on relative terms of trade, real rates (growth prospects), and relative unit labour costs. In the near term, we prefer selling the cross on potential rallies. All else being equal, our forecast for the Fed (first cut in March) and the ECB (first cut in June) suggests upside risk to EUR/USD in Q1. However, we believe that the cumulative market pricing in the G10 space, where we generally think the aggressive pricing in favour of rate cuts is overdone, could prove to be more crucial for the cross than the sole pricing between the Fed and the ECB. We also highlight that upside risk to inflation in the US and weak data from China could weigh on the cross. We forecast EUR/USD towards 1.05 on a 12M horizon.

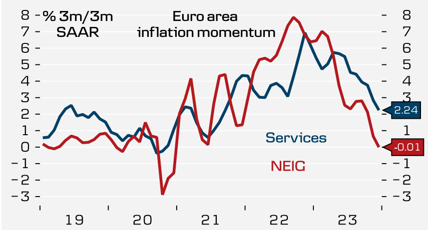
Regarding the 10Y Bund yield, we note the recent sell-off has reached our year-end target of around 2.30%. We expect the 10Y Bund yield to stay at current levels in the near term despite our expectation of markets taking out ECB rate cuts. That said, with the market narrative for the ECB to return its policy rate to 2% on a 2Y horizon (neutral anchor level), this provides limited upside risk to outright yields.

Underlying inflation has eased...



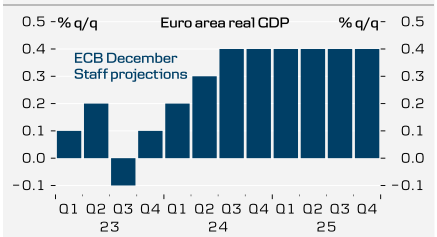
Source: ECB, Eurostat, Danske Bank, Macrobond Financial

... but service momentum is too high



Source: ECB, Macrobond Financial

Weak growth momentum but no recession in sight



Source: ECB, Macrobond Financial

A technical rate cut may come in connection with the operational framework review

The ECB's ongoing operational framework review is set to be published in spring this year, according to the guidance provided by Lagarde last year. While no further guidance is given on the exact timing, we highlight that the strategy review that was published in July 2021 was done outside the regular meeting calendar. Accordingly, we do not expect the framework review to be published during one of the governing council meetings scheduled but for it to be an independent announcement. Consequently, the exact timing is uncertain, but we highlight for example the ECB Watchers conference on 20 March to be a possibility for Lagarde to outline the key principles behind this.

In conjunction with the publication of the operational framework review, we may see a technical rate cut of the main refinancing rate and the marginal lending facility rate, by 25bp in each rate relative to the deposit rate. This would make the ECB's interest rate corridor symmetric and implemented as a goal to reduce the potential volatility in the front end. This should not lead to a market reaction as the policy relevant rate is the deposit rate, for the near future.

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Expected updates

None

Date of first publication

See the front page of this research report for the date of first publication.

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