24 July 2023

ECB Preview

All eyes on September guidance

27 July 2023

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

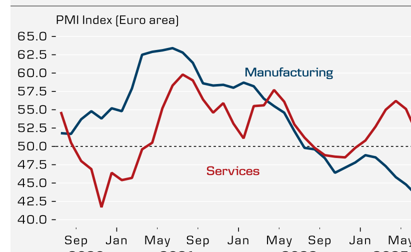
- A 25bp rate hike from the ECB this week is essentially a given. This outcome has been well communicated in advance by most members, and should not in itself lead to any noticeable market reaction.
- The focus will be on guidance ahead of the September meeting, where a pause or more definite stop to the rate hikes are on the table. The communication dilemma that ECB face is a trade-off between the lagged effect of monetary policy measures already taken and the strength of the incoming data. Therefore we do no expect a firm guidance for September, either for a pause or a hike, but a repeat of data dependence and in particular in light of the significant amount of data released before the September meeting.
- The weakening growth momentum, as well as some softening in core inflation measures will be the decisive for a potential final hike of 25bp at the September meeting. Further deterioration may change our baseline expectation of a final hike in September.
- Markets price 25bp for this week and another 20bp to a 3.95% peak in the deposit rate. We find that pricing fair.

Signs of softening growth provides some flexibility to the ECB

The euro area economy remains spared for the headwinds coming from the war in Ukraine. Energy prices are still significantly lower than last year, real incomes are recovering due to declining inflation and strong labour market conditions, and excess savings are substantial and still untouched. This gives a strong base for households to weather headwinds coming from tighter financial conditions. The solid economic foundation of European households is visible in the services sector, where activity measures rebounded remarkably between the turn of the year and the spring. However, the latest signs have been less encouraging. The Service PMI has moderated markedly since May, and, to that, manufacturing PMI still points toward waning activity despite easing supply chain issues and declining input costs. Today's preliminary PMIs pointed to further weakening in the euro area activity.

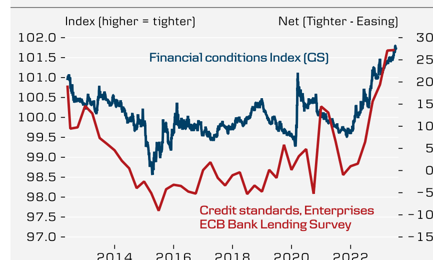
We still believe that the full effect of monetary policy tightening on the economy is yet to show. Credit standards have been repeatedly tightened since the beginning of 2022, and credit growth, which is among the best forward-looking economic indicators, has turned negative since the turn of the year. We expect banks to report further tightening in the new Q3 edition of the ECB Bank Lending Survey, set to be published this Tuesday. The report will surely gain some attention on the ECB meeting. However, the effect stemming from tighter financial conditions on the hot labour market and ultimately on inflation remains uncertain. Employment remains record high and still growing in the euro area, and various business sentiment indicators continue to point towards decent excess demand for labour across sectors. The imbalance between labour supply and demand lays the ground for an extended period of high wage growth in the euro area, and, by that, the worry that inflation ultimately will become unanchored from the ECB's goal. This worry is intact, although the latest signs of growth softening may have brought some calm in the governing council.

Growth signals have weakened lately



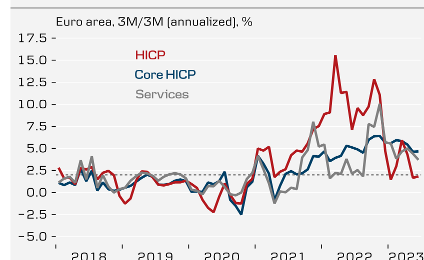
Source: Macrobond, S&P and Danske Bank

Financial tightening proceeds



Source: Macrobond, Bloomberg and Danske Bank

Core inflation figures still too strong



Source: Macrobond, Danske Bank

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Inflation softening still not sufficient

The “too high for too long” inflation outlook in the euro area is still the dominating theme for the ECB. The June staff projection inflation forecast for 2025 was revised up from 2.1% to 2.2%, and the monthly change in core HICP was in June still running above 5% on an annualized basis. As several members have pointed out recently, the core inflations measures are, despite their construction, not immune to moves in energy prices, and the substantially lower spot prices on natural gas and electricity since last winter will become gradually more visible in price measures for services and industrial goods from here. However, to achieve a sustainable return to 2%, this needs to be coupled with some relaxation in wage growth (negotiated wages reached 4.3% yoy in Q1). Some timely indicators as the Indeed Wage Tracker, which tracks listed wages on job postings, has shown some softening during 2023, but the labour market impulse to inflation still appear way too strong on most broad wage measures.

The battle for September has begun

The rate decision this week of 25bp, and status quo for the APP reinvestments, has been forewarned ahead of the meeting, and any deviation from that may trigger a substantial market reaction. We expect the main point of attention to be on any guidance ahead of the meeting in September. The ECB will stick with the ‘data dependence’ narrative, and we generally expect President Lagarde to retain maximum flexibility ahead of September, potentially even omitting the ‘more ground to cover’ from her press conference. In any case, the interpretation of the latest growth/inflation figures could give some indications of the reaction function from here. Based on recent speeches, the latest data points have sprouted some optimism among the doves on the inflation outlook, but the majority of the council is still demanding clearer evidence of a consistent softening of price pressures. Nonetheless, with the deposit rate now standing at 3.5%, the balance of risk has become more even. Known hawks as Knot are at this point not ready to pre-support hikes beyond July, and last week he explicitly pointed out the importance of being increasingly aware of the risk of overtightening policy. We continue to see the bias in the ECB being encapsulated in Schnabel’s remarks from June, stating that the ECB should ‘err on the side of doing too much than too little’ in the current situation. We see this making a strong case for a final 25bp hike at the September meeting – especially if the new staff projection by that time will show inflation above 2% until the end of the forecast horizon in 2025. We think it will.

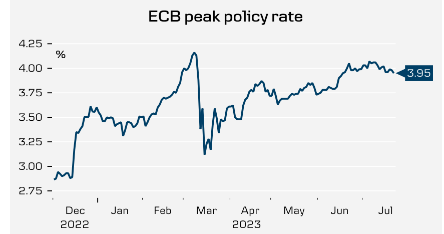
Balance sheet policy – what could be next in line?

At the June meeting, the ECB announced its full stop of APP reinvestments from July. The redemption profile shows a monthly decline of the stock of about EUR 27.7bn/month until June 2024, although with significant seasonal patterns. This comes on top of the TLTRO repayments, which accounted for a massive EUR506bn in Q2. With excess liquidity drainage coming from APP and TLTRO, speculation of new changes to the balance sheet policy has flared up in media stories the past month. Some coming from unidentified sources (e.g. considerations of outright selling of bonds), while others have been explicitly mentioned by members (e.g., changes to the PEPP timeline). We do not see any new signals this time around, as the ECB will require some time to monitor the impact of the already substantial reduction in excess liquidity over the past months. We expect to see an advancement of the PEPP timeline (today saying that reinvestments will ‘at least’ run to the end of 2024) being communicated in December.

Likely muted FX reaction on ECB decision

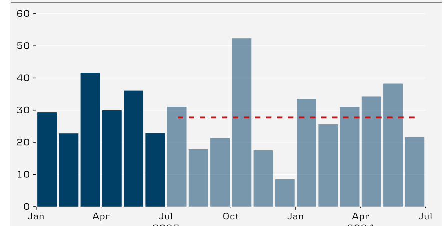
Overall, we do not expect the fully priced 25bp rate hike to have a substantial effect on EUR/USD. However, it is of course worth keeping an eye on the rhetoric on the press

ECB deposit rate cycle high



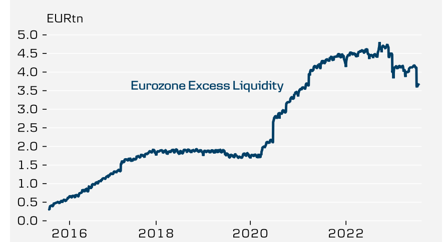
Past performance is not a reliable indicator of current or future results.
Source: Macrobond, Bloomberg and Danske Bank

APP redemptions



Source: ECB, Macrobond, Danske Bank

Excess liquidity



Source: Bloomberg, Macrobond and Danske Bank

conference and the sequential growth outlook priced by markets. If anything, we could see EUR/USD softening on the announcement if the ECB does not deliver any firm signs of a September hike.

July has generally been characterised by disinflation signs and increasing soft landing optimism benefitting cyclical currencies and sent EUR/USD to new highs for the year. Increased risk appetite and moves in relative rates have broadly led to a USD sell-off in July, although that picture has been reversed during the last week. We think the USD sell-off has been more driven by stretched positioning and sentiment than by fundamentals.

Going forward, we remain bearish on EUR/USD. We still think the lagging effect of the restrictive monetary policy is yet to filter through to the euro area economy. In contrast to the relatively robust US economy, we think the euro area economy looks fragile and it has already been showing weakening signs, especially in the manufacturing sector e.g. reflected in the recent July PMIs. We expect that to be a headwind for the EUR in the coming months. It is also worth noting that trade weighted EUR is around all-time highs in nominal terms, which we find difficult to explain from a fundamental perspective. Hence, we maintain our strategic case for a lower EUR/USD based on relative terms of trade, real rates and relative unit labour costs. We expect the relative strength of the US economy to weigh on the EUR/USD in the coming months, and we continue to forecast the cross at 1.06/1.03 in 6/12M.

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Expected updates

None

Date of first publication

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