02 September 2021

ECB Preview

Recalibrating, not tapering – but hawks will squawk

- The ECB meeting on Thursday next week is set to focus on the PEPP re-calibration and the inflation outlook. With stable and benign financial market conditions, record low real rates and an economy that is recovering well in Q3 as well, the conditions are met to slow the PEPP purchase pace…
- … but ECB will not call this tapering. We expect ECB and president Lagarde to stress that the re-calibration is not be compared to tapering, but ECB responding to the changes in financing and economics conditions by aligning its PEPP volume. We expect PEPP purchases to be similar to the January/February level of EUR60bn/month, down from the current c. EUR80bn/month. That said, without an external shock to the economy we find it hard to argue to for a higher PEPP volume in the current ECB growth and inflation narrative.
- Diverging views in the Governing council have already started to show in recent weeks. The July minutes showed varying views about how to align the communication to the new strategy. We expect further discussions about de-linking the rates forward guidance and APP to play a role at upcoming meetings, but foresee no changes to the guidance yet.
- At the December meeting, we expect a bigger QE calibration 'battle' to take place. Lane's interview last week said that APP volume cannot be seen in isolation of net supply, hence scaling up of APP cannot be ruled out at this stage. We also expect liquidity operations will be extended at the December meeting.
- That also means that from a market perspective, ECB will attempt to keep this meeting as uneventful as possible, yet the fall will be very interesting as hawks start to squawk more loudly than previous. We continue to expect Bunds to stay in a -60bp to -20bp range for the foreseeable future.

A balancing act – normalising, and keeping flexibility

Several ECB Governing Council members during the past two weeks have voiced the possibility of slower PEPP volume after the September meeting. Up until the March meeting, markets believed that ECB's flexibility also meant that ECB would continuously calibrate its purchases to market conditions, however, with the 'significant' higher purchase pace set on a quarterly frequency, recently the volume has been more important than the price. However, ECB wants markets to revert to the 'price is more important than the volume' mantra.

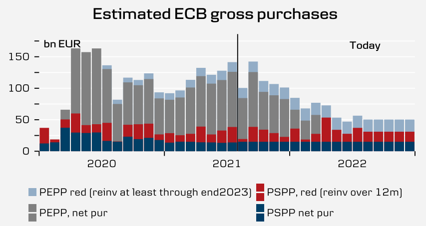
Transferring PEPP flexibility to APP is not given

In our view, the current market speculation and assumption that PEPP flexibility will be transferred to APP should not be taken as a given, which was highlighted this week by both Holzmann and Knot. Given the formulation of PEPP being related to pandemic-induced shortfalls of inflation and market fragmentation, should parts of the flexibility (such as easing the ISIN / issuer limit restriction) be applied to the APP, it would require a new

9 September 2021

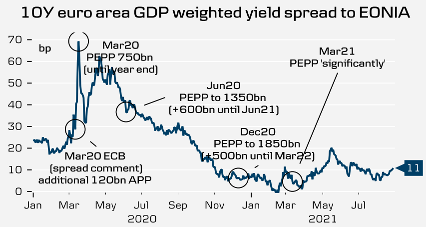
- 13:45 ECB decision
- 14:30 Press conference

Strong ECB buying even beyond March 2022



Source: Bloomberg, Reuters and ECB website

10Y euro area GDP weighted yield spread to EONIA



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Source: Bloomberg, Macrobond, Danske Bank

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monetary policy decision. ECB may end up taking such a new decision, but ultimately, ECB's renewed focus on 'price rather than volume' will be very important to incorporate into market expectations (leading essentially to a soft form of yield curve control). Discussions will follow in December. In our baseline, we do not expect PEPP flexibility to be transferred to APP.

Brightening prospects for the economy and inflation

After a contraction of -0.3% q/q in the first quarter, euro area GDP expanded by a strong 2.0% q/q in Q2 21, confirming that the economy has now firmly arrived on the road to recovery. Helped by the lifting of lockdowns in April and May, business and consumer confidence has surged, standing well above pre-crisis levels and unemployment has fallen back (though not quite to pre-crisis levels yet). With growth and inflation data surprising on the upside during the summer and more favourable technical assumptions feeding into the new staff projections, we look for an upward revision of the ECB's growth and inflation forecasts.

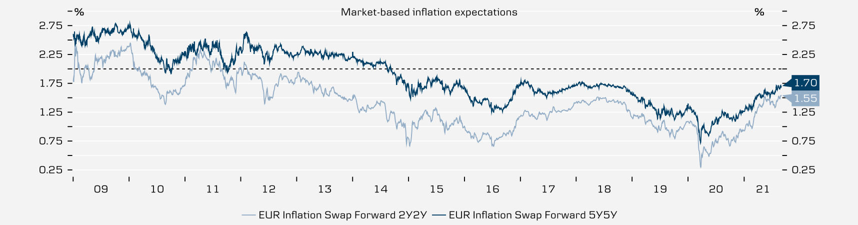
We expect ECB to maintain its broadly balanced risk assessment with respect to the growth outlook. Bumps on the road could still create setbacks in the European recovery, not least from the continued spreading of the delta variant and worsening supply chain bottlenecks. On the other hand, high frequency data so far suggests consumer spending has continued to rebound strongly in Q3 despite rising infection numbers.

Euro area headline inflation surged to 3.0% in August (highest since November 2011), as favourable base effects lifted core inflation to 1.6%. We expect ECB to acknowledge the rise in market-based inflation expectations, but maintain its narrative that the current elevated inflation pressures are transitory and will subside with the turn of the year, as wage growth stays subdued. The biggest upside risks to inflation stem from ongoing supply chain bottlenecks exerting upward pressure on goods prices. As some hawks in the Governing Council have become more vocal about these pro-inflationary risks recently, we would not be surprised to see them stressed more prominently in the introductory statement as well.

Markets are currently pointing to Dec2024 hike

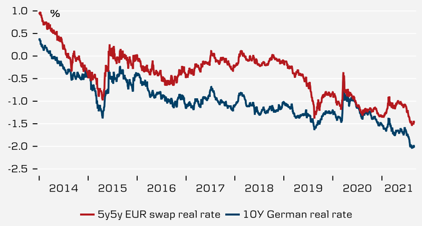
At the July press conference president Lagarde made it clear that any rate changes may only be tabled once inflation is at target in 12-18m ahead. This combined with the staff projections that of 1.5% in 2023, as well as a market pricing of inflation swaps being at 1.5% in late 2024, allows us to conclude that the current policy rate path priced by markets is aggressive. This may be driven by the link between the rate guidance and the asset purchase programme. Going forward it will be a major discussion point to possibly change this link, as also suggested by the ECB July minutes.

Inflation expectations have risen with higher realized inflation



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

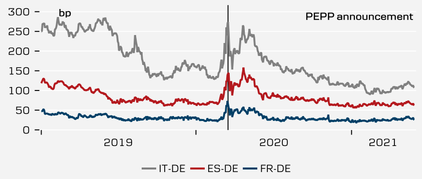
Real rates are at record low levels



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

Intra-euro area spreads are still tight

Sov yield spread vs. Bunds and ASW spreads for financials and corps



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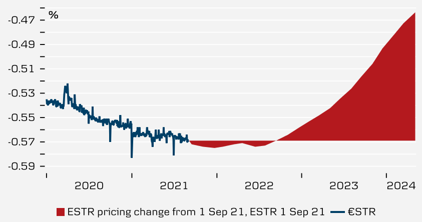
Source: ECB, Macrobond Financial, Danske Bank

ECB market pricing



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

Inflation and growth have surprised on the upside this summer (ECB staff projection and expectation to revisions)

ECB projections September 2021	2021		2022		2023	
GDP growth	5.0% (4.6%)	↗	4.6% (4.7%)	↘	2.1% (2.1%)	→
HICP inflation	2.1% (1.9%)	↗	1.6% (1.5%)	↗	1.5% (1.4%)	↗
Core inflation	1.2% (1.1%)	↗	1.3% (1.3%)	→	1.5% (1.4%)	↗

Parenthesis are the old ECB projections (from June 2021)

Source: ECB, Danske Bank

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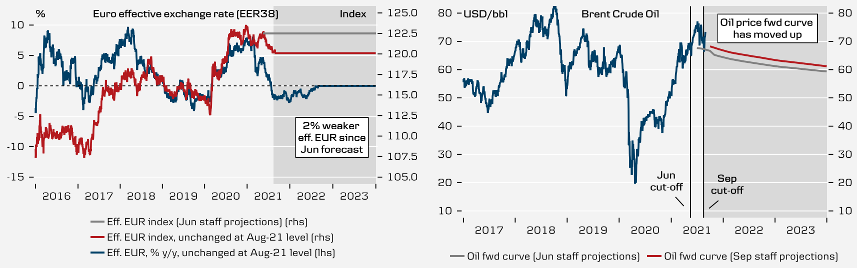
ECB not a gamechanger for EUR/USD spot

With ECB set to revise its growth and inflation projections higher and reflecting such in fewer bond purchases, we suspect that markets will take the que and bid EUR/USD spot a tad higher, e.g. by 50bp or so. Historically, one have at least on multiple occasions seen such optimism by policy makers reflected in spot dollar, upon announcement. That said, the bigger picture for EUR/USD spot remains the scale and scope of the slowdown in the manufacturing sector, and similarly the extent to which markets will lean further into the narrative of an increasingly hawkish Fed. If ECB induces a knee-jerk reaction higher in spot EUR/USD, we do see the risks as tilted towards lower spot over the coming year, targeting 1.15 in 12M.

Technical assumptions support upward revisions in forecast



Source: ECB, Macrobond Financial, Danske Bank

Disclosures

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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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