Liquid Insight

ECB Preview: One more and done

13 September 2023

Rates and Currencies Research
Global

Key takeaways

- We expect the ECB to hike this week, but is a very close call, with market pricing a 50% chance.
- We expect little forward guidance, but bias will be for more. Too early for news on balance sheet/liquidity/PEPP/APP.
- Stay bearish rates. Temporary EUR strength, but we remain bearish for the year.

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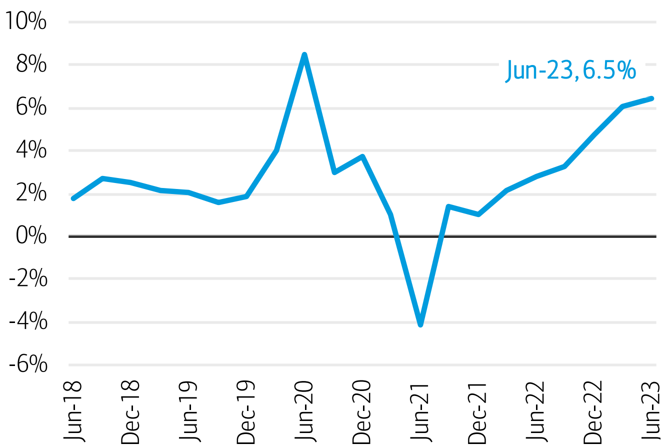
Exhibit 1: Euro area, unit labour costs (yoy%)
Acceleration in 2Q unit labour costs



Source: ECB

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Torn ECB

We see a 25bp hike on all three policy rates – still a very close call, but recent news supports a hike. The market is pricing 13bp for this week, but 22bp by year-end. We expect little forward guidance, but bias will be for more. We believe it is too early for news on balance sheet/liquidity/PEPP/APP. We expect the first cut in June 2024 at the earliest. If September inflation print challenges our disinflation view, we would likely delay our call for the first cut. We stay bearish rates. We may see some EUR strength if the ECB does hike, but we remain bearish EURUSD for the rest of the year on much weaker data Eurozone.

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One more and done

We expect the ECB to hike all three policy rates by 25bp this week. It is still a very close call, but we think that, on the margin, recent news supports a hike. We think that there will be enough support for a hike given 1) a weaker growth outlook (but no recession), 2) inflation almost (or fully) converging to target by the end of the forecasting period, but stronger inflation near-term, 3) small upticks in inflation expectations and unit labour costs (Exhibit 1) and 4) no clear evidence of a peak in core inflation.

We expect very little forward guidance for the following meetings but the bias will be towards doing more or pausing, and certainly not cutting. Meanwhile, we don't expect news on the balance sheet, and it's too early for additional changes on liquidity (given the discussion in the accounts of the July meeting and the pending outcome of the framework review) or PEPP/APP (which likely requires some certainty on the last hike being behind us).

While our conviction on the September hike is not strong, we do have strong conviction that, absent major surprises, if they don't hike this week, July would be the last hike of this cycle. If the data is not strong enough to warrant a hike this week, it is unlikely to justify a hike later, when activity will remain weak, and inflation will likely weaken more.

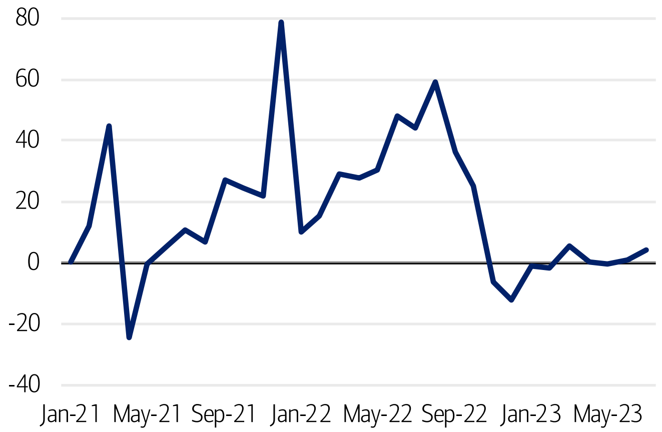
We still expect the first cut in June 2024 at the earliest, and only one cut per quarter throughout 2024 and 2025. If we are right and inflation underperforms in 4Q, the ECB will need forward guidance on the timing of the first cut to stop the market from pricing early and fast cuts. We think this week is too early for that and expect it later in the year. On the other hand, if by the September print our faster disinflation view is not evident in the data, we are likely to delay our call for the first cut, potentially by a couple of meetings at least.

A very close call indeed

Based on the ECB's assessment of the inflation outlook (forecasts) and the strength of monetary policy transmission, we think the dynamics of underlying inflation are likely to be the reason why they move this week. Forecasts should move closer to target than in June. Weaker external demand, a worse growth outlook, and a stronger nominal effective exchange rate are probably enough to move the inflation forecast to 2.1% (or even 2%) by 2025 (more on the forecasts below). Meanwhile, the transmission of monetary policy has not got substantially worse and, if anything, there seems to be some stabilisation in lending flows, at least in the case of corporates (Exhibit 2).

Meanwhile, while underlying inflation has probably not surprised the ECB on the upside, headline inflation likely has. Recent moves in oil prices increase the risks this remains the case even in the upward-revised short-term inflation forecasts from the ECB (we work on the assumption the latest move in oil is not part of the new forecasts). Meanwhile core inflation is off its recent peak but not enough to claim the worse is behind us. Additionally, the ECB consumer expectations survey showed a small uptick in medium-term inflation expectations (Exhibit 3), while unit labour costs, the new variable in focus, accelerated in 2Q (Exhibit 4).

Exhibit 2: Euro area, loans to nonfinancial corporates (flows, EUR bn)
Some stabilization in lending flows



Source: ECB. Note: adjusted for sales & securitization

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Exhibit 3: ECB consumer inflation expectations
The 3y ahead measure showed a small uptick in July

	May 2023	June 2023	July 2023
inflation expectations 12m ahead	3.9	3.4	3.4
inflation expectations 3y ahead	2.5	2.3	2.4

Source: ECB

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All in all, in the context of a very split Governing Council, we work on the assumption that a risk management approach will lead them to deliver a hike.

Very much data-dependent

We expect very little guidance on what comes next beyond ruling out cuts. We would expect the wording "interest rates will be set at sufficiently restrictive levels for as long as necessary to achieve a timely return of inflation to the 2% medium-term target" to be unchanged in the statement. Then at the press conference, as in July, we would expect ECB President Lagarde to insist on the need to see new data to decide on the next move but, at the same time, to say that the next move could be a hike or a pause, but not a cut.

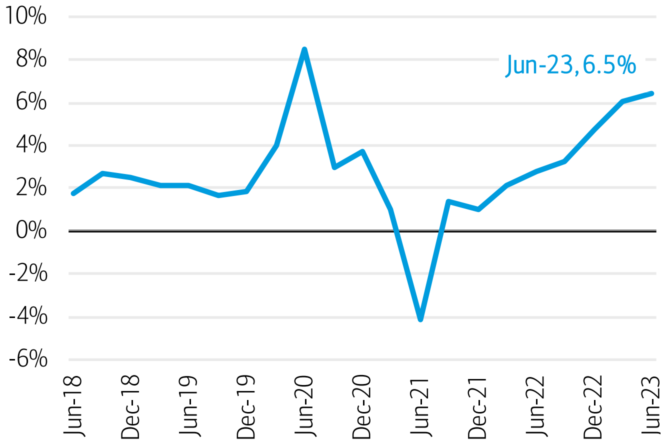
We have argued before that eventually we would expect the ECB to provide some forward guidance on the conditions that determine a cut. We think it is too early to do so and that any such move likely requires certainty that the hiking cycle is over. This is more likely in December, we think. We would expect some guidance symmetrical to that at the beginning of the hiking cycle, "the Governing Council expects the key ECB interest rates to remain at their present or lower levels until it sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and it judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at 2% over the medium term." And given our inflation forecasts and, likely, this guidance, we think June 2024 is still a valid call for the first cut.

Too early for news on the balance sheet

After the move in July to change the remuneration of mandatory reserves, we had plenty of questions on whether we would hear more news on the balance sheet this week. We doubt it.

On assets, after the move in July we argued that the bar for active sales of APP holdings is high given it would crystalise losses. In the context of some desire to increase the speed at which the ECB balance sheet unwinds, we think it is now likely that PEPP reinvestments will stop earlier than the ECB is indicating (December 2024). We think it is more likely than not that full PEPP reinvestments, if spreads remain resilient, will stop sometime in mid-2024. Similar to what we saw with APP, we would expect a progressive reduction, first moving to 50% reinvestments during 2H24. Then, in 2025, we would assume full (passive) PEPP QT. Still, we think the Governing Council want to make sure they are closer to the end of the hiking cycle before taking a step in that direction.

Exhibit 4: Euro area, unit labour costs (yoy%)
Acceleration in 2Q unit labour costs



Source: ECB

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At the same time, we believe that the likelihood of further remuneration rate changes on government and non-euro area resident deposits to 0% is very high. We think a lot of the noise in markets these days on reverse tiering is overdone, and we doubt the ECB wants to weaken the transmission of monetary policy. Still, the ECB itself created those doubts with the move in July and we would expect that noise to continue. But we would flag that any additional change is unlikely to happen soon. Most likely we would first need to see the outcome of the framework review.

We would argue that the in-depth discussion of these matters at the July meeting (as revealed by the accounts of that meeting) probably means the issue is settled for now. We would be very surprised if they were willing to reopen the discussion after only six weeks.

Forecasts of ECB forecasts: closer to target, weaker growth

Given the very optimistic starting point, we would expect a significant move lower in growth forecasts, particularly for 2024, heading closer to 1%. Recent developments in soft data, external demand, and external assumptions would justify such a move. 2025 is likely to move a bit lower too for the same reasons. That will pave the way for slightly softer core inflation in the medium term.

Meanwhile, headline inflation is likely to move up in 2023 on the back of higher oil prices but that should be compensated in subsequent years by lower prices for other energy items and food. Weaker growth and a stronger exchange rate are also likely to bring core inflation marginally lower in 2024 and close to target by 2025, while it is unlikely to change much near-term.

Rates: Bearish

Investors believe ECB's commitment to 2%. ECB may reinforce it this week

Based on the results of our Sep FX and Rates sentiment survey, the ECB shouldn't be concerned about the market's perception of its ability to achieve its mandate. In fact, around 50% of investors believe the ECB is the most committed central bank to the 2% target. In addition, the share of investors expecting inflation to drop sub 2% by end of 2024 has jumped, from just 10% to over a quarter (see Exhibits 2 & 3 of the survey).

Still, we expect the hawks to generate a consensus for another hike this week. They are likely to point to the rise in inflation breakevens over the summer (even if, in our view, it is more technical than fundamental), the small uptick in consumers' long term inflation expectations & unit labour costs, and the recent data flow (eg. core inflation flat vs Jul).

The staff forecast revisions may not be enough to deter them from hiking: the growth outlook is weaker, but recession is not in sight. Inflation will be pencilled in to almost (or fully) converge to target by end of 2025, but it will be shown as stronger near term.

The fact that the market is only pricing in 13bp of hikes for this meeting should not be seen as an issue. The ECB did deliver a 50bp hike in Jul-22, when the market was similarly pricing just 36% chance of that (conditional on a 25bp hike being certain).

Real money slightly less long, but not trading supply concerns. We stay bearish

As discussed recently (GRW, 1-Sep), we remain bearish Bunds near term due to the combination of: long positioning, elevated supply in Sep and hard data that can outperform low expectations on the back of the very weak PMIs.

The results of the FX and Rates Sentiment Survey do not challenge this view. Long duration positions have been reduced marginally in core EUR, but: (1) views have moved by more, creating a gap between (long) exposures and views – Exhibit 5, (2) the long rates position is seen as the most crowded trade, and (3) investors are not trading the high supply theme, even if most expect EGB supply to be harder to absorb in H2 (Exhibit 6).

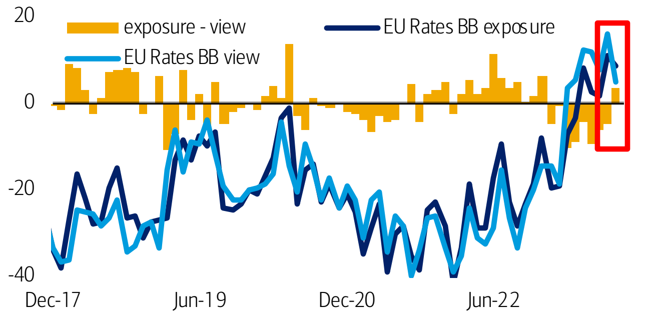
2s10s: summer dynamics to temporarily break around CB meetings this Sep

If the ECB delivers a hike, this can drive a bear flattening of the curve, while an on-hold decision will likely be accompanied by hawkish language to try and prevent a rates rally. In the latter scenario, the curve may still bull steepen as it will be hard for the ECB to push markets to price hikes later (in fact, our economists are strongly convinced of no hike beyond Sep, given that both activity and inflation will most likely weaken from here). However, with inflation falling, we think that, in Q4, 2s10s dynamics can settle back in line with what was observed this summer. The front-end should remain stable, especially as central banks insist on the high for long narrative, leaving the 5-10y in the driver seat – selling off on upside data surprises and rallying otherwise.

The two challenges to this belly-led curve dynamic in Q4 would be (a) upside surprises in inflation, leading to bear flattening – we watch commodity prices carefully, and (b) a shock that would warrant more immediate rate cuts, bringing forward a bull steepening.

Exhibit 5: Duration exposure and view: Core Europe

Duration views have pared back more than positioning in Aug



Source: BofA Global Research FX and Rates Sentiment Survey

BB is the Bull-Bear Index for exposure and view. It weights responses to create an index ranging from -100 to + 100, zero representing neutral. See appendix for formulas.

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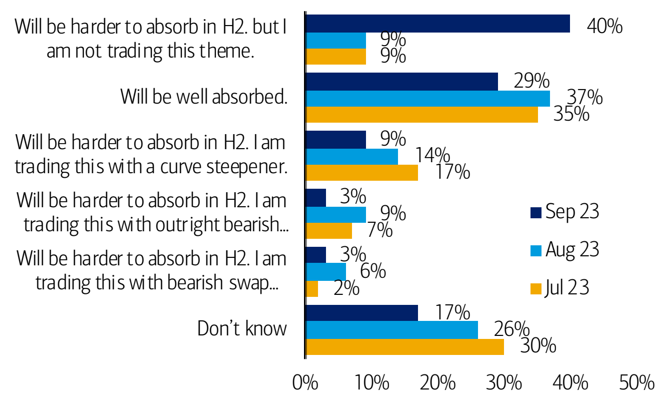
Exhibit 6: I believe core EGB supply:

Investors see supply as a risk but don't know how to trade it



Source: BofA Global Research FX and Rates Sentiment Survey

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Too early for decisions on changes to balance sheet or deposit remuneration

We don't expect news this week on the balance sheet, be it changes to the Quantitative Tightening (QT) plans or the remuneration of different ECB liabilities (government and foreign officials deposits or banks' minimum reserves or excess deposits).

All these elements will likely be debated further, as part of the operational framework review that is due to conclude in coming months. Ultimately, by year-end, we think the

ECB will likely take steps to minimise the costs of its large balance sheet (see The ECB's cost minimisation problem). These include:

(1) Lowering the remuneration of governments deposits to 0%, in a replica of the change the Bundesbank announced unilaterally for Oct 1st (European Rates Watch). This would then also affect foreign official deposits at the ECB.

(2) Bringing forward the date of PEPP QT. We pencil in that full PEPP reinvestments will end in Jun-24, even as the ECB currently plans on continuing until end of 2024.

(3) At the extreme, a potential small negative tiering for banks' excess reserves at the ECB. But we think a lot of the noise in markets on this punitive tiering is overdone. We doubt the ECB wants to weaken the transmission of monetary policy. Indeed, such a move would come with risks of significant volatility in money markets and thereby significantly weaken the central bank's inflation fighting credibility.

We do not expect active QT anytime soon, as this would lead to the crystallisation of additional losses, on top of the negative carry that the central bank is running (see ECB active QT: first cost estimates). We also read the discussion on a potential increase in banks' minimum reserve requirements in the account of the July meeting as suggesting that such a decision is unlikely at least in the near term, and rightly so, in our view. We would flag that increased min. reserve requirements (paid at 0%) and a negative tiering of excess reserves could have different implications for money market rates as banks would react differently to each. The ECB will likely want to conduct more analysis on this.

FX: Temporary EUR strength, but stay bearish

We may see some temporary EUR strength if the ECB indeed hikes this week, as we expect. Market is pircing a 50% chance (13bp). Even if the ECB stays on hold, we would expect their language to make it clear that this is a skip, not a pause, although in practice it may turn out to the the latter. We would not expect the EUR to strengthen by much in any case, as the market is already pricing a high probability of a last hike by the end of this year (22bp).

The main driver of the EUR remais relative data. The growth-inflation trade-off seems to have been much better in the US than I the Eurozone so far, supporting the USD. In any case, we also expect one more hike by the Fed, in November, which is not fully priced (market is pricing 13bp by December). We stick with our EURUSD forecast of 1.05 by year-end.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Christmas will not likely come early this year **Global FX Weekly**, 8 Sep 2023
- The beginning of the end **Global Rates Weekly**, 8 Sep 2023
- August flows, **Liquid Cross Border Flows**, 4 Sep 2023

Rates, FX & EM trades for 2023

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: Christmas will not likely come early this year 08 September 2023

Global Rates Weekly: The beginning of the end 08 September 2023

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