Liquid Insight

ECB Preview: the path to cuts

13 December 2023

Rates and Currencies Research
Global

Key takeaways

- We expect the ECB on hold. Communication and forecasts will suggest cuts are next, but not immediate.
- Risks of an April cut are up, but still not obvious.We stick to a first quarterly cut in June. We pull forward our PEPP call.
- We are still long duration but enter 3m1y payer spreads. Balanced EUR risks, but ECB communication will be a challenge.

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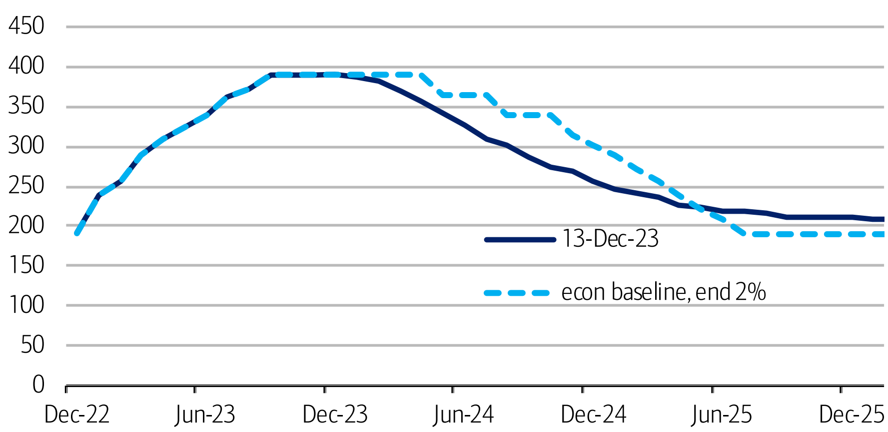
Exhibit 1: The Market is pricing a rapid start of the cutting cycle in 2024
Market implied path for €str vs BofA economists baseline



Source: BofA Global Research

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Done hiking, not cutting yet

We expect the ECB on hold this week. Communication and forecasts will suggest cuts are next, but not immediate. Risks of an April cut are up, but still not obvious. We stick to a first quarterly cut in June, faster moves in 2025. We pull forward our PEPP call. Full reinvestment likely ends in April (vs June before). That is not incompatible with cuts. We are still long Bund and received in 2y1y €str, to position for pricing of an even lower terminal. We like paye spreads to hedge against the pricing out of early '24 cuts and maintain our Euribor-€str spread steepeners on rising funding risks. We see balanced EUR risks, but ECB communication will be a challenge.

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The beginning of the path to cuts

We expect no policy changes from the ECB this week. The meeting should be about acknowledging that the next move is likely to be a cut. For now, we expect the ECB to maintain that "the Governing Council considers that the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target. The Governing Council's future decisions will ensure that the key ECB interest rates will be set at sufficiently restrictive levels for as long as necessary." That should come with the usual emphasis on data dependence and the three key ingredients for that assessment (forecasts, underlying inflation and transmission).

We can't rule out a bit more clarity on the conditions that would lead to the beginning of the cutting cycle, but we think that is more likely in the following meeting. Forecasts should be consistent with the ECB done hiking and (given the cutoff for the forecasts) a slower cutting cycle than the market prices, leading to inflation around target in 2025 and 2026. The evolution of unit labour costs and the absence of fiscal rules probably allow the national central banks to keep inflation forecasts there. Risks are likely to remain to the downside for growth and be more balanced, implicitly in the case of inflation.

We expect an acknowledgement of PEPP discussions, which will likely pave the way to an earlier end to PEPP than we thought before. We move our expectation of partial PEPP reinvestments to April from June. We hope for some clarity on a potential timing of the outcome of the operational framework, but it's probably too early for that guidance.

How much of a pushback?

Will the ECB and ECB President Lagarde be ready to push back against market pricing of early and fast cuts? Not decisively, in our view. We would expect Lagarde to give a similar answer to the one Schnabel gave in a recent interview, emphasizing data dependence, the need for more time to see what happens to wages, productivity and margins, as well as highlighting that caution is needed when making statements far out in time, given they have been surprised many times in both directions. That should come with an acknowledgment that cuts were not discussed in the meeting (too early for that) and a reminder that the upcoming spring wage negotiations are a key input for the path forward.

The market could take a dovish signal from that. Back in November, when asked about what "as long as necessary" meant, Lagarde argued that "long enough is long enough", adding that cuts were unlikely in the next couple of quarters. We doubt that, after more than a month, she is ready to repeat that statement.

A slow dovish pivot

We have seen a quick dovish pivot by the markets. Just a few days ago we were among the most dovish among consensus and more so than the market when it came to inflation and the ECB cutting cycle. Markets have moved beyond our call and now expect a much faster cutting cycle.

Still, we think markets are getting a bit carried away. We had argued before that an April cut seemed unthinkable; today this is no longer the case, but we are not there yet. The narrative from 'central bank speak' up until this week was that perhaps more hikes will be needed and that the risk inflation takes longer to get to 2% is much higher than the risk it converges faster. The next step is getting rid of that bias officially – likely this week. Then the ECB can start contemplating the milestones that would lead to the beginning of the cutting cycle.

Indeed, as we have been arguing recently, the ECB will need to become more transparent on the conditions that would lead it to begin cutting rates. Banque de France Governor Vileroy de Galhau laid us a potential path for this when he argued in a recent speech that we would need to see "a return to an inflation outlook that is compatible with our 2% target, firmly and durably. Firmly in the sense of being supported by actual data on headline inflation, as well as on underlying inflation and wages. Durably in the sense of forecasting 2% sufficiently ahead of the end of our projection horizon, and including a decline towards 2% of households' and businesses' inflation expectations."

This is not too far from the three conditions we have been pushing for a while: i) waiting for wage negotiations in the spring to confirm no significant upside surprises; ii) core inflation continuing to fall at a reasonable pace (ECB speak has flagged 3% as a key threshold); and 3) being able to see inflation at target and durably within 12 months.

We might get some more clarity on these lines as soon as this week, but on the margin, we think this is more likely in the following meeting. In any case, we still think this configuration makes June the base case for the beginning of the cutting cycle but there is an increasing likelihood of a cut in April.

An accelerated PEPP (passive and partial) Quantitative Tightening (QT)
It's been our call for a long while that we will see an early stop to full PEPP (Pandemic Emergency Purchase Programme) reinvestments by June 2024 (moving to partial 50% reinvestments until the end of 2024, and then a full stop in 2025), as long as spreads remain well-behaved. We are moving that call to April, with risks of March. The fact that Lagarde flagged that those discussions are about to happen and that spreads remain well-behaved probably accelerates the calendar.

In this context, we would expect an acknowledgment from Lagarde that PEPP has already been discussed. From here the conviction for the exact path is low. Committees could be tasked now or in the next meeting. A formal decision, effective in April, could be taken in January or March. Despite the accelerated calendar, we work on the assumption that the ECB won't have the appetite to start unwinding PEPP during 1Q, given the large seasonal issuance in that period; hence, we think April is more likely.

Hoping for some clarity on the operational framework timing
Recent ECB speak probably highlights that we have little clarity on the potential timing of the outcome of the operational framework review. April is still the expected timing, leaving several meetings open for the outcome. We will be watching closely whether we get more clarity on the timing, but we doubt it. As a reminder, we would expect only at that point a move to mandatory reserves of 2-3%.

ECB forecasts: target in reach, but cuts not imminent
The focus in forecasts will be on the magnitude of cuts to 2023/24 growth and inflation dynamics, and the stickiness of inflation into the 2026 forecast extension. In a nutshell, we expect inflation back at target in 2025 and possibly mildly below in 2026. The narrative would be that rate hikes are done (back to 2% in 2025), but with inflation just below target at the end of the policy horizon, rate cuts away from extra tight current levels are not urgent or imminent.

To the forecast nitty gritty: technical assumptions have arguably not changed enough from the September forecast to make much difference. Oil and gas prices are a tad lower, and financing conditions (3m Euribor and 10y government bond yields) a little higher, but insufficiently so to meaningfully alter forecast trajectories.

Data flow itself has been mixed. GDP growth and revisions mechanically pull 2023/24 forecasts lower. A delay to the recovery by a quarter or two is likely vs September assumptions. But the growth narrative is unlikely to change, given better-than-expected labour market resilience. We expect growth forecast cuts of 30-40bp to 0.6-0.7% for 2024, but a 1.4-1.6% above-potential recovery thereafter.

Inflation surprised the ECB quite meaningfully to the downside quickly. But with a cut-off on 22 Nov, the latest print shouldn't make it to the forecast (given this forecast round is driven by national central banks, we would assume a hard cut-off date). Slightly lower energy prices, the last ECB hike and somewhat tighter financing conditions should pull inflation forecasts lower. Wage growth hasn't outperformed expectations, but employment was better and growth weaker, so unit labour costs are up, helping to justify limited cuts to core inflation assumptions beyond the short term. We would hence expect 2024 core inflation forecasts to move to 2.5-2.6%, 30-40bp lower than before, with headline 20bp above core. The 2% target in core will likely be brought forward to 1H25, 2-3 quarters earlier than in the September forecast, moving only very gently lower thereafter.

A 2025/26 forecast at or just below 2% would not be a game changer, we would argue. Such a trajectory would be a natural extension of the Sep forecast, where 4Q25 core inflation was at 1.9% already. Hence, we would see it as confirmation that: a) hikes are done, b) policy rates are above neutral and thus will be lowered eventually, but c) cuts are currently neither urgent nor imminent.

Exhibit 2: ECB forecasts – technical assumptions (expected)
Cut-off date 22 November. Big market moves came only after

	Sep-23				Dec-23 (exp)			
	2022	2023	2024	2025	2023	2024	2025	2026
Oil price (USD/barrel)	103.7	82.7	81.8	77.9	83.3	80.0	76.5	73.5
Gas prices (EUR/MWh)	123.0	43.0	54.0	47.0	42.5	47.9	43.6	36.3
USD/EUR	1.05	1.09	1.09	1.09	1.08	1.08	1.08	1.08
NEER (1999Q1=100)	116.8	123.0	124.9	124.9	122.4	123.5	123.5	123.5

Source: ECB, BofA Global Research estimates

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Exhibit 3: ECB growth and inflation forecasts
Inflation at or slightly below target a sign that hikes are done, but not that cuts are imminent

	Sep-23				Dec-23 (exp)			
	2022	2023	2024	2025	2023	2024	2025	2026
Real GDP	3.4	0.7	1.0	1.5	0.5	0.6-0.7	1.4-1.5	1.5-1.6
HICP	8.4	5.6	3.2	2.1	8.4	2.7-2.8	1.8-1.9	1.8-1.9
ex food & energy	3.9	5.1	2.9	2.2	4.9-5.0	2.5-2.6	1.9-2.0	1.8-1.9

Source: ECB, BofA Global Research estimates

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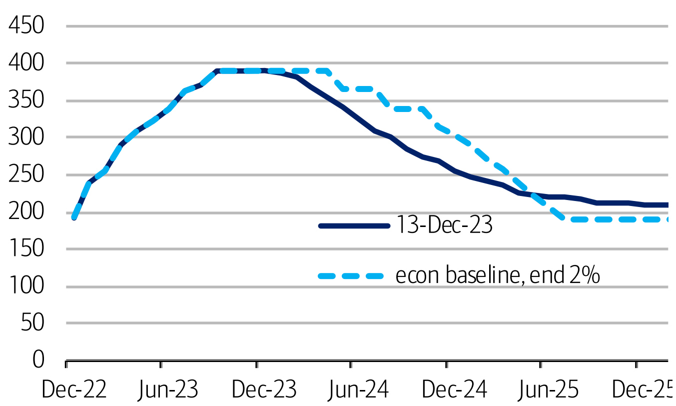
Rates: could price out early cuts, but room for lower terminal

Global rates rallied significantly in the last couple of weeks, with the rally in euro rates further supported by a weak November EZ inflation print and a dovish pivot by ECB's Schnabel. The market is pricing in a faster path to neutral rates than our base case, with almost 40bp of cumulative cuts priced in by the April 2024 meeting and inflation below or close to target from 2H 2024 (Exhibit 4 and Exhibit 5). We hedge a potential pricing out of 1H24 cuts with EUR 3m1y payer spreads ATM+25bp/ATM+50bp (current: 6bp, target: 15bp, stop: 0bp). Risks to the trade are additional downside surprises in inflation.

Exhibit 4: Market pricing in faster approach to 2% than our baseline
ECB depo rate: historical, market pricing and BofA forecasts



Source: BofA Global Research, Bloomberg

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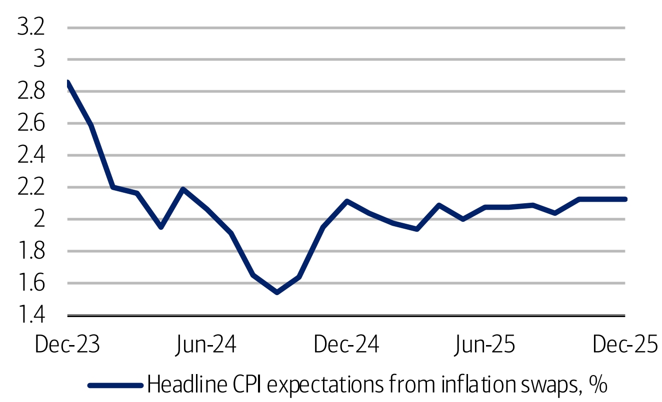
Exhibit 5: Market pricing in below or close to target from 2H 2024H
Headline euro area HCPI implied by inflation swaps curve



Source: BofA Global Research

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We remain bullish outright, however, as we believe the terminal rate in the ECB's cutting cycle, currently implied at 2%, could still reprice lower over time. We are long 10y Bunds (current: 2.2%, target: 2.0%, stop: 3.1%) and receiving 2y1y €str (current: 2.0%, target: 1.7%, stop: 2.9%). Risks to the trades are better than expected data/higher inflation.

Bringing the wall closer

We estimated banks' reserve demand for LCR purposes is between €2.1trn and €3.4trn, with excess liquidity projected to be around €2.7trn by the end of 2024 (Exhibit 6). Our economists' revised call for PEPP QT to start in April skews the risk of reserve demand exceeding supply sooner, even if the change is marginal vs the overall liquidity reduction.

Accelerated QT when there is still a risk of the operational framework review not being concluded at the same time is a perhaps a more fundamental risk. The operational framework review is scheduled to be concluded in "Spring 2024". As reserve supply declines, the ECB may need to reassure markets of its willingness to address potential reserve shortages by adjusting existing, or introducing new, lending operations.

If the details of such lending operations are not decided upon and announced when QT is accelerated, there is a risk that market concerns over potential bank funding pressures increase. We express this view via ERU4 vs ERM4 €str spread steepeners (current: +1.3bp, target: +5.5bp, stop: -1.6bp). The main risk to the trade is a very large short-term shock that causes the Euribor futures-€str spread curve to invert.

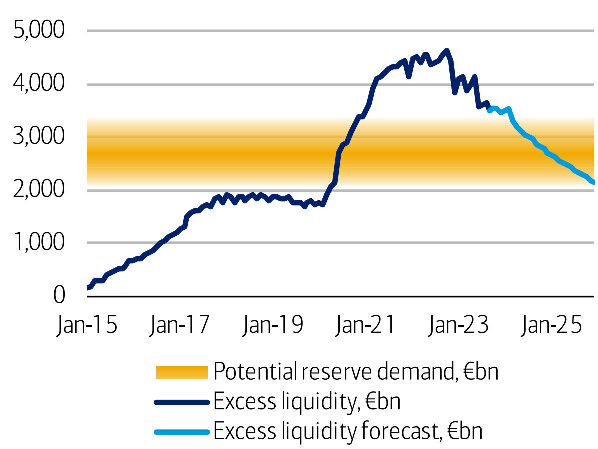
Effect of PEPP on EGBs = minor in the big picture

The change of call on PEPP QT start from June to April does not bring significant changes to the outlook for EGB supply or spreads in our view. This is despite the fact that Apr-May represent two consecutive months of large redemptions (largest 2-month sequence), and with therefore fewer PEPP reinvestments now (Exhibit 7).

The impact on the Eurozone Government Bond complex is in the order of €15bn. This is a number that pales in front of the €530bn of net bond issuance (inclusive of our prior QT call and its effect) expected in 2024. It is also small compared to the range of uncertainty related to gross issuance (eg in Germany, as discussed two weeks ago – see Rates EU section of Global Rates weekly, 24-Nov).

Looking at the breakdown of reduced PEPP reinvestments for Eurozone Government Bonds over April and May, we note it is mostly Germany (€3.8bn), Italy (€3.6bn), Spain (€3.4) and France (€2.7bn) that will be affected. In terms of actual market impact, BTPs are the most exposed (negatively) to this story but we doubt it is big enough to significantly dent our call that 10y BTP-Bund can tighten to 160bp.

Exhibit 6: Euro area excess liquidity
Earlier start to QT increases demand/supply imbalance risks



Source: BofA Global Research, ECB

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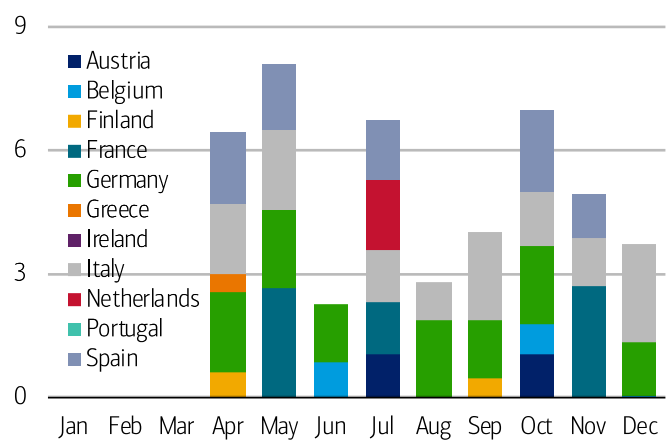
Exhibit 7: Assumed missed ECB reinvestments from PEPP in 2024
Assuming 50% reinvestments, we see c.€46bn impact on net EGB supply



Source: own calcs. Numbers in EUR billions

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Balanced EUR risks

We expect the ECB communication to be a challenge, but if they get it right, the meeting this week should not have much EUR impact. If they were to push against market pricing early rate cuts, it would be hawkish compared with expectations and positive for the EUR. On the other hand, if they come across as endorsing market pricing, it would be dovish and negative for the EUR. We don't see incerntives for any such signals. Their job is somewhat easier given the rates repricing from 6 to 5 cuts this week, but still difficult. Emphasizing data dependence is the best way to strike the right balance in our view, and this is what we expect.

As our economists argue, if data weakness and the drop in inflation continues in Q1, we could see a risk that the ECB starts cutting rates in April, from June in our baseline. This could weaken EURUSD once again, but as long as the Fed cuts rates in June, we would not expect sustained weakness. Our basline remains that US recoupling, Fed cuts and soft landing will support EURUSD, as the USD weakens across the board in risk-on next year. The way EURUSD has traded since the end of October is consistent with this view, strengthening when global rates rallied, and weakening when the market priced earlier ECB cuts.

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