Euro Area Watch

ECB Review: still more ground to cover

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25bp it is, more to come, terminal at 3.75%

We went into this ECB meeting with a very low-conviction call for a 50bp hike. Instead, we got 25bp. But, as we expected, it came with a clear signal that there is more coming. We still feel comfortable with our call of two more 25bp hikes (June and July), with the earliest the ECB can stop being September. Risks are clearly biased towards more from a central bank that remains extremely data dependent, with a lot of weight on the short-term evolution of core inflation. We still don't expect the first cut before June 2024.

At the same time, the ECB announced the expectation (unless something goes wrong) to stop APP reinvestment in July. That seems to somewhat contradict the reason to slow hikes. Meanwhile, as we expected, there seems to be little appetite for a proactive liquidity bridge. As we have argued, the ECB will act if/when tensions in the funding market become evident.

Why 25?

The decision to slow was not based on changes in the economic outlook. As we have mentioned before, activity data has been surprising on the upside and the description of the inflation outlook in the press conference was, if anything, a bit more hawkish. It was the Bank Lending Survey (BLS) that led them to 25bp. Two factors were flagged. First, that banks had tightened standards by more than they expected at the end of last year. We see the surprise as statistical noise, so we are not sure what new information was contained here relative to what we knew in March. And the other factor, that demand from corporates is dropping fast, is consistent with what monetary policy is trying to achieve.

We would argue that the ECB is probably using the BLS to buy some optionality. As we have said before, while there may be stronger conviction in a clear move lower in core 5-6 months down the line, there is plenty of uncertainty in the near term given the delayed pass-through of the peak in energy prices (and the behaviour of corporate margins). Slowing down gains some time for that "noise" to fade away and limits the risk that the ECB has to press harder than we expect them to do, at the risk of breaking something more meaningfully.

Why 3.75%?

It's been our view that the ECB would need to see a sustained move lower in core inflation for them to pause in the hiking cycle. That, to us, means that 3.75% is a lower bound for the terminal rate, with the ECB stopping at the September meeting, i.e. the minimum we get from here is two additional hikes of 25bp after the one we saw this week. Consensus is biased towards 3.5%, with a median expectation of 3.75%. We see risks clearly biased the other way: we would argue that 4% is still more likely than 3.5% given the asymmetry of risks in the near term to the core inflation outlook.

Full APP passive Quantitative Tightening (QT), reactive TLTRO

The ECB decided to be more cautious on rates after seeing the BLS. At the same time, it remains reactive when it comes to new liquidity operations and it felt brave enough to announce this week a full stop to APP reinvestments by July. We see that as contradictory, particularly given that the BLS was signalling QT and TLTRO repayments as contributing further to tighter lending standards. Still, the ECB was cautious at trying to delink APP QT from the PEPP portfolio, given the risk that an earlier run-off of APP could be read as PEPP QT coming soon.

When asked about bridge liquidity operations Lagarde pointed out existing facilities and argued that the ECB can be inventive on bank liquidity if needed. That to us confirms our view that they will remain reactive and act when/if funding tensions arise.

Rates: terminal rate, periphery spreads & ASW impact

The ECB meeting impacted the rates market in three ways, but we need to interpret the moves in the context of the continued US led global risk-off sentiment:

1. A bull steepening of 2s10s curve w/ repricing of the terminal rate lower

The 2s10s curve steepened due to a 10bp repricing lower of the ECB terminal Depo rate: from 3.75% pre statement, to around 3.65% post press conference. The repricing in peak €str took place despite the clear mention from the ECB that it has more ground to cover, and Lagarde's reference to future decisions (insisting on the plural in "decisions"), which would imply that the ECB's baseline is still for two more hikes at least (to 3.75% Depo). This tells us that:

- Investors are likely seeing more downside than upside risks to this ECB baseline, in the context of the continued US regional banking stress.
- Investors may be pricing out some of the policy mistake risks (hence the steepening, which we weren't expecting). This could be because the ECB appeared more conscious of the growing impact of its past rate hikes (noting the forceful transmission in its statement and making several references to the bank lending survey in the press conference - esp. the lower corporate loan demand resulting from higher rates). We are skeptical of the reduced policy mistake risks, especially given Lagarde's response to the question of what represents a "sufficiently restrictive level": we will know when we get there.

The curve steepening further out the curve was also aided by the heavy long-end EGB issuance from earlier in the morning, and the move to a full QT run-off from July onwards, especially when it comes to the bond curve (see below).

We continue to believe that it is too early to call the end of the swaps curve flattening. Risks in our view are still tilted to a higher terminal rate than 3.75% (rather than lower – see above). The ECB will likely keep rates on hold longer than the market expects (20bps of cuts are already priced by the first meeting of 2024). And duration demand from investors (who are likely still, in practice, less long than what their views suggest) can support further curve flattening.

2. A widening in periphery spreads

Periphery bonds cheapened vs Bunds (c.5bp for 10y BTP-Bund). This is consistent with the global risk-off move (periphery spreads tend to be well correlated with equities still) as well as the ECB's announcement of an end to APP reinvestments starting in July.

This full run-off will mean an extra €10bn/m on average to be absorbed by private investors in all types of bonds taken together (European Govt bonds, agencies, regional bonds. supras, corporate bonds, covered bonds and ABS). For EGBs specifically this could represent an extra c.5-6bn/m. While the impact will be felt most significantly in October, when large PSPP redemptions are due, we would argue that these amounts are not dramatic in terms of extra supply in EGB space (an increase of less than 7% for 2023).

For peripheral government bonds, we take comfort in: (1) the fact that the ECB reiterated its forward guidance on PEPP reinvestments (full reinvestments until at least end of 2024). It is indeed PEPP (via its reinvestment flexibility) that represents the official practical backstop for the periphery, and (2) Lagarde's mention that the full APP run-off in July corresponds to an "expectation", maintaining therefore some optionality to extend APP reinvestments should periphery spreads come under meaningful pressure.

3. A flattening of the Asset swap curve

2y German bonds richened over 4bp vs swaps, while 10y bonds richened by 2bp. As for periphery spreads, this flattening in the ASW curve is consistent with:

- a continuation of the risk-off move related to the collapse in US regional bank equity prices (2y German bonds tend to richen most in those risk-off episodes), and
- the pricing of the marginal additional supply pressures stemming from QT (indeed, the bearish impact of QT on bonds vs swaps tends to be expressed most in the 10y sector rather than the 2y).

While German swap spreads are currently rich across the curve vs periphery, vol and repo rates (and especially so in the 2y sector), we acknowledge these levels of richness can still be sustained on continued US banking sector risk, debt limit uncertainty in the US, and a possible additional bid for EUR short dated paper from foreign central banks.

EUR: dovish FX market overreaction

The EUR weakened after the ECB today, but this may be an overreaction. The EUR initially weakened on the decision to cut by 25bp, as the market was pricing slightly more (29bp) going into the meeting. The EUR then recovered some of its losses during the press conference, as the tone was hawkish. Then the EUR weakened again after the press conference. EURUSD ended somewhat higher, but back to yesterday's levels.

The ECB has slowed the pace of hikes but remains hawkish. Based on Lagarde's answers during the press conference, it seems it was a close decision, with the Bank Lending Survey this week being the decisive factor, at the end leading to a strong majority for 25bp. However, Lagarde kept repeating there was "more ground to cover," suggesting that slowing was not pausing and also did not suggest a lower terminal. She also continued emphasizing data dependency and upside inflation risks.

The early announcement to stop APP reinvestment was hawkish in our view, but Lagarde somewhat downplayed it by saying that this was consistent with their earlier intentions to reduce their balance sheet. She also allowed some optionality by saying that this was an expectation for now, although we would think the bar is high to backtrack in June.

With EURUSD already at our end-year forecast, we don't necessarily expect much further upside. We do expect further EURUSD strength next year, going toward its historic average. However, for now it will all depend on the data and the core inflation dynamics. As long as core inflation in Europe remains stuck at high levels, we would expect the ECB to remain hawkish and the EUR to remain supported, keeping everything else equal.

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