Liquid Insight

ECB Preview: still ground to cover

13 June 2023

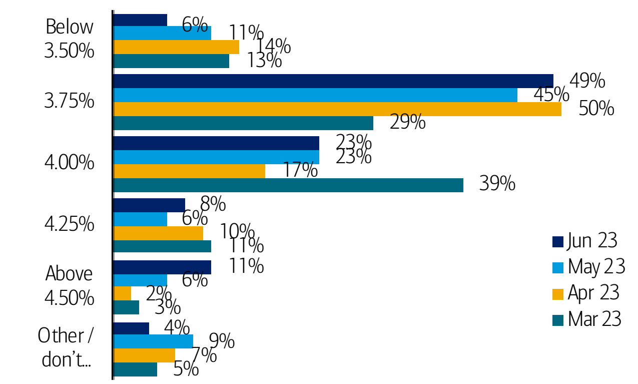
Rates and Currencies Research
Global

Key takeaways

- 25bp hike, message for more, vague on how many. Forecasts: higher near-term core but medium-term inflation at target.
- We are bearish front-end, curves may not steepen by as much as expected, like Euribor-€str wider, swap spreads tighter.
- Balanced EUR risks as the market is already pricing hikes for this meeting and next

By Ruben Segura-Cayuela, Athanasios Vamvakidis, Ralf Preusser, Sphia Salim, Ronald Man and Erjon Satko

Chart of the Day: see the terminal ECB depo at:
42% of respondents expect a terminal rate above 3.75%



Source: BofA Global Research FX and Rates Sentiment Survey, June 2023.

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25bp and still ground to cover

We expect a 25bp hike from the ECB this week, with a message of more to come. The ECB is likely to be vague on whether that means one or several additional hikes; there is little pressure or need for such a signal this week. Forecasts are likely to continue to feed divisions, with higher near-term core but medium-term inflation at target. We are bearish front-end, believe curves may not steepen by as much as expected, like Euribor-€str wider, swap spreads tighter. We see balanced EUR risks, as the market is already pricing hikes for this meeting and next.

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25bp in June, still ground to cover

We expect the ECB to hike all three policy rates by 25bp this week. Additionally, we would expect a clear message that there is still ground to cover, without a precise signal on whether that means one or several more hikes. The Governing Council at this point is unlikely to be willing or ready to provide guidance beyond what it had signalled in May. In other words, we believe the ECB is still likely to avoid giving forward guidance and to insist on data-dependence, mainly focusing on core inflation.

We still expect the ECB to take the depo rate to 3.75% by the July meeting, with risks of 4% in September. Those risks are perhaps smaller after the last inflation data. We continue to think 3.75% is pretty much a lower bound, though, given the profile for core inflation in the next few months. Cuts need to wait until June 2024.

Still some divisions left

Once again, as in March, forecasts are likely to feed the division within the Governing Council. Medium-term and core inflation forecasts should converge significantly to target, if not necessarily fully. That would embolden the doves, with a more forward-looking reaction function. They could also reference the drop in long-term inflation expectations reported in the May consumer expectations survey. On the other hand, short-term core inflation forecasts are likely to move higher, which the hawks, with quite the backward-looking reaction function, will take as a signal that perhaps more is needed beyond what was agreed in May (a signal for several hikes, i.e. a minimum of two after the May hike).

But at this point, given market pricing, the evolution of the data, uncertainties around the outlook, and the emphasis on data dependence, we think there is little pressure to agree on anything other than the move this week and a signal that there is, still, ground to cover, without specifying whether that could mean one or several additional hikes. That would be consistent with a quasi-endorsement of current market pricing.

Few changes in wording

A repeat of the language in the last statement, “our future decisions will ensure that the policy rates will be brought to levels sufficiently restrictive to achieve a timely return of inflation to our two per cent medium-term target and will be kept at those levels for as long as necessary” would suffice to signal:

- First, that there is more tightening ahead without being specific on whether this means more than one hike.
- Second, that rates are unlikely to move lower for a while and perhaps later than the market has been pricing.

Without forward guidance, the ECB will likely continue to insist on data-dependence and the need to look at the three ingredients described in March: the inflation outlook (forecasts), the dynamics of underlying inflation, and the strength of monetary policy transmission. Our perception is still that core inflation has a predominant role in these three conditions. We would expect a clear signal on the need for a sustained moved lower in core inflation for the ECB to pause the hiking cycle.

Still the same risks to our ECB call

We have been at 3.75-4% for terminal for quite some time. We still think it’s a very close call whether we will get a last hike at the September meeting (our call is for a last hike in July). Those risks are perhaps smaller after the last inflation data. But they are still sizeable. The ECB would need to see a significant drop in core inflation before stops hiking rates. By the September print, we expect core and headline to be not far from 4.5%, down more than 100bp from the peak. Is that enough of a decline for the ECB to stop? We are certainly entering very subjective territory.

But we also still think 3.75% is pretty much a lower bound. With core inflation likely north of 5% by the July meeting, we have a hard time thinking the ECB can't hike at that meeting.

Forecast of ECB forecasts: getting there

The forecast update will once again have something for the hawks and something for the doves, we think. A weaker short-term outlook is likely to push growth lower in the near term. Base effects from 2023 should also lower growth in 2024. Meanwhile lower energy prices should be compensated, at least partly, by slightly higher interest rates and a somewhat stronger exchange rate. Overall, we would expect the medium-term growth outlook to be broadly unchanged or marginally lower.

Headline inflation is likely to move little in the near future. Lower energy prices should be compensated by slightly stronger core. But we would expect the impact of energy prices and the exchange rate to move inflation to 2% in the medium term, or even slightly lower. This will be compensated by a stronger core inflation forecast in the near term, close to 5%, with the medium-term core inflation forecast moving little, we think.

These changes, once again, will feed the disagreements within the Governing Council, we think. Hawks would feel emboldened by the higher core inflation in the near term given a more backward-looking reaction. Doves are likely to push the idea that given the market pricing embedded in those forecasts, we are getting close to the end point and hence caution is warranted.

Exhibit 1: Forecast of ECB forecasts – technical assumptions
Oil curve slightly lower, FX has appreciated

	Mar-23				Jun-23 (exp)			
	2022	2023	2024	2025	2022	2023	2024	2025
Oil price (in USD/barrel)	103.7	82.6	77.8	70.3	101.1	77.8	72.9	74.5
USD/EUR exchange rate	1.05	1.08	1.08	1.08	1.05	1.09	1.09	1.09
NEER (1999Q1=100)	116.8	120.2	120.2	120.2	116.7	121.4	121.7	121.7

Source: ECB, BofA Global Research

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Exhibit 2: Forecast of ECB forecasts – growth and inflation
Something for the hawks and something for the doves

	Mar-23				Jun-23 (exp)			
	2022	2023	2024	2025	2022	2023	2024	2025
Real GDP	3.6	1.0	1.6	1.6	3.5	0.7-0.8	1.3-1.5	1.5-1.6
HICP	8.4	5.3	2.9	2.1	8.4	5.2-5.4	2.4-2.6	1.9-2.1
ex food & energy	3.9	4.6	2.5	2.2	3.9	4.8-4.9	2.4-2.6	2.1-2.3

Source: ECB, BofA Global Research

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Besides precise numbers, we assume the emphasis will be on unusually large uncertainty intervals around the base case, especially amid uncertainties over gas supply and weather conditions in the coming months. Risks to the inflation outlook are still likely to be biased to the upside both in the short and medium term.

Rates: risks still skewed for more

We are bearish front-end and believe curves may not steepen by as much as the market expect. The market is pricing in c. 55bp of further hikes by the ECB, close to the lower bound of our economists' expectations. Our FX & Rates Sentiment Survey (FXRSS) showed that, despite the weaker than expected inflation data, terminal depo rate expectations increased in June vs May: 42% of respondents to our June FXRSS expected the terminal depo rate to be above 3.75% vs 35% of respondents in May (Chart of the Day). We also believe the front-end of the swaps curve may not steepen as much as the market expects despite it being near record flats: the market expects cuts to be delivered sooner than our base case.

Jun23 TLTRO maturity not much of a concern

We do not think the ECB will be concerned about the decline in excess liquidity from the maturity of the targeted longer-term refinancing operation (TLTRO) III.4 on 28 June 2023, which alone will decrease excess liquidity by €477bn. While some banks have a reserve shortfall vs TLTRO borrowings, strong funding pressures are unlikely to arise this month. Banks in Italy, which have a shortfall at the country level, will have c. €140bn of TLTROs maturing this month. This is less than the c. €250bn excess reserves they have at the central bank. We cannot rule out the possibility of some individual banks having a shortfall this month, but we believe meaningful funding pressures from TLTRO repayments are more likely to build nearer the TLTRO III.7 maturity in March 2024.

Bridging operations unlikely for now, if at all

Bridging operations from the ECB may help certain banks bridge the reserve-TLTRO shortfall. But it is not obvious to us what the price and tenor of such operations would be. The Bank of Italy estimated if banks in Italy with a reserve shortfall borrowed from the central bank via regular operations to finance the shortfall, then their return on equity will fall by 350bp. We believe the central bank may consider any such bridging operation to be available at a more favourable rate. The tenors of such operations may also need to be at least one-year from a stable funding perspective. In May 2023, the ECB said that it will complement a targeted review of selected banks with a material reliance on TLTRO and are vulnerable to increases in market funding costs with a broad analysis of banks' liquidity and funding plans. This suggests bridging operations are unlikely to be announced as soon as the June 2023 meeting, if at all.

ECB collateral haircuts to return to pre-pandemic levels

The second step in the three-step plan to phase out collateral easing measures will be effective on 29 June 2023. Valuation haircuts on collateral pledged at the Eurosystem will return to pre-pandemic levels: current valuation haircuts are 10% below pre-pandemic levels. The phase out coincides with the largest declines in TLTRO outstanding. So we do not believe the upcoming collateral changes will cause banks to have a shortage of collateral to sustain remaining TLTRO borrowings following the phase out, and any associated impact on front-end rates will be limited.

Spreads – tighter swap spreads, reduced long bias on BTPs

The resolution of the US debt limit and the resulting drop in implied volatility across asset classes has added an excuse for investors increasing exposure on carry trades and accepting lower risk compensation. Being in the camp of those bearish on vol, bullish on Euro Area sovereign credit and expecting tightening in swap spreads (especially in the 10y point) we welcome the move overall, with a few elements of caution.

Swap spreads remain biased for more tightening given the liquidity/risk environment and considering the very intense bond issuance activity last and this week (last week we topped syndication volumes, this sees one of the highest weekly auction volumes of the year). EGB spreads may also continue tightening but, at 165-170bp, we think BTP spreads trade at fair levels considering the context of 1) over-restrictive policy rates and deteriorating economic activity indicators 2) possible further acceleration of financial conditions tightening after the TLTRO repayment. For BTPs specifically, we share our economists' worry on Italy's NGEU project implementation, the risk of a freeze of country's next loan tranche and the resulting political repercussions.

FX: Balanced risks

With the market already pricing fully at least two more ECB hikes, the meeting this week should not affect the EUR much. Communication from the meeting will matter in the short term, but we don't see a sustained impact. We would expect the ECB to akcnowledge that finally core inflation has peaked, but also warn that it remains well above the ECB target, as well as the ECB forecasts, which in turn suggests more tightening is necessary. We don't see any reason for the ECB to push against market pricing one way or another. The ECB will continue emphasizing data dependence.

As we have argued recently, most EUR crosses have found support from the hawkish ECB this year, but EURUSD depends more on the USD and the Fed. As long as the US economy remains on a non-landing scenario, we would expect the USD to remain strong and EURUSD historically weak. Only after the inevitable landing we would expect a more sustained EURUSD move upwards (for details, please see Why is the EUR failing to rally? 07 June 2023).

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- High(er) rates for (much) longer **Global FX Weekly**, 09 June 2023
- Commonwealth Surprise **Global Rates Weekly**, 09 June 2023
- USD breather, **Liquid Cross Border Flows**, 05 June 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: High(er) rates for (much) longer 09 June 2023

Global Rates Weekly: Commonwealth Surprise 09 June 2023

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