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Liquid Insight

ECB preview: waiting for December forecasts

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Rates and Currencies Research
Global

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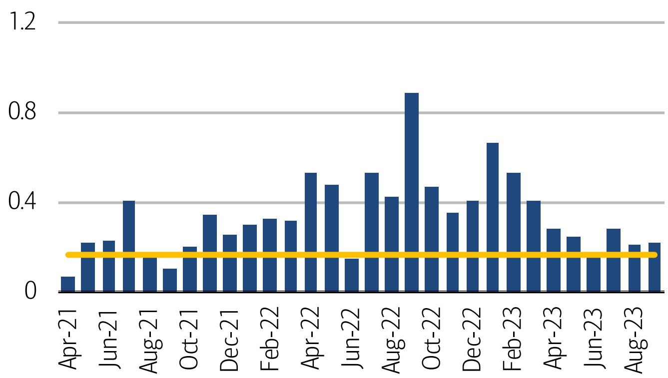
Key takeaways

- We expect the ECB to discuss the risk balance from higher energy prices and the rise in real yields, but no policy action.
- Questions on PEPP reinvestment and TPI likely, symptomatic for the fragile market environment. We expect no actionable news.
- A placeholder, with some risks for dovish tone, but no sustained market impact.

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

Exhibit 1: Eurozone core inflation, bottom-up SA

Eurozone core inflation is on track towards the target



Source: BofA Global Research

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A placeholder

The ECB would probably not mind skipping this week's meeting. It's not the moment to revisit the September message. Energy prices have risen, but so have real yields. Our measure of seasonally adjusted bottom-up monthly core inflation suggests the ECB is on track towards its inflation target (Exhibit 1).

Our expectations for this week's meeting are confined to clarification on the state of play in the minimum reserve requirement and PEPP reinvestment discussion. Neither is probably for the prepared statement, but for the Q&A. We would expect ECB President Lagarde to say that the minimum reserve requirement discussion is confined to "normalization" (ie 2% or close to that) in the context of the operational framework review. If this were part of the prepared statement, it would be a much firmer signal. Meanwhile, we would expect Lagarde to be non-committal on PEPP reinvestment discussion. Acknowledging the discussion in the prepared statement would be a hawkish signal, which we expect the Governing Council to shy away from.

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Two-sided risks

We expect no policy changes from the ECB this week. The meeting should be about flagging risks that have emerged since the last one and putting in a placeholder for the December meeting when a new set of forecasts would allow, if anything, a reconfiguration of policy. For now, we would 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).

Additionally, we would expect a clear signal that changes to mandatory reserves, if any, would need to wait until the conclusion of the operational framework review next spring. We think there is probably a majority willing to stop this debate for now, to avoid a credit crunch (see note Wage spirals that don't happen, policy debates that shouldn't happen). Adding a clear reference to this in the written statement would be a strong message. Alternatively (and more likely), Lagarde will probably clarify so during the press conference.

Beyond mandatory reserves, and given the evolution of rates and spreads, we would expect very little appetite to rock the boat on Pandemic emergency purchase program (PEPP). We think Lagarde will be non-committal on the PEPP reinvestment discussion during the press conference. At most, we would expect some vague reference to a discussion having happened with no immediate implications.

As a reminder, our call for the ECB is for no further hikes and a first cut by June 2024 at the earliest, one cut per quarter from there, a stop to full PEPP reinvestments also in June 2024, and mandatory reserves moving to 2-3% after the operational framework review is finalised.

Something for everyone

We would expect the discussion on the economic outlook to centre on the two most important developments since the last meeting in September. First, the move in energy prices, which risks leading to higher headline inflation than the ECB is forecasting for the later part of the year and early 2024. Second, the movement in yields and, more importantly, real yields.

Indeed, as we have flagged before, higher energy prices create some residual probability that the ECB will be tempted to hike again in December. But unless the move is wider, we remain comfortable with the ECB being done, for now. The accounts of the ECB meeting in September highlighted two important points. First, that the last hike was seen as giving some safety margin in the case of additional shocks. That leaves some room for headline inflation to surprise on the upside without creating the need for more. Second, "turning to the assessment of monetary policy transmission, members noted that ample evidence could now be found that this was proceeding strongly, more so than expected". We would read that as implying that the ECB may have gone too far, but that is our take. For the ECB this likely also raises the bar for another hike.

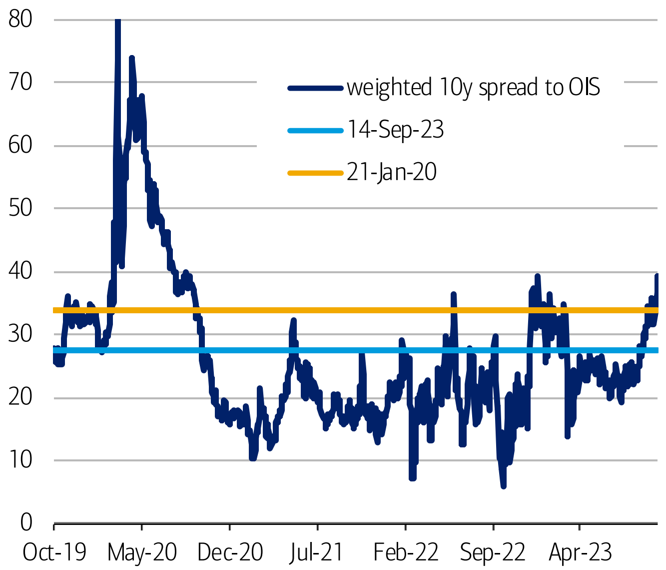
On top of transmission being too strong, the move in real yields since the September meeting (see Exhibit 2 and Exhibit 3) risks “breaking something.” Indeed, our (and the ECB’s) forecasts could become old quickly if the move were to persist. Something has to give: the market reprices some of the recent moves since they do not look consistent with fundamentals this side of the Atlantic, or something other than the economy "breaks", or the economy breaks.

So, for now, while acknowledging both developments (oil and real rates), we would expect Lagarde to put a placeholder in the December forecasts as a way of understanding how recent developments affect the economic and policy outlook.

To TPI, or not to TPI

Given the move in BTP spreads, Lagarde is likely to be asked about Transmission Projection Instrument (TPI). We would expect Lagarde to flag that PEPP reinvestments are the first line of defence, that TPI is a tool that will be available to use when they judge it necessary. But as we have heard from many ECB speakers, we would expect, if anything, the message that recent moves in spreads do not suggest fragmentation is at play.

Exhibit 2: Euro Area 10y bond spreads to OIS highest since Oct-20 (bp)
Euro Area GDP weighted 10y bond spreads to Overnight Indexed Swaps (OIS)



Source: Bloomberg, BofA Global Research

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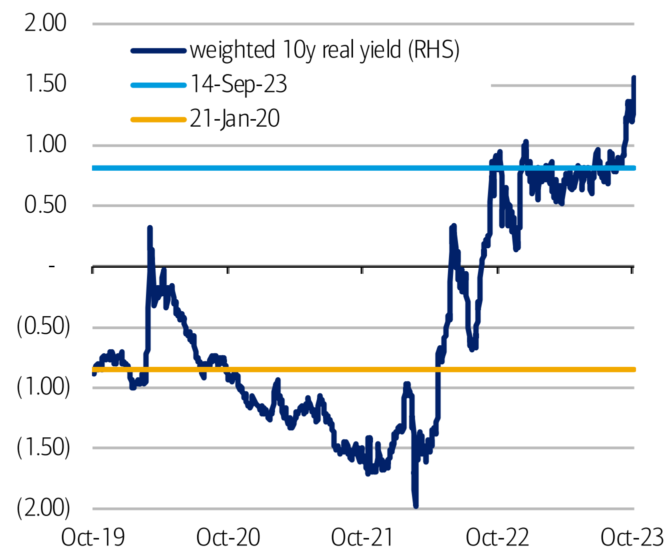
Exhibit 3: EA GDP weighted 10y real rate surged 75bp since Sep ECB
Euro Area GDP weighted 10y real rate (*)



Source: Bloomberg, BofA Global Research. (*) Calculated using nominal 10y bond yields for each Euro Area country and subtracting 10y German breakeven level.

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Rates: Opportunity to comment on real rates surge

We expect no rate move from the ECB this week. As the selloff in rates is already driving periphery spreads wider (Exhibit 2), we expect very little appetite to rock the boat with a change in the PEPP reinvestment plan.

We expect the discussion on the economic outlook to centre on the two most important developments since the Sep meeting: 1) the move in energy prices, which risks leading to higher headline inflation than the ECB forecasts for the short term, 2) the surge in real yields (Exhibit 3). We believe that the Sep hike was delivered to give some safety margin in case of similar inflation shocks. The move in real yields is now compounding its effect and risks to quickly become self-defeating. But the ECB may delay its verdict on this, pushing its assessment of the balance between (1) and (2) to the December meeting.

We would expect a clear signal that changes to mandatory reserves, if any, would need to wait until the conclusion of the operational framework review next spring. Risks of a move at that stage should be reflected in wider FRA-€str spreads most likely from 2Q24 and cheaper term repo rates vs €str that extend at least through 1H 2024 (via reduced excess liquidity & increased repo in banks' funding mix – [EUR Rates Viewpoint, 29 Sep](#)).

EUR: Could take it as dovish, but without sustained impact

We would expect the FX market to focus on what Lagarde has to say about the rates sell-off and the increase in oil prices. Although the two have opposite inflation implications, they are both negative for the economy. If her comments focus on the latter, the market may take her tone as dovish. However, we would not expect any intentional message and agree that Lagarde would prefer to wait for the December ECB forecasts. Therefore, we would not expect any sustained negative EUR impact.

The USD (and the Fed) remains the main driver for EURUSD. Indeed, beyond the USD, the EUR continues to perform well. It has only done worse that the USD and the CHF since the USD rally and the rates sell-off started at the end of July. EURUSD is also slightly up so far in October.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Positioning matters until it doesn't**, Global FX Weekly**, 20 Oct 2023
- Hi 5s 20**, Global Rates Weekly**, 20 Oct 2023
- Waiting for the next catalyst, **Liquid Cross Border Flows**, 16 Oct 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: Positioning matters until it doesn't 20 October 2023

Global Rates Weekly: Hi 5s 20 October 2023

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