Euro Area Watch

ECB Review: not the time to rock the boat

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No ECB surprise, we stick to our call

ECB President Lagarde put in a good performance. We had expected the ECB to try to avoid rocking the boat, by sending as balanced a message as possible without fuelling the market moves of the last few days. And that is what we got.

During the press conference Lagarde gave a balanced message on the different risks accumulating: geopolitics, a weakening labour market, and the US-driven move in rates. We were told there was no discussion on PEPP or minimum reserves. All in all, we feel there was a strong desire not to send any signal into the future.

Still, we would argue that, on the margin, the ECB (and Lagarde) seems more worried on growth and less so (also, on the margin) on inflation. There was also an explicit acknowledgement that the recent move in yields is US led and not justified by fundamentals in the Euro area. In other words, the move adds an exogenous tightening to the one delivered by the ECB at the previous 10 meetings. Lagarde added that this latest development needs to be taken into account. To us, that means the timing of the start of the cutting cycle will, if anything, move forward, not backwards.

Balance of risks slowly shifting

We have flagged some residual risk of another ECB hike in December given the oil price move. That is probably lower after this week's ECB meeting. Concerns on the impact of geopolitical developments on energy prices were two-sided (growth and inflation). Also, Lagarde emphasize that not all energy price shocks require the same response, initial conditions matter (as a way of suggesting the response to the oil shock does not need to follow what we saw in the last energy price shock).

For a while, our call has been for the first ECB cut in June 2024E at the earliest, or possibly September. Recent data and the evolution of the transmission, together with the exogenous tightening of real rates, make a June call more likely than September.

Earlier cuts than that would need a proper recession, which is not unthinkable if real rates keep moving (exogenously) higher and/or the move is persistent. At the end of the day, the ECB really wants visibility on wages for 2024, something that will be more evident after the spring. But we are surprised by the change in consensus where the first cut recently moved from March to September 24. Recent data can hardly justify that. And certainly, it doesn't feel consistent with the balance of risks that we perceived today from the ECB.

What we thought was needed and didn't happen

We were expecting a clear signal that changes to mandatory reserves, if any, would need to wait until the operational framework review is concluded next spring. That was lacking. Yes, we were told mandatory reserves (MRR) were not discussed.

Refer to important disclosures on page 4 to 6.

But our concern is that the constant noise on changing the MRR to minimise central bank losses risks triggering a proper credit crunch. Avoiding that is easier if there is a clear statement from the ECB. From here we remain subject to the usual headline risk on the matter.

As a reminder, we expect a stop to full PEPP reinvestments in June 2024, and mandatory reserves moving to 2-3% after the operational framework review is finalised in spring.

Rates implications

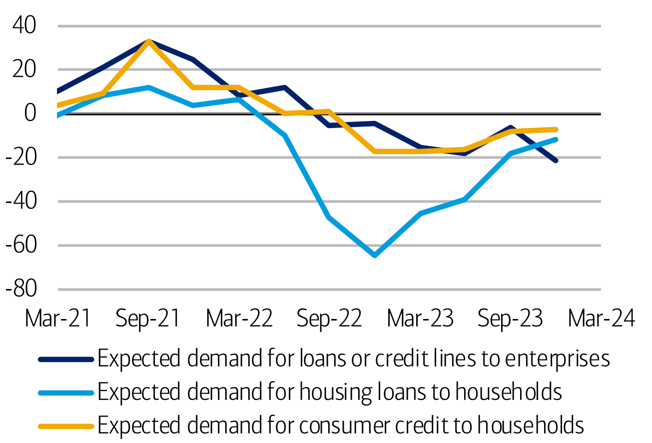
President Lagarde's opening remarks in her press conference were on weak economic activity, more expensive funding for banks, and weak credit demand from the central bank's latest bank lending survey (Exhibit 1). The market's reaction was to price in a lower neutral rate of c. 5bp, and it now implies a terminal rate much closer to the lower end of the recent 2.80%-3.00% range. Yet the market implied neutral rate remains high relative to our economists' and the ECB's estimates. We remain constructive the belly of the EUR rate curve vs the US.

Sovereign spreads supported by PEPP comments and recognition of risks

The ECB confirmed that the early end of PEPP reinvestments was not discussed either, confirming our priors that the ECB would have tried not to rock the boat given the widening in periphery spreads seen so far.

Despite the selloff in both equities and credit globally, 10y BTP-Bund spreads tightened 3-5bp by the time of writing, emphasising the sensitivity of this asset class to the PEPP story. The rates rally following the 3Q US GDP release over the same time provided another leg for tightening.

Exhibit 1: Expected credit/loan demand over next 3 months
Loan demand remains weak



Source: ECB

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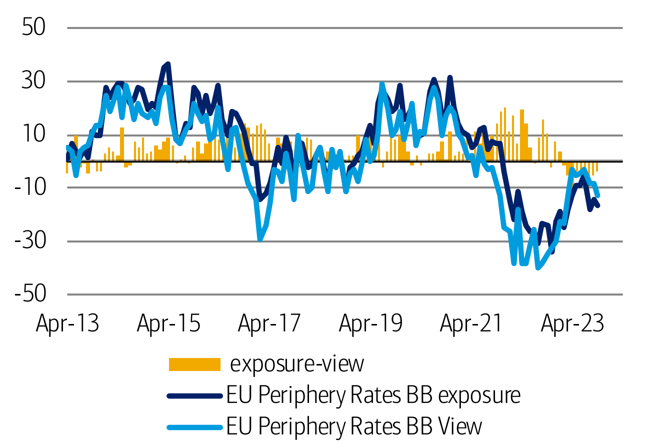
Exhibit 2: Duration exposure and view: Peripheral Europe
Investors turned slightly more bearish periphery



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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GGBs were the outperformer on the day not only because of the sensitivity to PEPP (reinvestments there are worth around 50% redemptions, highest amongst Euro Govies) but also because of the discussions around rating upgrades. Once GGBs enter IG bond indices (perhaps by Q1 next year), the market should see c. €16bn in rebalancing inflows and support further tightening in a market with yearly gross issuance in the order of €10bn (see our: Euro Area Viewpoint: Investor trip to Greece: Key Takeaways 06 October 2023).

All in all, while the information flow does justify EGB spread outperformance, the size of the move relative to the wider market continues to indicate a sizeable short/underweight base there, reducing the bar for a tightening trend once the global rates sell-off stabilises (see [Euro Area Watch: Italy: unstable equilibrium 19 October 2023]) (Exhibit 2).

Risk of noise on minimum reserves remains

As discussed by our economists, a clear signal on minimum reserves was not given by the ECB in its latest meeting. Nevertheless, the risk of further noise on potential changes could prompt the market to price in widening pressure on Euribor-€str spreads and cheaper general collateral (GC) repo vs €str in 2024, as any such change would bring forward the decline in excess liquidity and incentivises banks to adjust their funding mix to reduce their reserve requirement.

EUR: Even more of a non-event that we had expected, but many risks remain

The EUR hardly moved during the ECB press conference today. We had low expectations and considered the meeting to be a placeholder, but it was even worse than that. We were still expecting more details on a number of very interesting issues and challenges that could have affected the EUR at least during the meeting, but we did not even get that.

The ECB message is now clearly that rates will remain high, but not higher, for as long as it takes. Although this is consistent with market pricing, it reaffirmed a similar message the ECB gave in the last meeting. The ECB remains data-dependent and could in theory reconsider after the December forecasts, but data so far do not point to any major revisions.

Of course, substantial risks remain. Geopolitics and oil prices stand as the most obvious, and Lagarde was balanced on the negative risks to growth and positive risks from higher oil prices. Italy is another risk, but Lagarde avoided addressing directly related questions. She also acknowledged spillovers from the rates sell-off in the US and said they were taking it into account but avoided to elaborate further.

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