Liquid Insight

ECB Preview: To slow or not to slow

03 May 2023

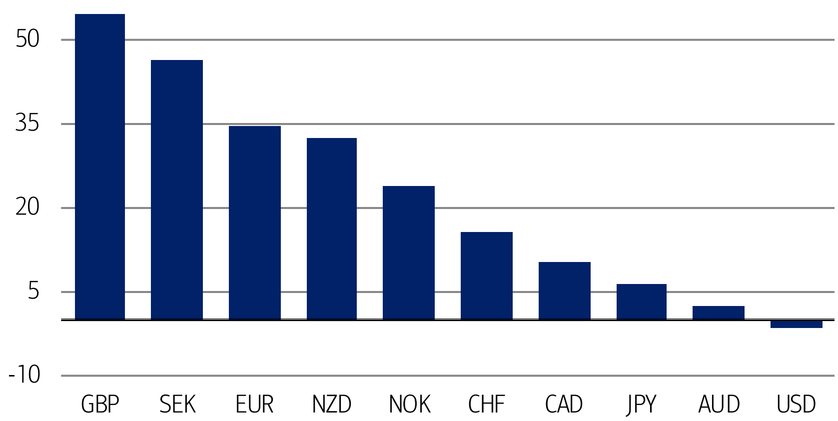
Rates and Currencies Research
Global

Key takeaways

- We expect a 50bp ECB hike, out-of-consensus but very close call, highly dependent on data this week. QT decision in June.
- We see scope for further curve flattening in 2s5s. A 25bp hike could unleash duration demand, but supply would rise.
- EUR impact also depends on communication, which may partly offset decision, but positive balance of risks.

By Ruben Segura-Cayuela, Athanasios Vamvakidis, Sphia Salim, Alessandro Infelise Zhou, Erjon Satko

Exhibit 1: G10 Inflation surprise compared with the consensus
Eurozone inflation surprise remains one of the highest in G10



Source: Bloomberg, BofA Global Research

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A very close call for 50bp hike

We have argued that core inflation in line or stronger than our expectations and no bad surprises on lending would be consistent with a 50bp ECB hike. Given data this week, we stick to that call, but with low conviction. Strategic considerations could lead to a 25bp hike still. We believe the ECB is still likely to avoid giving forward guidance and to insist on data-dependence, mainly focusing on core inflation. A decision on QT is more likely in June (3Q acceleration to €20bn). On new TLTRO, we doubt the ECB is ready, but if there are evident funding pressures down the line, some new operations could be designed. We see scope for further curve flattening in 2s5s. A 25bp hike could unleash duration demand, but supply is set to rise. EUR impact will depend on communication, which may partly offset the decision, but the balance of risks is positive for the EUR in our view.

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50bp it is, conviction low

Core inflation came in at 5.6% yoy, down only a few basis points from the record-high March print. This is in line with consensus but above our expectations of a decline to 5.4%, and, in our view, not significant enough for the ECB to argue that the peak in core inflation is behind us. In addition, lending standards and flows did not deteriorate beyond what might be expected given macroeconomic fundamentals.

Hence, on the margin, we still expect the ECB to deliver a 50bp hike this week. This should come with an emphasis on data-dependence, an indication that there is still ground to cover, and a clear signal, again, on the need for 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 three additional hikes of 25bp.

Risk of a 25bp, for strategic reasons

The ECB may still decide to hike rates by 25bp this week. There are strategic considerations for slowing down now, as we have remarked before: while there may be stronger conviction on a clear move lower in core 5-6 months down the line, there is much 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.

While we still expect a 50bp move this week, it is a very close call. Even in cases where those data points clearly favour 50bp or 25bp, those strategic considerations can end up playing a role.

Beyond the size of the hike, we would expect the ECB to signal that as long as the baseline scenario from the March set of forecasts persists (i.e. doesn't get worse), there is still some ground to cover. And this seems to be the case so far, with activity data surprising on the upside relative to ECB forecasts and likely something similar in the case of core inflation. Of course, if the news from lending standards and flows were to be very negative, that could push them into changing this message.

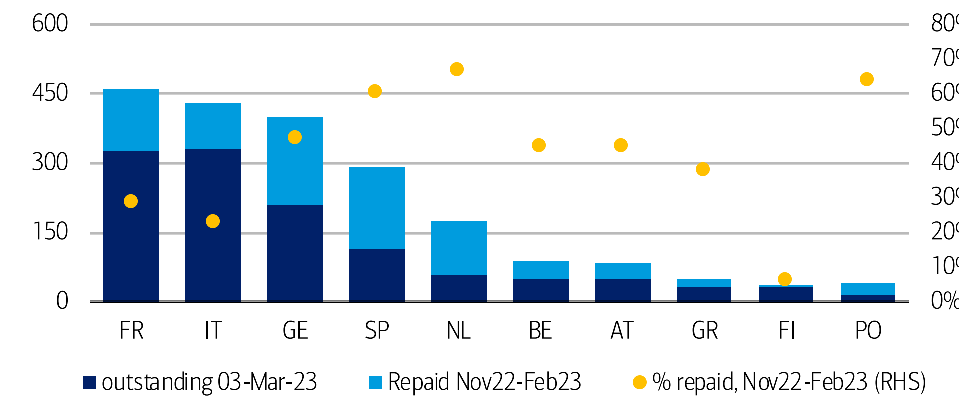
The ECB will likely continue to avoid giving forward guidance, and insist on data-dependence and the need to look at the three ingredients described in March: the inflation outlook (forecasts), the dynamics of underlying inflation, and the strength of monetary policy transmission. As we have argued before, our perception is still that core inflation has a predominant role in these three conditions. We would also expect a clear signal, again, on the need for a sustained move lower in core inflation for them to pause in the hiking cycle.

QT acceleration: too early for a decision. Watch TLTRO repayment readiness

We don't expect news on quantitative tightening (QT) yet. Given recent developments, we think it makes sense to wait for a few more weeks, to assess the extent to which banks are well prepared for the c.€475bn of TLTRO repayment at the end of June. This Wednesday, we will get a new release of the ECB disaggregated balance sheet, which will provide us with the breakdown of banks' TLTRO holdings by country as of end of March (i.e. post the latest €120bn TLTRO repayments). The breakdown as of early March is presented in Exhibit 2. It indicates that, while Euro-area banks had repaid 42% of their TLTROs since November last year, the Italian and French ones had only repaid c.24-29%.

To decide on full APP run-off now, we think the ECB would need some comfort about funding conditions. If they are not convinced, they would need to almost pre-announce a bridge measure as soon as this week. We don't think they are ready for that. Instead, we would expect them to be reactive on the provision of liquidity. If there are funding pressures down the line, new operations could be designed. Otherwise, there is probably no desire to create them until the conclusion of the framework review.

Exhibit 2: ECB LTRO borrowing by banking system
Euro-area banks repaid 42% of borrowings, but FR & IT banks paid < 30%



Source: ECB

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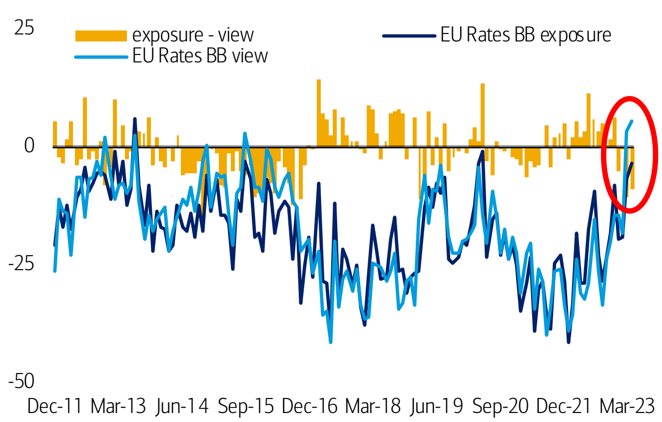
Assuming no deterioration in bank funding stress and continued resilience in periphery spreads, we now believe the ECB will announce an acceleration of APP QT to €20bn/m for 3Q at its June meeting, with likely a run-off of €25bn (roughly full QT) by 4Q. We can't rule out a "preserving favourable conditions" dynamic either, where decisions on the QT pace are taken with more flexibility, every six weeks.

50bp -> bear flattening; 25bp -> duration demand

We would expect a 50bp hike to translate into a higher terminal rate and put bear flattening pressure on the 2s5s curve (see scenario tables in the report Global Rates Weekly 14-Apr). On the other hand, because a 25bp hike would mark another slowdown in the pace of tightening, it has the potential to unleash some duration buying from investors who have had a bullish view on fixed income but have so far limited their investments (with a still underweight positioning), waiting for more clarity on the path ahead (see gap between record bullish views on core EUR duration and still underweight, albeit also stretched, positioning – Exhibit 3).

The question then will be whether this duration buying can offset the increased duration risk delivered via EGB issuance in May (Exhibit 4 shows that supply pressures will rise vs Mar-Apr). If that is the case, then this should drive a bull flattening of the Bund curve (especially if the very front of the curve doesn't richen much more on asset swap).

Exhibit 3: EUR core duration: bull/bear exposure and view
Duration views are record bullish. Positioning stretched but still underweight



Source: BofA Global Research, April FX and Rates Sentiment Survey BB: is the Bull-Bear Index. It weights responses to create an index ranging from -100 to + 100, zero representing neutral

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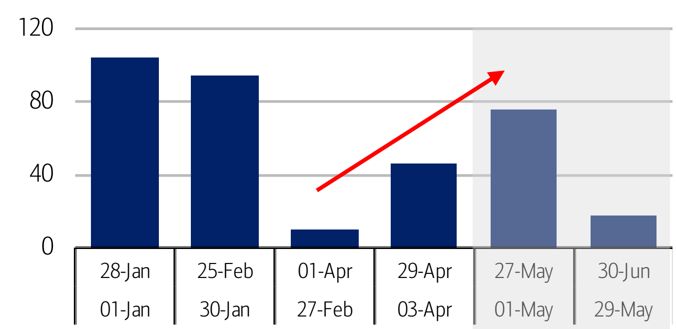
Exhibit 4: 2023 Euro Govie Net Flows (monthly, DV01 EURmn)
May should see a sizeable increase in supply pressures to private investors



Source: BofA Global Research own calculations and ECB. We aggregate the maximum likely gross reinvestment profile of private investors and ECB into/out of EGBs. We include reinvestments of coupon flows, bond repayments, QE/QT dynamics as well as private month-end bond index rebalancing. We look at data at a daily frequency and transform flow in DV01-equivalent terms (depending on assumed duration of assets benefitting from reinvestment flows). Numbers are expressed in EUR millions. Shaded area indicates a forecast

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EUR: focus on implications for terminal, but we may not get much

As the market is only pricing 28bp for the ECB meeting this week, going for 50bp will be a hawkish surprise. However, communication can be dovish if it signals that the fast pace does not necessarily point to a higher terminal rate—which the market is currently pricing at 3.67%. Similarly, although a 25bp hike would confirm market expectations, hawkish communication that hikes would continue for as long as it takes to bring core inflation sufficiently down could be hawkish. In both cases, the ECB may partly offset its decision with its communication, arguing that the decision does not necessarily signal something for policies ahead. The ECB will avoid giving any forward guidance and will remain dependent on data, as we argued above.

For the meeting to have a strong and sustained impact on the EUR, the ECB would have to use this week's hike to signal what comes next, which we do not expect. If the ECB hikes by 25bp and also signals that they are approaching the end of the hiking cycle, then we would expect the EUR to weaken. At the other extreme, a 50bp hike pointing to a higher terminal would strengthen the EUR. Anything between could have mixed implications, but we would argue that the balance of risks is still positive for the EUR, given the bullish consensus, searching for more opportunities to buy the EUR despite an already long position.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 – Year Ahead 2023: Pivot ≠ Peak**, 20 Nov 2022
- A year of many narratives, **Global FX Weekly**, 28 Apr 2023
- Are we there yet**, Global Rates Weekly**, 28 Apr 2023
- EURUSD & NZD selling, mixed JPY & NOK, **Liquid Cross Border Flows**, 24 Apr 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: A year of many narratives 28 April 2023

Global Rates Weekly: Are we there yet? 28 April 2023

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