Euro Area Watch

ECB Review: See you in September

27 July 2023

Macro
Europe

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25bp, no guidance, and a lot of emphasis on data

The ECB hiked all three rates by 25bp, gave very little guidance for September, and placed a lot of emphasis on data dependence and the new forecasts in September. This was a good meeting. But it was not easy. In a way, they only needed to emulate what the Fed did the day before. But the important difference here is that the ECB had to change the statement to get to the same place as the Fed. This was a risk that was resolved as well.

True, the market took some of Lagarde's comments as dovish. She was asked about the burden of proof to hike in September. She argued she wasn't ready to say whether there was more ground to cover (our take on her "I wouldn't say so" comment is that at this point she wouldn't say whether there is more ground to cover). We still think it's a close call for September. Forecasts will move to target by 2025E absent any major news from now until then.

Whether they hike or not is still very dependent on where core is by that meeting and, given that we are below consensus (and below ECB forecasts), our base case remains that the rate hikes this week are the last in this hiking cycle. If anything, the more dovish take on the data and the transmission of policy, together with slightly higher conviction in our below-consensus core inflation call, suggest to us that a pause in September is a bit more likely than a few days ago.

Small but important changes

Changes to the statement were quite close to our expectations. Rather than rates "will be brought" we now have "rates will be set". During the press conference "there is more ground to cover" was replaced by "data will tell us whether there is more ground to cover". Smooth and flexible enough to allow for any outcome.

We were expecting some signal that the burden of proof would fall on the data and forecasts improving to not hike in September. Lagarde had many chances to do so and still she refuses. This is extreme data dependence, at least on paper. ECB sources will tell us eventually where the balance is as of today. But even if there is not an explicit burden of proof there is an implicit one, on forecasts. With medium-term inflation above target by 2025 that needs to improve certainly for the ECB not to hike. That is the first key necessary condition. Still, we think that bar is set low. and we work on the assumption this will be the case given the evolution of external demand, activity data, and the nominal effective exchange rate since the June meeting.

The second necessary condition is for core to convincingly have dropped by then, which, for a while, we have taken as core being below 5% by the September ECB meeting. And that is where the biggest uncertainty is.

Refer to important disclosures on page 4 to 6.
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Taxing the banks

The ECB decided to adjust the remuneration of minimum reserves. We think this will have little impact on the transmission of monetary policy. The way we read it is that this is the central bank version of an inheritance tax, which you collect without distorting incentives. But it certainly creates doubts about many other aspects of the balance sheet that could come back and damage the transmission down the line.

No word on cuts

There was no mention (or pushback) on market pricing of cuts. This will be increasingly challenging. The market is still keen on pricing quick cuts anytime there is a sequence of dovish data prints. Down the line, some guidance will be needed if they want to anchor that part of policy expectations, if they want to make “higher for longer” resilient. But some conviction on being at terminal is probably needed before moving there.

Rates: ECB meeting: 3 reasons behind the bullish interpretation

The ECB statement and press conference resulted in a rally in European govt bonds, with curves bull steepening (2y, 5y and 10y yields down 8bp, 7bp and 4bp respectively).

We had expected a rally during the press conference under the premise that President Lagarde would cover the evolution of the medium-term outlook (weaker demand and stronger exchange rate), underlying inflation (declining as the ECB expected it to) and the state of the transmission of monetary policy (still strong).

Lagarde did indeed touch on all those points, but we also noted three elements of language (or lack-therefor) which supported bond prices:

1. Comments on the “ground to cover”: While in previous meetings, Lagarde had consistently mentioned that the ECB had more ground to cover in terms of policy tightening, this time, she fully embraced the data dependency mode. This is inline with our expectation, but the specific quote: “Do we have more ground to cover? At this time, I wouldn't say so” could be interpreted as a challenge to market pricing of a terminal Depo rate close to 4%. Overall, pricing for peak €str corrected around 3.5bp lower, to 3.82% (implying peak ECB Depo of around 3.92%).

2. No explicit pushback on market pricing of cuts in 2024: The ECB’s statement notes that “key ECB interest rates will be set at sufficiently restrictive levels *for as long as necessary* to achieve a timely return of inflation to the 2% medium-term target”. However, in the press conference, Lagarde did not go out of her way to push back against market pricing of cuts in 2024 (a total of c.70-75bp). In fact, she made no reference to 2024 and was only explicit in ruling out cuts at the Sep meeting, The market is now pricing a full cut by the June 2024 meeting (vs July previously).

3. Stance on QT: Lagarde was asked whether there could be a trade-off between rate hikes and QT, with an acceleration of QT being contemplated as a potential alternative to rate hikes. She dismissed this, stating that rate hikes remain the primary tool to deliver on the inflation mandate, and that there is not trade-off between the two tools. This is an additional marginal support for bonds, given some investors may have been underweight bonds in anticipation of a QT acceleration later this year.

That said, we still believe that the rally in the very front-end of the curve may be counteracted later today or in coming days by ECB sources, looking to prevent the market from pricing in early rate cuts, given the easing that it represents for financial conditions. We continue to think that the belly of the curve will be the most volatile, inline with recent price action. The data dependence of the ECB is likely to be most felt in that part of the curve, especially as supply could amplify the effect of any upside surprises in the hard data.

A technical change, because we can

The ECB adjusted the remuneration rate on minimum reserves to 0%. At the latest Depo rate, banks would receive c. €6bn less on these minimum reserves than before the change. As minimum reserves are required, we do not believe this will lead to a search for yield by banks in short-dated assets.

The remuneration rate change may give banks an incentive to reduce their minimum reserve requirements by 1) reducing deposit and debt issued with maturity less than 2 years; 2) increasing fixed term deposits, repo, and debt securities issued with maturity over 2 years; and 3) making use of standardised deductions by shifting more of their liabilities to debt securities issued with maturity up to 2 years and money market paper.

Given the declining excess liquidity environment from QT and TLTRO roll off, we believe banks are unlikely to have a strong incentive to reduce their liabilities outright. Rather, any changes taken to reduce the minimum reserve requirements are more likely to result in a marginal shift of their funding mix towards liabilities with maturity greater than 2 years, as well as more issuance of debt securities and money market paper.

No change was announced with respect to government and foreign central bank deposits, but this gives a sense of what the ECB is thinking about I.e. reducing costs when it comes to the remuneration of its liabilities. A change in the remuneration on min reserves was never a pre-requisite for government deposit remuneration change.

FX: EUR lower, but data more important

The EUR ended lower after the ECB meeting today. The market took the ECB emphasis on data dependence for the September meeting as dovish. This should have not been such a surprise in our view, but the market has been pricing a high probability of another hike. The market may have also taken the change in the renumeration of minimum reserves to 0% as partly offsetting the hike, although we do not believe this was the intention, or the case. Most of the EUR weakness during the press conference was most likely because of the very strong US data released as the event started.

Still the market is pricing a much higher probability of an ECB hike (70%) than a Fed hike (23%) in September, which we don't see as consistent with the very similar message of data dependency both central banks delivered this week. This can change depending on the data in the next two months, starting with the regional Eurozone CPI data tomorrow and the Eurozone CPI next week.

We also note that both Lagarde and Powell emphasized in their press conferences this week their strong commitment to the 2% inflation target, while the market seems to assume more flexibility. The extent to which the two central banks will stick to their commitment if inflation get stickier on the way down will increasingly become the key driver for FX markets in the months ahead in our view.

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