Liquid Insight

ECB Preview: Not yet, but soon

04 March 2024

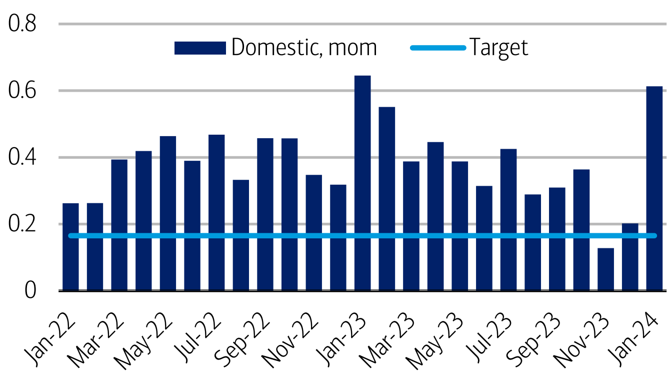
Rates and Currencies Research
Global

Key takeaways

- We expect unchanged ECB guidance in the press release, but soft guidance cuts coming very soon at the press conference.
- Confidence the missing ingredient, data will be crucial. We stick to our call that cuts are likely to start in June.
- We are received 2y1y €str. We don't expect a sustained impact on EUR from the ECB meeting.

By Ruben Segura-Cayuela, Evelyn Herrmann, Sphia Salim, Athanasios Vamvakidis, Michalis Rousakis

Exhibit 1: Euro area, domestic inflation, mom%
The January print gives a reason to wait



Source: Eurostat, BofA Global Research

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Almost there

We expect unchanged ECB guidance in the press release this week, but soft guidance that cuts are coming very soon at the press conference. ECB forecasts are likely to show 2.0% core in late 2026. Confidence likely to be the missing ingredient; the next few months' data will be crucial. We stick to our call that cuts are likely to start in June. We are received 2y1y €str. We would not expect a sustained impact on EUR from the ECB meeting and believe that US data, the Fed, and overall risk sentiment matter more for EURUSD; we would expect the ECB impact to be greater in the crosses.

Global Rates & Currencies Research
MLI (UK)

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

Evelyn Herrmann
Europe Economist
BofASE (France)
evelyn.herrmann@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 20 7995 0279
athanasios.vamvakidis@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
michalis.rousakis@bofa.com

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
adarsh.sinha@bofa.com

Janice Xue
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
janice.xue@bofa.com

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Not yet ready to firmly pre-commit

We expect unchanged guidance from the ECB in the press release. Soft guidance during the press conference that we are almost there when it comes to ECB cuts is likely though. This could come in the form of a suggestion that, as long as wages and underlying inflation near-term confirm expectations, the conditions will be there to start a cutting cycle. If something along on those lines were to be included in the press release, it would send a stronger signal, but it's not our base case. We would also expect Lagarde to acknowledge they have started to discuss the right conditions for the beginning of the cutting cycle.

A few weeks ago we were contemplating – on the back of forecasts that would likely show the job is pretty much done – a strong signal in the March meeting that a cutting cycle could start in the following two meetings. We were even slightly open to an April cut after Banque de France's Villeroy's interview in Les Echos. We still think the signal from forecasts will be there, but recent data printing hawkish on the margin has probably reduced the likelihood that the Governing Council is ready to move partially away from data dependence to some sort of date dependence. The need for more confidence is a key theme across central banks these days, and the ECB is no exception. We don't think the ECB is ready yet to confidently signal that a cutting cycle is about to start.

We think it's too early to get details on the operational framework review, but we could get news on an announcement coming soon. In line with recent reports, we would expect the ECB to move to a demand-driven framework, with a narrower corridor, a new lending facility with, hopefully, longer maturity than one week, and a small structural portfolio of assets. We work on the assumption of no changes to minimum reserve requirements (MRR), but small (one-off) changes can´t be ruled out.

A few reasons to be cautious

Details of the January inflation print, growing signs of an accelerating economy, and the first signals from wages for 1Q probably do not create a sense of urgency for the ECB to cut before June. We would add that some of the data probably even created more resistance to signal anything too firm this week. This is particularly the case for domestic inflation. Even in sequential terms, the January print is likely to cause some additional caution (Exhibit 1).

We still expect the first (25bp) cut from the ECB in June this year. We have 75bp of cuts in 2024E and 125bp in 2025E (one per quarter in 2024, accelerating to one per meeting in December). By June, we expect data to sufficiently comfort the ECB that disinflation has legs. Data will eventually push the ECB to speed up the cutting cycle by more than they currently expect. Hence, our call for the ECB depo to be at 2% by mid-2025. We have been flagging the risk of earlier acceleration of the cutting cycle than we expect now (by September), but that implies at most 100bp of cuts in 2024 and a lot more than is priced in for 2025.

April or June?

While our base case is June, we would not expect any clear pushback from ECB President Lagarde on an April cut. Rather, we would expect her to reiterate what she said in the last ECB meeting, emphasising data dependence rather than date dependence. We would not be surprised if she stands by her words in Davos earlier this year when asked about the timing of cuts, without providing specifics.

In our view, absent any major surprises on the very little data we (and they) will have between the March and April meetings, we doubt they can build consensus for an April cut if they are not ready to provide firmer guidance this week.

ECB projections: the price of confidence

In December, the ECB surprised with a very hawkish set of inflation forecasts, with core inflation, in particular, still at 2.1% on average in 2026E. Three months later, it will be tough to avoid cuts to the whole inflation trajectory, given the almost 10% decline in the (weighted) average of gas and oil prices over the forecast horizon. The ECB's own sensitivity analysis in the June 2023 forecast would suggest c 20-30bp of headline inflation at risk in 2024/25 and c 10bp in 2026 via energy prices alone. Food prices should compensate partly, but a mild downward revision even in 2025/26 is likely.

The ramifications for core inflation are not so obvious. Lower headline inflation and looser financing conditions (the 10y government bond yield moved down c 40bp between the forecast cut-off dates) will probably bring better growth forecasts once the 2023/24 winter lull is passed. A cut to 2024 growth by 20-30bp to 0.5-0.6% is likely, followed by upward revisions of 10-20bp per year in 2025/26.

Compensation per employee growth may have ended 2023 a tad weaker than the ECB initially expected, but paired with weaker growth in the short term, unit labour cost pressures remain (at least) as expected.

All combined, we expect only marginal changes to core inflation forecasts. The path in 2024-25 might be 10bp lower (at most 20bp), and we think there is a possibility of the ECB adjusting the back-end to the 2026 core inflation forecast by 10bp to 2%. It is unclear if that would be enough to push the 2026 average to 2%, but it strikes us as unlikely that the ECB will forecast an undershoot in this round.

Why not normalise rates when the target is reached in the relevant monetary policy horizon? The argument would be that reaching 2% is still so far off that the option value of waiting for further confirmation of the disinflation process is low.

Exhibit 2: ECB projections – GDP and inflation

Path to target is created, confidence in it is missing

	Dec-23				Mar-24 (exp)			
	2023	2024	2025	2026	2023	2024	2025	2026
Real GDP	0.6	0.8	1.5	1.5	0.5	0.5-0.6	1.6-1.7	1.5-1.6
HICP	5.4	2.7	2.1	1.9	8.4	2.3-2.4	2.0-2.1	1.8-1.9
ex food & energy	5	2.7	2.3	2..1	5	2.6-2.7	2.1-2.2	2.0-2.1

Source: BofA Global Research, ECB staff projections

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Exhibit 3: ECB projections – technical assumptions

Gas and oil prices are on average almost 10% below Dec forecasts

	Dec-23				Mar-24 (exp)			
	2023	2024	2025	2026	2023	2024	2025	2026
Oil (USD/barrel)	84	80.1	76.5	73.6	82.5	79.2	74.8	72.1
Gas (EUR/MWh)	42	47	44	37	41.4	29.4	30.8	28.6
USD/EUR	1.08	1.08	1.08	1.08	1.08	1.08	1.08	1.08
NEER (1999Q1=100)	121.9	123.5	123.5	123.5	122.3	123.1	123.1	123.1

Source: BofA Global Research, ECB staff projections

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Getting there on the new operational framework

A story from an ECB source out last week suggested consensus is slowly building on the new operational framework. A demand-driven framework seems to be the choice, with liquidity operations set, eventually, at market prices within a smaller corridor and, perhaps, a structural bond portfolio. The story lacks details on whether a new liquidity facility would be created and its potential maturity. It also suggests some national central banks are still pushing the idea of a higher minimum reserve requirement.

We don't think the ECB will be ready to unveil such a framework this week: key details are yet to be determined, according to the story, and those won't be easy to settle. We work on the assumption that there will be a new facility, hopefully with a maturity all the way to one year. That would facilitate a smooth transition from the current situation to one in which demand for liquidity for regulatory reasons can be met without heightened uncertainty. We also work on the assumption that the corridor will eventually (not necessarily immediately) be narrowed to 25bp. That would reduce the stigma of such a new facility.

Finally, as we have been flagging, changes to the MRR, if any (we don't have a strong view), would be likely to be small and one-offs, although we work on the assumption of no change.

Rates: Stay structurally bullish post repricing

ECB pushback and better than expected global data prompted the market to price just c. 85bp of cuts for 2024, from over 160bp back in December. Having closed our tactical bearish positions in the very front-end, we see pricing of 2024 as fair. We can quite conceivably interpret the current market pricing as one that expects the ECB to deliver a first cut in June, a second one in September and assigning some probability to an acceleration in cuts to one per meeting thereafter. This is not our economists' baseline (they pencil in an acceleration of cuts only for December onwards), but it is a risk that they now highlight given the recent inflation prints.

Our conviction is stronger further out the curve, where we reiterate our medium term structural bullish view, expressing the notion that the trough in the ECB's cutting cycle is likely to be much lower than currently priced. We stay received 2y1y €str (current: 2.38%, target: 1.70%, stop at 2.90%). The risk to the trade is upside surprises in Eurozone growth/inflation.

Front-end: eyes on new lending arrangements

ECB sources said the ECB could unveil a demand-driven floor system as soon as 13 March. This would be sooner than previously guided. President Lagarde said in Dec that the operational framework review is likely to be concluded by the end of Spring. If such a framework is comprehensively announced on 13 March, the risk of an unintended sharp rise in bank funding conditions may be reduced to the extent new lending arrangements are effective.

Our base case for the refi-depo corridor to be narrowed from 50bp to 25bp implies the magnitude of potential widening in 3M Euribor-€str could be less than previously thought, as the corridor can be seen as the cap on potential widening (Exhibit 4). But the directionality should still be the same, i.e. wider, as the current spread is still below 25bp and bank reserve demand may exceed supply in at least some euro area banking systems this year. We like ERU4 €str wideners (current: 10bp, target: 20bp, stop: 5bp). Risks are less reserve demand by banks than we expect, slower QT than we expect, and new lending operations introduced at a very low price.

To us, an equally contentious issue relates to maturity. ECB sources said the demand-driven floor system will be facilitated by changes to the rate on the ECB's weekly cash auctions, i.e. the MROs. MROs have a maturity of one-week. While banks get the full benefits from an LCR perspective despite the short maturity, this is not the case from an NSFR perspective. This questions whether MROs would be effective in satiating banks' reserve demand as TLTRO rolls off and QT accelerates, especially if stigma is attached to them. We would not rule out new operations with longer maturities.

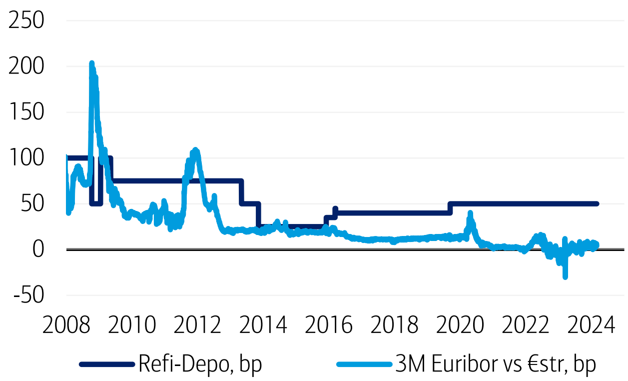
Sovereign spreads: rich/tight but not more than rest of market

The composition of GDP growth in the Euro Area split by country is positive on periphery countries, especially relative to Germany. This, together with the normalisation of inflation has supported the tightening in Euro sovereign spreads to Germany so far. This happened even though January saw over €40bn more supply than expected.

Supply from here remains constructive for risk assets as does macro in our forecasts. Furthermore, if the ECB really does end the operational framework review process earlier than we thought, it would reduce the tail risk for (wider) spreads given the fact that, currently, excess liquidity is particularly concentrated in Germany and France.

That said, risk pricing is already low across asset classes and we remain very sensitive to a potential slowdown in the disinflation process or any further downside risks to growth. Combined with the lower liquidity in secondary market (Exhibit 5) we think there is value in soft-short bias trades like 5s10s BTP ASW steepeners.

Exhibit 4: Refi-depo corridor and 3M Euribor vs €str spread
Narrower corridor can limit scope of widening



Source: BofA Global Research, Bloomberg, ECB
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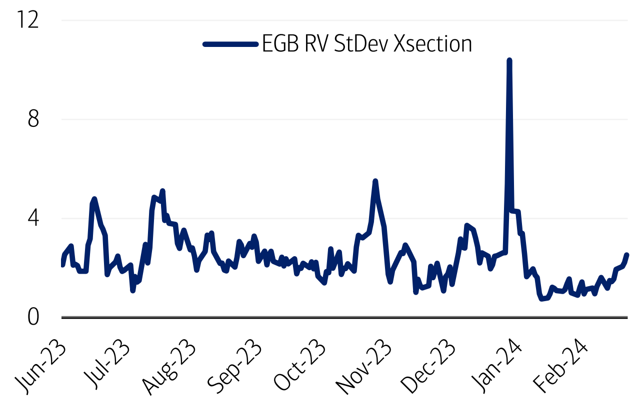
Exhibit 5: Average deviation of 10y EGB spreads from fair value*
EGB spread dislocations in the 10y rose but remain orderly



Source: Bloomberg, own calculations. *fair value defined as value expected from PCA 1-comp.
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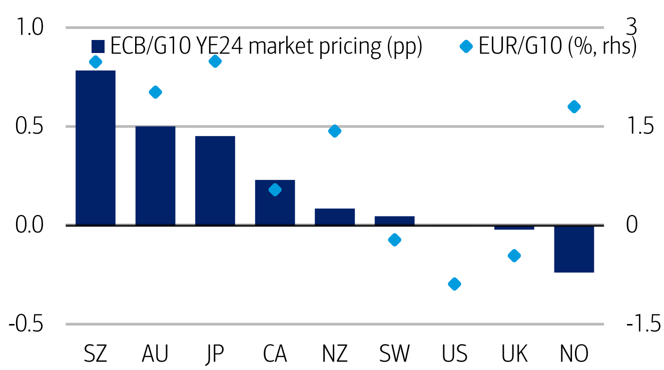
FX: No sustained EUR impact

We would not expect a *sustained* impact on EUR around the ECB meeting. The new ECB forecasts will likely lean slightly dovish, but the market is already pricing almost four cuts for this year, while our economists expect three and no more than four cuts. A slightly bearish risk is the ECB's message around an April cut (6bp in cuts now priced by then), but our economists doubt the ECB will be able to build consensus for it.

We continue to believe that US data, the Fed, and overall risk sentiment matter more for EURUSD: we still forecast EURUSD at 1.15 by end-24 (but 1.07 at end-Q1), driven by a tighter US-EA sequential growth spread and supportive risk sentiment amid Fed cuts.

We would expect the ECB impact to be greater in the crosses, roughly in line with what we have seen this year (Exhibit 6). We expect the relative ECB stance to modestly support the EUR vs. CHF, NZD, and CAD this year, but weigh on it vs. GBP. We also expect EUR to weaken vs. AUD and the Scandies, as we likely gradually move past peak China and Euro area bearishness (Exhibit 7).

Exhibit 6: ECB/G10 change in YE24 market pricing vs price action
We expect the Fed to continue driving EURUSD...



Source: BofA Global Research, Bloomberg. Chart is for the period Jan 5-Feb 29. We show the change in ECB-G10 central banks differential priced by YE 24 and the price action over the same period. Positive values suggest wider ECB differential (left axis) and stronger EUR (right axis)
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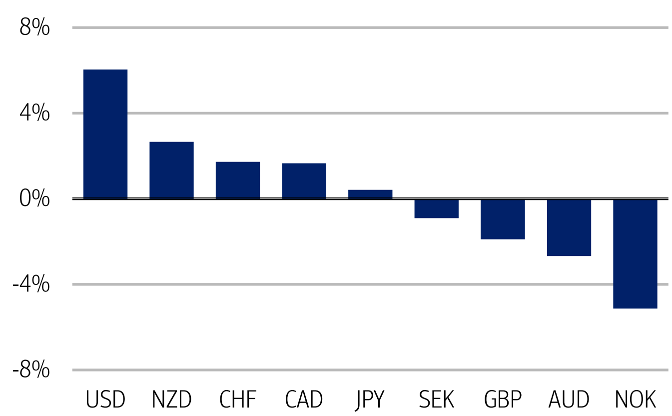
Exhibit 7: EUR/G10 FX by YE 24 – BofA forecasts vs current spot
...but the ECB to matter more in the crosses



Source: BofA Global Research, Bloomberg. Forecasts and spot as of Feb 29.
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Research Analysts

US

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Paul Ciana, CMT
Technical Strategist
BofAS
+1 646 855 6007
paul.ciana@bofa.com

John Shin
FX Strategist
BofAS
+1 646 855 9342
joong.s.shin@bofa.com

Vadim Iaralov
FX Strategist
BofAS
+1 646 855 8732
vadim.iaralov@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Europe

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
+44 20 7995 7331
ralf.preusser@bofa.com

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 020 7995 0279
athanasios.vamvakidis@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Pac Rim

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Shusuke Yamada, CFA
FX/Rates Strategist
BofAS Japan
+81 3 6225 8515
shusuke.yamada@bofa.com