Liquid Insight

ECB Preview: 25bp with little guidance

26 July 2023

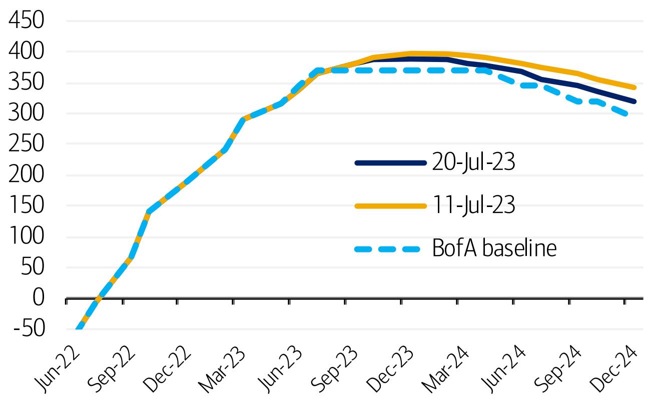
Rates and Currencies Research
Global

Key takeaways

- We expect 25bp hike from ECB this week, fully priced, without much guidance for what comes next, emphasizing data-dependence.
- ECB to leave door open for September, but balanced communication could be challenging.
- Any impact on front-end rates temporary, belly of the curve to move most. Not much EUR impact, which remains data-driven.

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

Exhibit 1: Market implied path for €str, vs BofA baseline
The market is pricing a peak €str rate at 3.9% and first full cut by Jul-24



Source: BofA Global Research

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25bp and open door for September

We expect a 25bp hike on all three rates from the ECB this week, which is already fully priced. We don't expect much guidance, as the outlook has not changed much since June. Some stronger emphasis on higher rates for longer is likely. There could be ground for some optimism, but, with focus still mostly on underlying inflation, the door for a September hike will remain open in our view.

Communication could be challenging for the ECB, but the impact on the front-end may ultimately be temporary. We still expect the belly of the curve to move most. With the market already fully pricing the hike this week and the ECB not willing to commit one way or another for September, we would not expect much impact on the EUR, which remains mostly data-driven.

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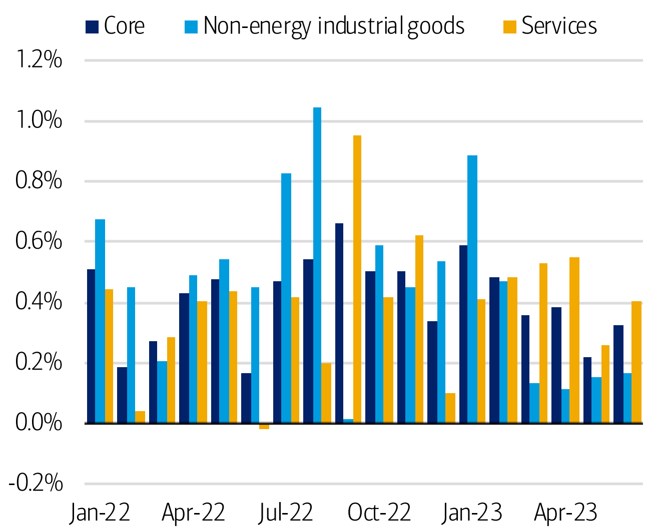
25bp, little guidance, emphasis on data dependence

We expect the ECB to hike all three rates by 25bp this week. This has been widely telegraphed and should not surprise markets—it is fully priced already. The key will be what we learn for the September meeting. With an outlook that has not changed a lot since the June meeting we would not expect clear guidance. If they weren't ready in June, they're not likely to be ready now, given the absence of strong news in either direction. We expect the statement and the press conference to be a placeholder for the new set of forecasts and the evolution of the data until then.

Something along the lines of "decisions will ensure that policy rates are sufficiently restrictive" rather than "will be brought" is probably the right balance and should be reflected in the statement. We expect an even stronger emphasis on higher for longer rates, although we will likely have to wait for clearer guidance on this. And given the June forecasts, we would expect the burden of proof for not hiking in September to fall on the need for the inflation outlook to improve, a softer version of the kind of guidance we saw in March.

As a reminder, we do expect the ECB outlook to improve. Together with the drop in core inflation we anticipate in the next two prints, our base case is for no hike in September, but it remains very close, as reflected by recent communication even from some of the hawks at the ECB. And given our inflation forecasts and a much weaker growth outlook, June 2024 is still a valid call for the first cut.

Exhibit 2: Euro area, month-on-month inflation (SA)
SA mom figures are now half what they were a few months ago



Source: Eurostat, BofA Global Research

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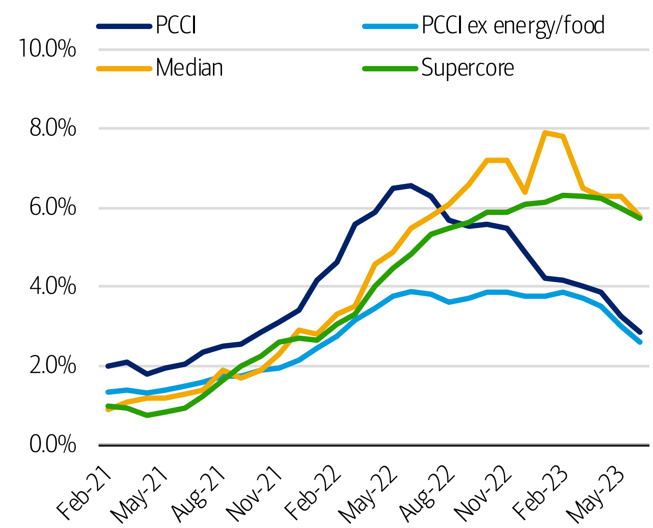
Exhibit 3: Alternative measures of underlying inflation
Alternative measures continue to move in the right direction



Source: ECB. BofA Global Research

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Nothing much has changed

The ECB now focuses on the medium-term outlook, underlying inflation, and the transmission of monetary policy to guide its decisions. We have had little news on those three fronts. The medium-term outlook for growth, at the margin, has probably deteriorated given soft and hard data that seem inconsistent with what the ECB expects near-term in terms of growth (0.3%QoQ). Additionally, the evolution of market variables (particularly the nominal effective exchange rate) is a significant headwind for medium-term growth and inflation.

Weaker demand and a stronger NEER will help bring their 2025 inflation forecast closer to target. But this is precisely why it is important to put in a placeholder for the next meeting and the new set of forecasts, then decide on the next move. On the other hand, the renewed emphasis on wages and, more importantly, unit labour costs, which will feature prominently during the press conference, is a reason to remain worried about the medium-term outlook.

Meanwhile, inflation and underlying inflation, for once, have evolved exactly as the ECB was expecting them to, with headline inflation averaging 6.2% in 2Q23 and core inflation 5.5% the same quarter.

There are grounds for some more optimism when it comes to the three conditions that dictate policy these days. But with a central bank that puts a disproportionate weight on underlying inflation in its decisions, data evolution since the June meeting is unlikely to provide a clear trigger that would overcome the internal disagreement on what to do beyond this week.

A difficult balance

The ECB likely wants to leave the door open for the September meeting, without showing a clear strong bias in either direction. We expect emphasis on data dependence and the new set of forecasts throughout the press conference. At the same time, the ECB probably wants to move slowly away from the emphasis on terminal towards a greater focus on "higher for longer", in line with recent communication.

Changes to the statement won't be easy. We would expect something along the lines of "the Governing Council's future decisions will ensure that the policy rates are sufficiently restrictive to achieve a timely return of inflation to the 2% medium-term target and will be kept at those levels for as long as necessary." Of course, many other configurations are possible, but replacing "will be brought" with "are" we think would leave it open to either staying on hold or hiking again in September. This could be perceived as dovish, perhaps, but the press conference could still allow for a fine-tuning of communication.

With that in mind, we would expect some form of conditional communication like in March 2023. Given the starting point (the June forecasts), we would expect the burden of proof to fall on the need for the inflation outlook to improve. We would expect Lagarde to flag in the press conference that "we may still have some ground to cover if there isn't an improvement in the outlook for inflation in the September forecasts, the evolution of underlying inflation, and the transmission of policy".

Guidance for cuts?

A lot of the emphasis from ECB speakers recently has been on the timing of cuts, with some insisting that the market is likely to end up being too optimistic on this front. We understand there may be an implicit intention by some of the hawks to get the market to price out cuts and do their job for them. Still, trying to micromanage the curve so far out can be a difficult proposition, particularly when there is strong disagreement on the outlook between the ECB and others. As argued above, we expect that emphasis on "higher for longer" to continue in the statement and during the press conference.

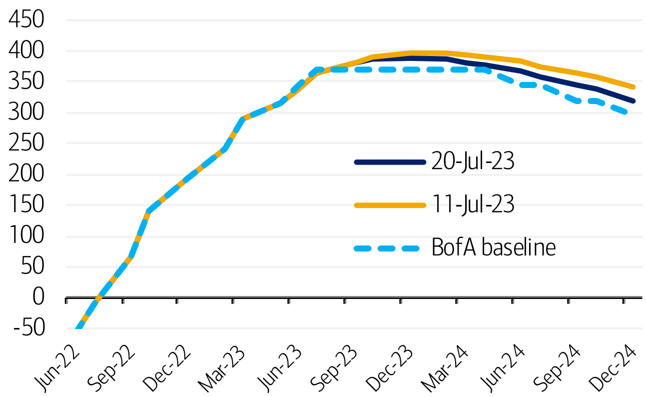
But eventually they will probably need to converge to somewhat more objective guidance if they want to steer the market. We think July and probably even September are too early for that – they need some degree of certainty they are almost done to take this step. But down the line, potentially in December, we would expect some guidance symmetrical to that we got at the beginning of the hiking cycle, "the Governing Council expects the key ECB interest rates to remain at their present or lower levels until it sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and it judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term." Given our inflation forecasts and, likely, this guidance, June 2024 is still a valid call for the first cut.

Rates: Balanced ECB message unlikely to alter pricing

Any front-end rally on a dovish interpretation of Lagarde's comments in the press conference could be counteracted by ECB sources later in the afternoon. The market is pricing 60% probability of another 25bp hike in September, and a first cut by Jul-24 (Exhibit 4). We believe a balanced ECB messaging is unlikely to alter this pricing dramatically, and continue to think that the belly of the curve will be the most volatile, inline with recent price action (Exhibit 5).

Our baseline for ECB rates is unchanged. Ultimately, we expect the ECB's inflation outlook to improve. Together with the drop in core inflation we anticipate in Jul & Aug, our baseline is for no hike in Sep, but it remains a very close call. Our inflation forecasts and a much weaker growth outlook are still consistent with a first cut in June 2024.

Exhibit 4: Market implied path for €str, vs BofA baseline
The market is pricing a peak €str rate at 3.9% and first full cut by Jul-24



Source: BofA Global Research

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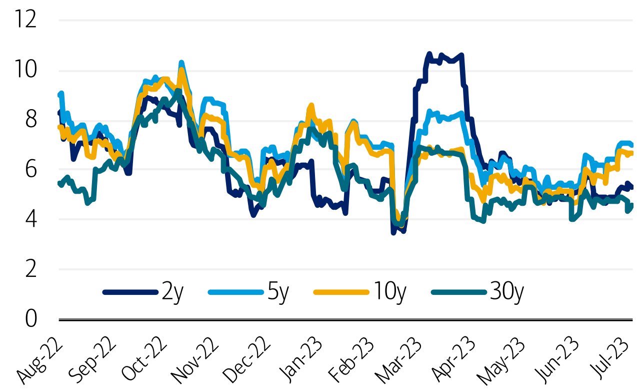
Exhibit 5: 1M delivered volatility (bp/day) across swap tenors
5y and 10y swap rates have recently been more volatile (incl vs 2y & 30y)



Source: Bloomberg, BofA Global Research

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Accelerating QT: not for now, but here are some numbers

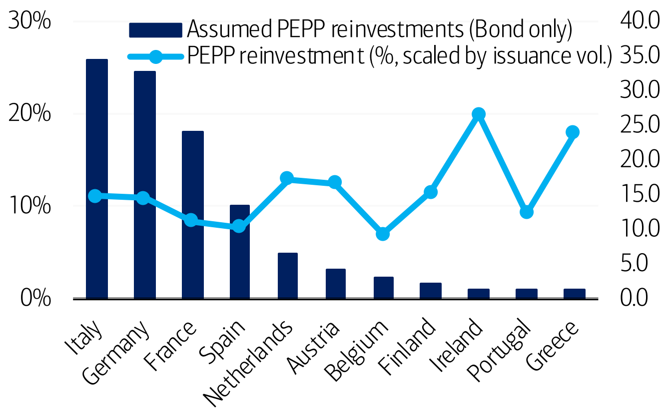
While the more hawkish members of the ECB's governing council may have surprised recently with limited push for more rate hikes, they have continued to voice their desire for a continuation, if not acceleration in QT. One could argue that, even if policy rates may be close to levels deemed "high" by the governing council, the permanence of large QE stocks of (APP+PEPP) may stand out as an unnecessary policy tool, especially if credit/equity valuations remain as "rich" as they currently are.

With APP already being subject to full passive QT (no reinvestments of bond maturities), the ECB could either consider active sales of APP stock or the start of passive QT for PEPP (reneging on the commitment to fully reinvest PEPP maturities until end of 2024).

We estimate that the component of PEPP re-investable from EGB maturities in 2024 amounts to c. €125bn, or 30% of this year's net issuance (before accounting for ECB flows, buybacks or coupon reinvestments). Given the feature of reinvestment flexibility, skewing reinvestments towards the periphery at the expense of core if/when spreads widen, a rollback of PEPP reinvestments would be most detrimental to BTPs and GGBs (Exhibit 6 and Exhibit 7). Beyond the periphery, smaller debt markets like the Irish, Dutch and Austrian may also feel an oversized impact from a drop of PEPP reinvestments.

Exhibit 6: Potential PEPP reinvestment flows in 2024

Italy likely tops the ranking for absolute PEPP reinvestment flows in 2024, GGBs and IRISH that of in % of issuance



Source: ECB, own calculations

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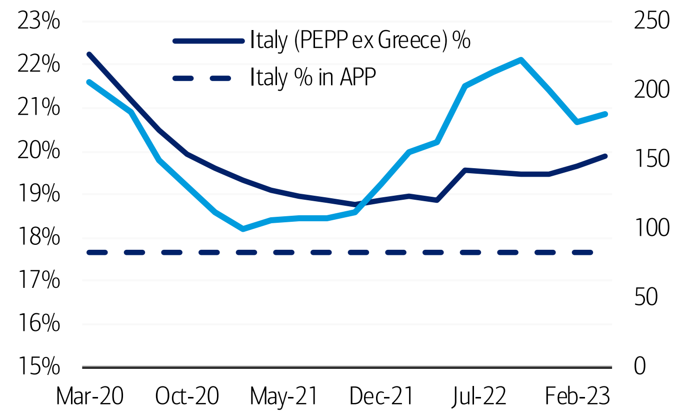
Exhibit 7: Share of PEPP allocated to Italian public debt securities

PEPP net flows into BTPs tend to be positive when the spread widens, and vice versa



Source: ECB, own calculations

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FX: The ECB is not the driver

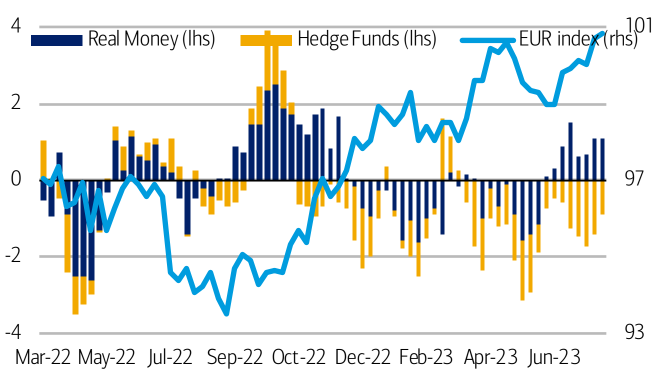
The last time the ECB affected the EUR was in the December meeting, when the central bank finally got serious about fighting high inflation. Since then, the ECB has been broadly doing what the market is pricing, with mixed communication. We expect something similar this week.

With the market already fully pricing the hike this week and the ECB not willing to commit one way or another for September, we would not expect much impact on the EUR. The ECB is data-dependent, which suggests the EUR is data-driven. Weak Eurozone data, but sticky inflation and stretched labor markets keep the EUR within a range, choppy and somewhat stronger vs. the USD, but weaker against most of the rest of G10 this year.

Recent EUR flows have been mixed. Real money has been buying EUR, but hedge funds have been selling (Exhibit 8). As a result of these flows, real money is long EUR, but hedge funds have just turned short (Exhibit 9)—both started the year long EUR.

Exhibit 8: EUR proprietary 4-week flows (z-score)

Recent EUR flows mixed, with real money buying and hedge funds selling.



Source: BofA Securities, Bloomberg.

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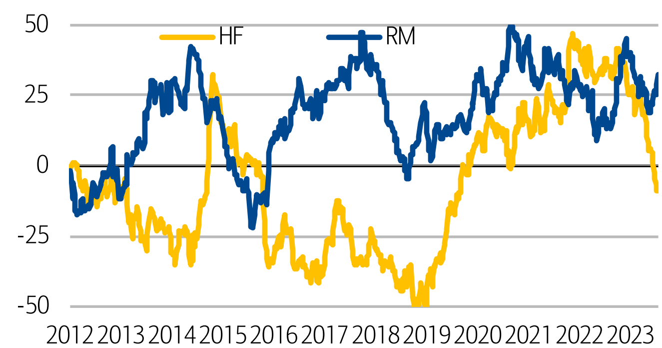
Exhibit 9: Investor EUR positioning

Real money is long EUR, but hedge funds have just turned short



Source: BofA Global Research, BofA Securities. For methodology, please see: Global Rates and FX Primer 26 May 2021

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- From monthly narratives to weekly narratives **Global FX Weekly**, 21 July 2023
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