Liquid Insight

ECB Preview: one more pushback on early market pricing

Key takeaways

- On hold with more pushback on early market cuts. We stick to first cut in June, with risks of faster action thereafter.
- We like payer spreads top left for delayed cuts vs pricing, received 2y1y €str for neutral rate closer to 1% than 2%.
- ECB pushback against market pricing EUR positive, but without sustained impact.

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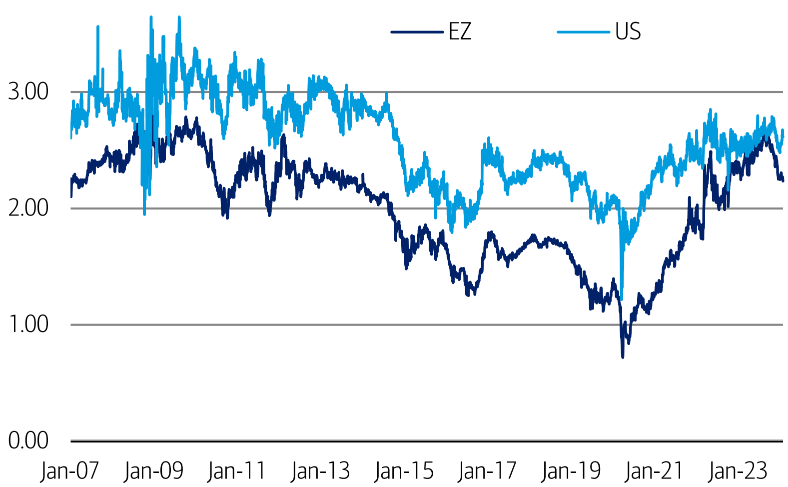
Exhibit 1: 5y5y inflation swap rate
Eurozone inflation expectations have started diverging from that in the US again



Source: Bloomberg, BofA Global Research.

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Wait for the summer

We expect no changes to policy or communication, but additional pushback on early market pricing for cuts from the ECB this week. The ECB regards current market pricing as a risk to inflation converging to target. Wage and profit developments are key inputs for the next move. We stick to our call of a first cut in June but see a risk of faster action thereafter, depending on disinflation. We like payer spreads in the top left to position for delayed cuts vs market pricing, received 2y1y €str to express our view that neutral rate is closer to 1% than 2%. ECB pushback against market early cuts should be EUR positive but is not new and we would not expect a sustained impact.

Timestamp: 23 January 2024 11:30PM EST

24 January 2024

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The beginning of the path to cuts

We expect no policy changes from the ECB this week. Nor do we expect changes to communication, but we do anticipate additional pushback on market pricing. With the outlook not differing much from the one published in forecasts, we would expect this week's meeting to be a repeat of December's. Pushback on market pricing is likely to be strong, with Lagarde indicating that the early and fast cuts priced by the market are not necessarily consistent with inflation going back to target. As a way of reinforcing the pushback, we would expect Lagarde to reiterate her line at Davos that we are at the peak for rates and that cuts around the summer could make sense.

Recent communication from the ECB has been clear. Market pricing is a risk to inflation converging to target, according to most speakers. Wage and profit developments all the way to May are key inputs to be reassured inflation will move back to target. The bar for cuts before then remains very high. We believe that there is a bigger risk of faster cuts post-June than earlier cuts at this stage.

We expect the first cut from the ECB in June, quarterly cuts thereafter for 2024E, and one per meeting in 2025E until the depo is back at 2%. We then expect a pause, with more cuts in 2026E.

January inflation prints will be important for this. The usual menu-cost adjustments will determine how persistent core inflation will be throughout 2024 and therefore be an important input for the speed of the cutting cycle in 2H24. We could easily see the accelerated cutting cycle beginning in September 2024 if ECB staff forecasts were to show some persistent (modest) inflation undershoot.

Unchanged outlook, unchanged communication

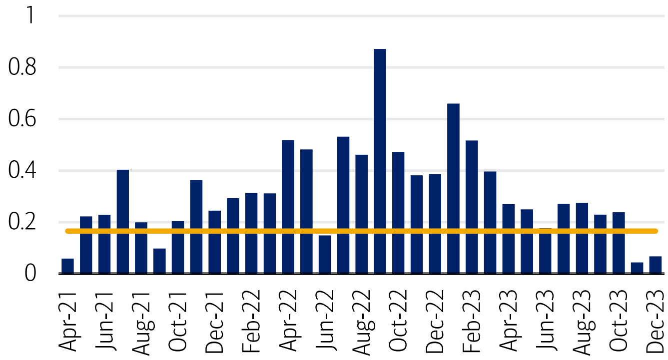
We had argued in the review of the ECB's December meeting that, while growth forecasts were too optimistic and inflation (particularly core) was coming down too slowly, this was not the case for the immediate future. Indeed, growth has behaved broadly in line with what they (and we) expected. The ECB has intensified the disinflation trajectory in its quarterly core inflation forecast compared with the September profile, in the near term, but then assumes inflation will move sideways in 2H24. Unsurprisingly, ECB speakers have acknowledged that inflation in December has not surprised them much.

Communication has barely changed too. Back in December Lagarde pointed to the move in market pricing since the forecast cut-off date, implying that pricing today is not necessarily consistent with inflation going back to target. We have had several more explicit statements since then, including from Lagarde. Some ECB speakers have even argued that market pricing is making the ECB's job more difficult and that aggressive market moves risk delaying action from the central bank. We see Lagarde's reference to the summer as a potential timing for cuts as a way of giving more (soft) calendar-dependent forward guidance, given that so far other forms of pushbacks have not been successful. We would hence expect a reinforced pushback to take centre-stage at the press conference this week, including calendar dependent forward guidance.

Slim chance of earlier cuts without surprises

With conservative forecasts in the near term, absent major surprises in either growth or inflation, we would expect the ECB to remain reactive and wait patiently for confirmation from wages and profit margins that inflation will be heading to 2% by 2025. That would put the focus on the June meeting, eventually. And this is despite stronger evidence that the job is almost done on inflation looking at current seasonally adjusted mom rates for core inflation (Exhibit 2) or momentum measures (Exhibit 3).

Exhibit 2: Core inflation, mom% bottom-up seasonally adjusted
Monthly SA rate suggests job on inflation is almost done



Source: BofA Global Research, Eurostat

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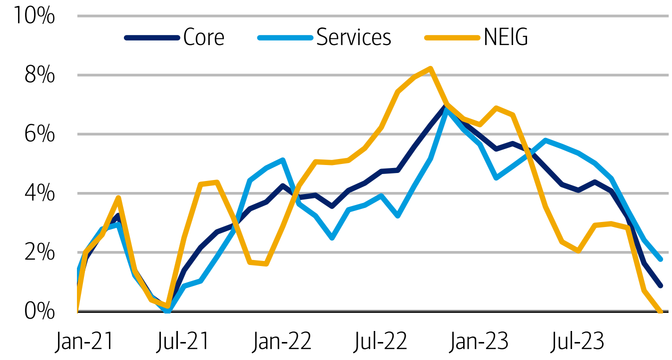
Exhibit 3: Inflation momentum
Clear downward momentum in inflation



Source: BofA Global Research, Eurostat

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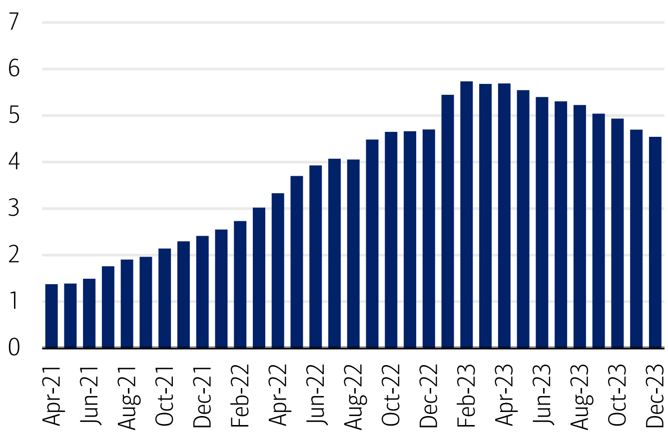
To us, the latest developments and comments reflect a still reactive and backward-looking central bank. The latest line of reasoning that puts the focus on wages is that progress on domestic inflation and non-contact intensive services inflation is slow, i.e. that inflation is quite sticky. Hence, the need to wait for confirmation that wages are well behaved. Wages are usually the last variable to adjust and provide a backward-looking view of inflationary forces. Negotiated wages lag inflation by around six months. One could argue that we need to be vigilant about second-round effects and the risk that wages do not just reflect partial compensation from past inflation but react to inflation expectations. That is a hard case to make, though, when expectations continue to move lower.

We would even argue that the focus on domestic and non-contact intensive services inflation will be hard to sustain over time. To show this we replicate the ECB measure of domestic inflation, that is, components that have less than 18% of import content (35% of the basket). The final outcome is clearly dependent on how data is seasonally adjusted – we use our preferred bottom-up approach (i.e. adjusting each component and then aggregating). Results can vary but the qualitative message would be the same. Exhibit 4 shows the yoy rate for our measure of domestic inflation. Yes, the yoy rate remains far from 2%, quite a long way. But this reflects mostly base effects, since the mom data shows a very significant deceleration to rates not far from those consistent with target (Exhibit 5).

Exhibit 4: Euro area, domestic inflation measure, yoy%
Far from target, but mostly due to base effects



Source: BofA Global Research, Eurostat

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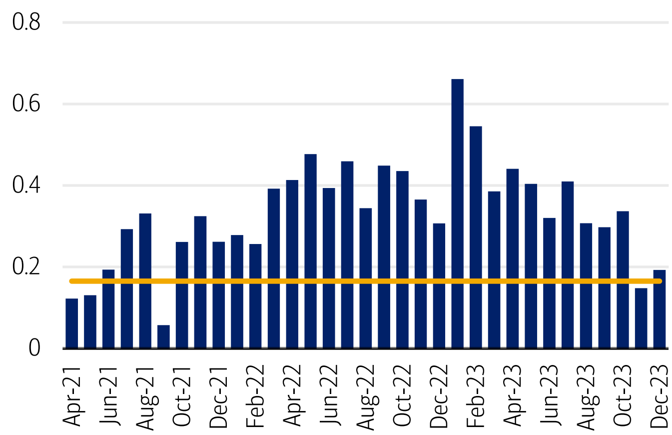
Exhibit 5: Euro area, domestic inflation measure, mom%
Very significant deceleration, now close to target



Source: BofA Global Research, Eurostat

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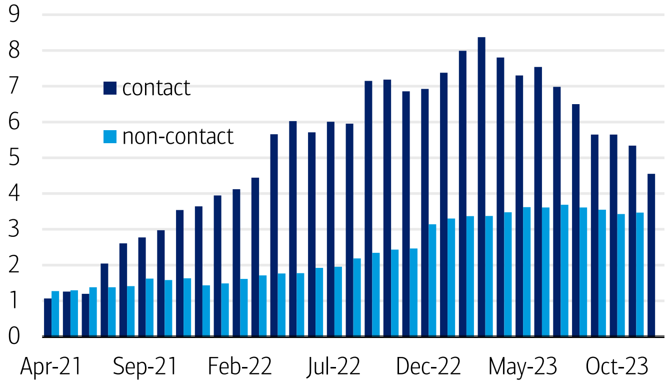
Exhibit 6: Contact vs non-contact services inflation, yoy%
Improvement has been driven by contact services



Source: BofA Global Research, Eurostat. Contact intensive sectors include Transport services, Recreational and cultural services, Package holidays, Restaurants and hotels, Hairdressing salons and personal grooming establishments. Non-contact intensive services include the rest of services.

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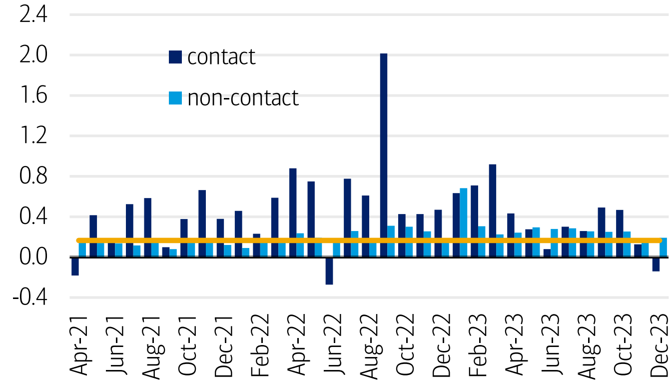
Exhibit 7: Contact vs non-contact services inflation, mom%
But, even in non-contact services, monthly rates have normalized



Source: BofA Global Research, Eurostat. Contact intensive sectors include Transport services, Recreational and cultural services, Package holidays, Restaurants and hotels, Hairdressing salons and personal grooming establishments. Non-contact intensive services include the rest of services.

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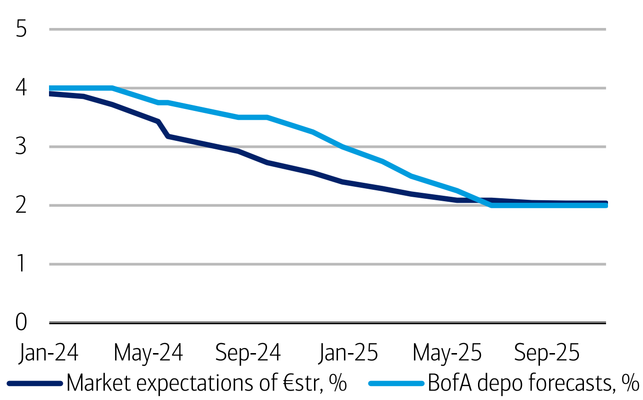
What about non-contact intensive services inflation? The fact that the focus for the beginning of the cutting cycle is shifting to a bit more than 20% of the inflation basket already reveals a very reactive reaction function. And yes, a lot of the improvement in yoy rates for services inflation has been driven by contact intensive services as of late, with non-contact services moving sideways. (See Exhibit 6 for our own measure that tries to replicate the one from the ECB.) But once again, base effects play a large role here, with even non-contact intensive services now showing monthly inflation rates quite close to levels consistent with target (Exhibit 7).

Rates: Position for delayed ECB cuts via payer spreads

Following an aggressive rally into the end of 2023, euro rates partially retraced at the start of 2024 as the ECB pushed back on market pricing. Yet rate cut expectations remain strong. The market is pricing in a cumulative 133bp of cuts by the ECB in 2024, vs our economists' expectations of 75bp, and still a much faster return of the depo rate to 2% (Exhibit 8).

Exhibit 8: Market pricing vs BofA forecasts
Market pricing in a much faster approach 2% than our economists forecast



Source: BofA Global Research, Bloomberg

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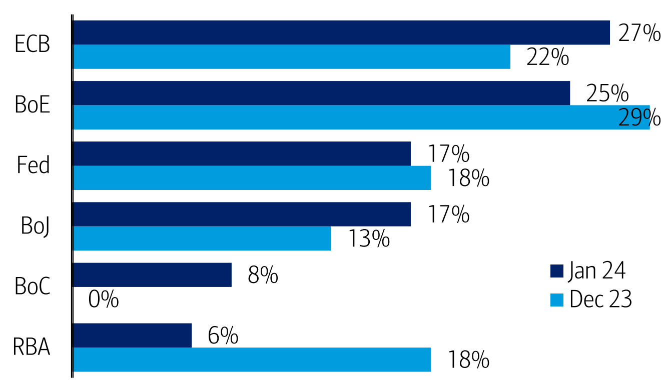
Exhibit 9: Which central bank is most likely to deliver a more dovish outcome by YE 2024 than current market pricing:
ECB seen as most likely to surprise dovishly after the hawkish Dec meeting



Source: BofA Global Research FX and Rates Sentiment Survey

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For the April 2024 meeting, the market still prices in c. 17bp of cuts. We believe this may reflect (1) the market pricing in the possibility of steps of 50bp when the ECB cuts in the summer, which would mechanically lead to some probability of cuts priced for April through interpolation, or (2) the market believes the ECB will need to cut sooner than its latest guidance: the ECB is viewed as the central bank most likely to surprise on the dovish side by the end of 2024 (Exhibit 9).

Near term, we see potential for euro yields to move slightly higher on: (1) ECB pushback on early 1H24 rate cuts, (2) elevated EGB supply in the coming weeks (Exhibit 10), and (3) real money positioning being still long, albeit less so than in early 4Q23.

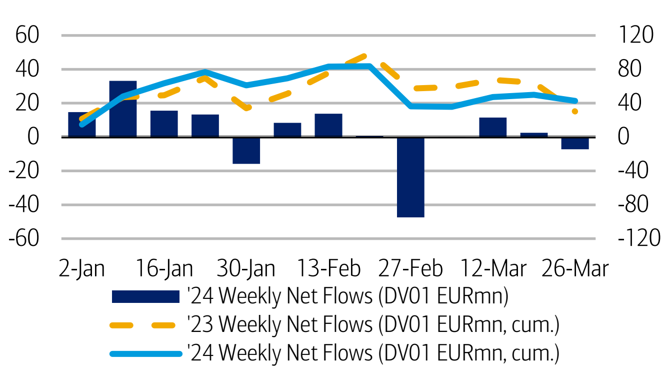
But any downside surprises in the data can accelerate the pricing of rate cuts in 2024. We would not exclude a situation where the market moves to pricing 200bp of cuts in 2024 (i.e. an even more rapid return to the 2% level that the ECB has flagged as potential neutral rate), even without a negative shock materialising. We therefore express our baseline of delayed ECB cuts vs market pricing via payer spreads in the top left (e.g. 3m1y), as these allow for limited downside.

Expect pricing of lower neutral rate medium term

Medium term, we hold a moderately bullish duration view. We continue to believe the ECB will have to cut rates below 2% sometime in 2025-26 as the neutral rate is likely to be closer to 1% than 2%. Increased chances of a de-anchoring of inflation to the downside should help the market recognise this. This process may take time, but there are signs of such change: our FX & Rates Sentiment Survey showed ECB terminal rate expectations moved lower despite the hawkish ECB (Exhibit 11). We believe market pricing for the terminal rate could decline to 1.7% by Dec-24. We are received 2y1y €str as a structural trade to position for this repricing (current: 2.1%, target: 1.7%, stop: 2.9%). Risks are upside data surprises in either Europe or the US.

In bonds, we look for Bund yields to decline to around 2% by 4Q24, assuming some cheapening of bonds vs swaps, especially in the 5-10y and in 2H24 as QT accelerates with start of partial PEPP reinvestments and rates vol decline. We also project a widening in the 10y UST-Bund spread to above 200bp & look for an outperformance of European bonds vs US also in linkers space.

Exhibit 10: Supply net of "systematic" EGB flows (gross ECB flows + private reinvestments & index extensions) - expressed in DV01 terms
Net supply in DV01 terms will remain elevated until mid February



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.

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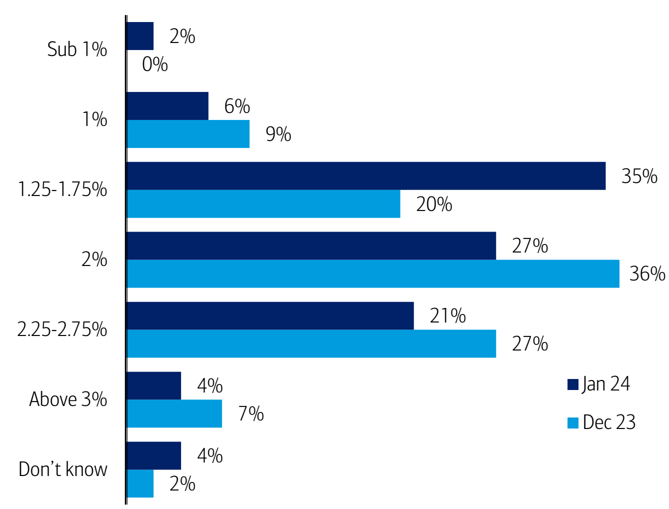
Exhibit 11: I expect the ECB to cut rates to a terminal rate:
ECB terminal rate expectations moved lower



Source: BofA Global Research FX and Rates Sentiment Survey

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FX: EUR positive, but not sustained

We expect no changes to policy or communication, but additional pushback on market pricing for early cuts in the ECB meeting this week. The ECB considers current market pricing of early cuts as a risk to inflation converging to its target. Wage and profit developments are key inputs for the ECB cutting cycle. We stick to our call of a first cut in June but disinflation points to risk of faster policy easing thereafter.

Despite strong ECB pushback, including by various ECB officials in Davos last week, the market continues pricing early and fast cuts. The market is now pricing 17bp for April, although this is much lower than 30bps earlier last week. The market is pricing 133bp of cuts by year-end, compared with our call for 75bp. Despite some adjustment last week, it is still surprising to us why the market is still pricing so much, but it may have more to do with Fed pricing. All ECB speakers so far this year, both hawks and doves, have delivered the same message of later rate cuts and we stick to our view.

If our call turns out to be right for Fed cut in March and ECB cut in June, EURUSD should find some support, keeping everything else constant. However, we believe that the Fed and overall risk sentiment matters more for FX. Even if the Fed starts earlier, if they deliver less cuts than the size that the market is currently pricing, it will be hard for the EUR to sustain a rally in h1, even if by the end of the year EURUSD is higher, as indeed we expect.

We could argue for some positive EUR risks for the meeting this week and the ECB pushback against market pricing. However, this message is not new and markets have so far ignored it. Therefore, we would not expect a sustained EUR impact. We believe that US data, the Fed, energy prices, geopolitics and overall risk sentiment matter more for EURUSD for now than the ECB.

Notable Rates and FX Research

- **Global Macro Year Ahead 2024 -** Hope for the best, prepare for the worst, 19 Nov 2023
- **Global Rates Year Ahead 2024 –** Cloudy with a chance of landing, 19 Nov 2023
- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- Explaining USD resilience, **Liquid Cross Border Flows**, 15 Jan 2024

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: Destination unknown 19 January 2024

Global Rates Weekly: Longs on ice 19 January 2024

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