ECB Preview: hawkish tone but tightening far out

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Important disclosures and certifications are contained from page 17 of this report.
We expect a hawkish tone from the ECB at the meeting in June after it was perceived as slightly dovish at the latest meeting [see ECB review: Less downside risk to growth but no change to inflation, 27 April]. A lot of speculation among market participants has been on whether the ECB will change its forward guidance and remove the ‘or lower levels’ phrase from its guidance on policy rates. However, in our view, sticking to this guidance and instead delivering another hawkish twist to the introductory statement is most likely. We expect the ECB to argue that the options provided for further accommodation are less likely to be used. See more here: ECB Research: Hawkish wording but changed forward guidance less likely, 5 May.

The main argument why the ECB will not change its forward guidance should be that it could result in an unwarranted tightening of financial conditions. According to the ECB, ‘a very substantial degree of monetary accommodation is still needed for underlying inflation pressures to build up’. Added to this, the minutes from the latest ECB meeting confirm that the ECB considers the forward guidance as part of the current policy stance, which should only be changed when there is sufficient evidence of a sustained adjustment in the inflation path.

On the other hand, Mario Draghi has said the ECB’s forward guidance was meant to address tail risk and some tail risks are less and less probable. Along the same lines, the point was made at the latest ECB meeting that it could be acknowledged that recourse to the options for providing further accommodation was becoming less likely. In our view, these arguments should not yet dominate the ECB’s view of a need for a cautious approach regarding the future evolution of its policy communication.
ECB preview: hawkish tone but actual tightening is still far out

1. Hawkish wording but no change to forward guidance yet

2. ECB concludes labour market slack will contain wage dynamics

3. Slightly lower ECB inflation projections with more in store

4. Most likely the ECB does not see a need to address the repo issues

5. EUR/USD – too early for the ECB to allow the next uptick
Forward guidance likely to remain in place:
A lot of focus has been on whether the ECB will change its forward guidance at the June meeting. However, in our view, it will take a more cautious approach in order to avoid an unwarranted tightening of the financial conditions, which would reduce the likelihood of the underlying price pressure building up.

Instead of changing the forward guidance the ECB has many other options if it wants to express a more hawkish stance. We expect it to argue that the options provided for further accommodation are less likely to be used. The ECB could also change its rhetoric regarding the growth outlook, saying that risks to growth are largely balanced instead of ‘to the downside’. This should eventually result in a change to the forward guidance, but for now, we believe the ECB perceives this possibility as too risky.

ECB forward guidance in five parts:

| (1) Level of policy rates | Key ECB interest rates are expected to ‘remain at present or lower level...’ |
| (2) Policy rates horizon | ‘...for an extended period of time, and well past the horizon of our net asset purchases’ |
| (3) QE magnitude | 'net asset purchases, at the new monthly pace of EUR60bn, are intended to run until the end of December 2017, or beyond, if necessary...' |
| (4) QE tapering condition | ‘...and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim’ |
| (5) QE flexibility | 'If the outlook becomes less favourable, or if financial conditions become inconsistent with further progress towards a sustained adjustment in the path of inflation, we stand ready to increase our asset purchase programme in terms of size and/or duration'. |
Market is pricing in rate hikes but inflation expectations are low

Market still pricing in hikes from the ECB

Inflation expectations at QE announced levels

Source: ECB, Eurostat, Danske Bank Markets
#1 Hawkish wording but no change to forward guidance yet

**Economy expanding but labour slack keeps wage growth subdued**

GDP growth not as strong as sentiment

Wage pressure too low to lift core inflation

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**GDP growth not as strong as sentiment**

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<table>
<thead>
<tr>
<th>Year</th>
<th>PMI and GDP growth</th>
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<tbody>
<tr>
<td>2010</td>
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Source: ECB, Eurostat, Danske Bank Markets

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**Wage pressure too low to lift core inflation**

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<tr>
<th>Year</th>
<th>Core inflation and wage growth</th>
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<tr>
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<td>0.5%</td>
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<tr>
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<td>2010</td>
<td>2.5%</td>
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<tr>
<td>2014</td>
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<tr>
<td>2016</td>
<td>4.0%</td>
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</table>
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Source: ECB, European Commission, Eurostat, Danske Bank Markets

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The high core inflation in April was mainly due to the early Easter last year and due to this the figure declined again in May.

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Slack will continue to contain wage dynamics: The ECB published a piece recently where it concluded that labour market slack affects 15-18% of the extended labour force in the euro area and that this large amount of slack is likely to continue to contain wage dynamics. See Assessing labour market slack, 10 May.

These conclusions are in line with our finding that a number of labour market factors, including a high share of discouraged and underemployed workers, point to continued subdued wage growth. See Research: Euro area wage growth should stay subdued, not supporting core inflation significantly, 5 May.

This suggests a continued accommodative monetary policy stance from the ECB as a turnaround in wage dynamics is the linchpin for higher underlying price pressure.
NAIRU has been revised lower but it is still too high in periphery

NAIRU is likely to be lowered in the periphery

- The structural unemployment rate in the periphery countries is estimated to be higher than prior to the crisis despite the labour market reforms.

ECB expects a much steeper Phillips curve

- The Euro area structural unemployment rate (EU Com. estimate) is lower than in Germany.

Source: ECB, European Commission, Eurostat, Danske Bank Markets

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ECB argues slack is very high and likely to contain wage dynamics

Slack around 18% of extended labour market

Source: ECB, European Commission, Eurostat, Danske Bank Markets

U6 unemployment is much higher than in US

Source: ECB, European Commission, Eurostat, Danske Bank Markets
Lower inflation projections from the ECB:
Following upward revisions to the ECB’s headline and core inflation projections in March, both of these are likely to be lowered in June (see table for our expectations).

A downward revision to the headline inflation projection should follow due to a lower oil price as well as a decline in food commodity prices over the past three months.

Additionally, the modest upward revision to core inflation in March reflected – according to the ECB – some indirect and second round effects of higher oil prices, as well as some upward effects from the lower euro exchange rate. Both of these factors have less of a positive impact now; hence, the ECB is likely to lower its core inflation projections again. We expect a moderate revision but the process should continue as wages stay low.

ECB’s inflation forecast requires higher core

<table>
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<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
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<td>HICP inflation</td>
<td>0.2% (0.2%)</td>
<td>1.6% (1.7%)</td>
<td>1.5% (1.6%)</td>
<td>1.6% (1.7%)</td>
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<tr>
<td>Core inflation</td>
<td>0.9% (0.9%)</td>
<td>1.1% (1.1%)</td>
<td>1.4% (1.5%)</td>
<td>1.7% (1.8%)</td>
</tr>
</tbody>
</table>

Parenthesis are the old ECB projections (from March 2017)

Source: ECB, Eurostat, Danske Bank Markets

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#3 Slightly lower ECB inflation projections with more in store

**Limited underlying price pressure even in the largest economies**

**ECB usually expects higher core inflation**

The ECB revised its core inflation forecast higher in March due to (1) indirect and second round effects from higher oil prices and (2) some upward effects from the lower euro exchange rate. Both of these should be less supportive in the June projection.

**Low service price inflation across countries**

Source: ECB, European Commission, Eurostat, Danske Bank Markets

Source: ECB, European Commission, Eurostat, Danske Bank Markets

Note: The service price inflation figures are the average over the past three months up until April while the long-term unemployment figures are from Q4 2016.

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Oil price in EUR lower than in March forecast

Commodity food prices have declined

Revising down inflation due to lower oil and food commodity prices

Source: Eurostat, Danske Bank Markets

Note: the expected updates from the ECB are based on an assumed cut-off 16 May
Reduced likelihood the ECB will alter the repo facility further

Reducing urgency for the ECB on repo issues:
The ECB has released the first data regarding the utilisation of the ‘bond for cash’ lending facility, which was introduced in December 2016, in an attempt to ease the very squeezed repo market.

The data disclosed a ‘cash for collateral’ utilisation of EUR18bn in April and March up from EUR12bn in February and EUR11bn in December against a maximum of EUR50bn.

Hence, the ECB has shown that the current securities lending facility is fully operational and has plenty spare capacity, reducing the urgency of the ECB to alter the facility further at the upcoming meetings.

German yield curve affected by ECB’s QE

Source: ECB, Danske Bank Markets
#4 Most likely the ECB does not see a need to address the repo issues

The ECB’s future purchase pattern is set to drive curve dynamics

Maturity of German purchases has fallen

The average maturity of the German purchases amounted to 4.7Y in April after having decreased from above 12Y in December. The bias towards the short end of the German curve will probably prevail. Additionally, purchases in Germany have slowed a bit due to the issue constraint. So far, the deviation from capital key has been small but if the QE programme is extended, purchases in Germany are set to be lowered.

Source: ECB, Danske Bank Markets

ECB purchase pattern drives German yields

Source: Bloomberg, Danske Bank Markets
#4 Most likely the ECB does not see a need to address the repo issues

**Early QE reduction in Germany – benefiting the periphery?**

**German QE purchases already being reduced**

**Periphery spreads strongly supported by QE**

Source: ECB, Danske Bank Markets

Source: Bloomberg, Danske Bank Markets

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Even if the ECB goes for a slightly more hawkish introductory statement at the meeting, we maintain that as long as the wording regarding policy rates is left unchanged, the euro should stay relatively calm as the key for FX markets will be the signal of a change in stance on policy rates and a first move towards an exit from negative rates.

Indeed, following a significant uptick in the effective euro during the month of May, the ECB should be wary of fuelling further currency strength near term. While fixed income markets may have become somewhat complacent on the ECB, the marked sentiment change towards EUR/USD in mid-May due to reversing political risks and euro growth and equity outperformance recently point to the risk of a short-term correction, not least if cyclical momentum starts to fade within the eurozone.

Crucially, we believe that it will not be until the ECB removes its commitment to negative rates that EUR/USD will see the next round of fundamental correction higher; this should be a story for H2. At the same time, we think the Fed will demonstrate its determinedness over the summer to move on with both rate hikes and announce balance-sheet reduction ahead. Taken together, this makes for an interim period of EUR/USD softness led by central banks, as our short-term tactical recommendation to sell EUR/USD around these levels is testament to. See Danske FX Trading Portfolio: Sell EUR/USD for short-term dip on June reality check for details.

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Disclosures

This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S ('Danske Bank'). The authors of this research report are Pernille Bomholdt Henneberg, Chief Analyst and Christin Tuxen, Chief Analyst.

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