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MACRO MORNING BRIEFING

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ECB Needs To Set Bar For Easing

Divergent Governing Council needs to clarify meesage

- Labour market remains soft but progress on wages frustrating
- Rate pricing increasingly asymmetric, difficult to push cuts back further
- Limited carry flow into euro for now; equity interest may disappoint

ECB Q1 staff projections can lay the ground for rate cuts

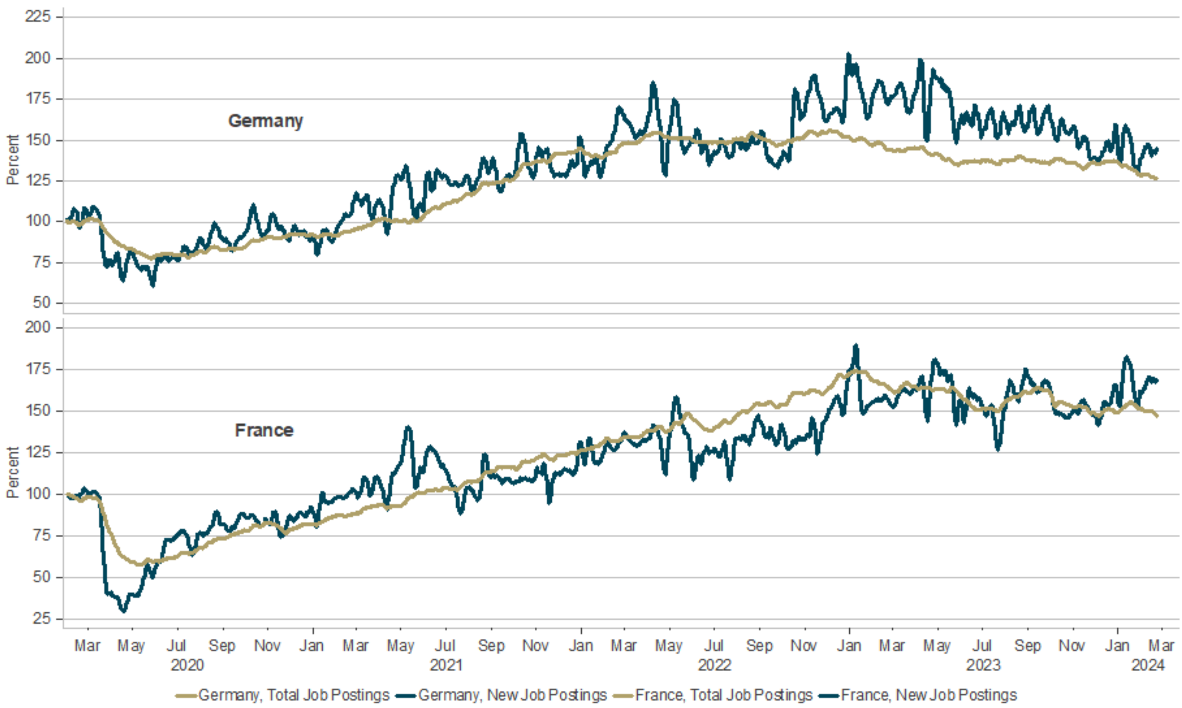
At the end of November 2023, a 25bp rate cut at the European Central Bank's March 2024 meeting was fully priced. Then ECB staff projections in December indicated that progress towards hitting the inflation target was not as advanced as doves had envisaged. It took until well into January-February for that March cut to get almost fully priced out. Compared to the US, we do not see Eurozone inflation and activity data generating any substantial positive surprises, but the force of the Federal Reserve's repricing has impacted global pricing.

Irrespective of where the Governing Council stands, we think asserting policy independence is crucial for the ECB. We suspect that President Lagarde on Thursday will face questioning over the ECB’s own cycle relative global circumstances. That, along with commentary accompanying the rate decision, would present an opportunity for the GC to set out its own criteria for easing. We think this is necessary for the sake of policy clarity. Whether GC members can agree on the criteria is another challenge, however.

For example, the Bank of England’s leadership has already expressed the view that rates can be cut before the inflation target is reached, and that rate cuts themselves need to mean financial conditions would necessarily loosen in absolute terms if real rates remain high. Several of the ECB's more hawkish GC members would likely push back heavily against such a policy stance and argue that price stability needs to be achieved before rate cuts can be contemplated. Considering the ECB’s own orthodoxy and the recent misjudgments on ‘transitory inflation', hawks would likely argue that ‘transitory disinflation’ would pose a similar risk to price instability – it is far worse for credibility to have cut too late than to have cut and reverse due to misjudging inflation. In addition, the GC is far from settled on determining the nature of current inflation. What President Lagarde could do as a compromise is settle on a move around mid-year (or ‘summer’, in her words). The next phase of communication would then be regarding the total size of cuts anticipated for the year – an area where we see the risk only towards larger moves relative to current pricing.

Even at the current pace of data deterioration, we doubt that the March forecasts can point to HICP heading to 2.0% until much later in the year, especially as the base effects from energy on headline HICP will likely rise again in the first half of 2024. Based on the December forecasts, however, core inflation ex-food and energy will fall to below 2% in Q2 2024. Considering some inflation hawks were worried about wage growth keeping core inflation above headline and favoured a shift in the target as a result, the same criteria should now yield a much more dovish path. These voices, however, have now shifted back towards targeting headline. The ECB is clear about stubbornly high wage inflation, and the recent news around industrial action in Germany does give credence to the view that inflation expectations require additional anchoring in certain sectors. But there is no momentum whatsoever in German and French labour market openings on a new and cumulative basis (exhibit 1). On a forward-looking basis it is extremely hard to justify additional labour market tightening. What does matter for policy is any willingness to get ahead of disinflation, and there is no majority at present in the GC for such a change.

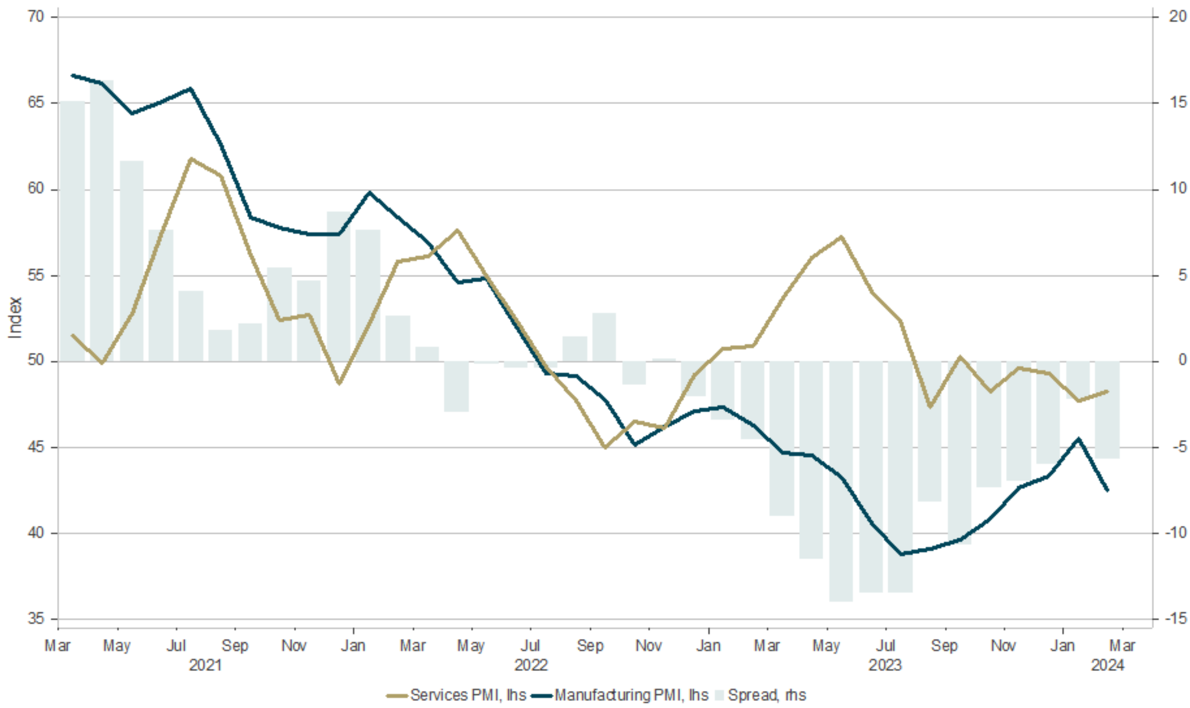
Exhibit #1: Labour Market Openings, Germany & France



Source: Macrobond, BNY Mellon

Meanwhile, the manufacturing sector continues to deteriorate. We have highlighted in previous notes that services PMI not surprising to the downside in January triggered a disproportionate reaction in ECB rate expectations. While it is possible that stabilisation in the sector points to resilience in domestic demand, the ongoing losses in value-added growth and employment from the manufacturing sector is inescapable. The spread between the two sectors (exhibit 2) has widened yet again, and there will be additional calls for an easing in financial conditions to avoid scarring in production. As highlighted in our recent note on Eurozone imports, the lack of demand is affecting the entire supply chain, and economies with greater intermediate-goods exposures will likely feel the effects on aggregate demand much sooner. The near-term rebound in energy and input prices also threatens to eat into margins. Corporates would likely welcome some relief in the form of a weaker euro, which current rate expectations are inhibiting.

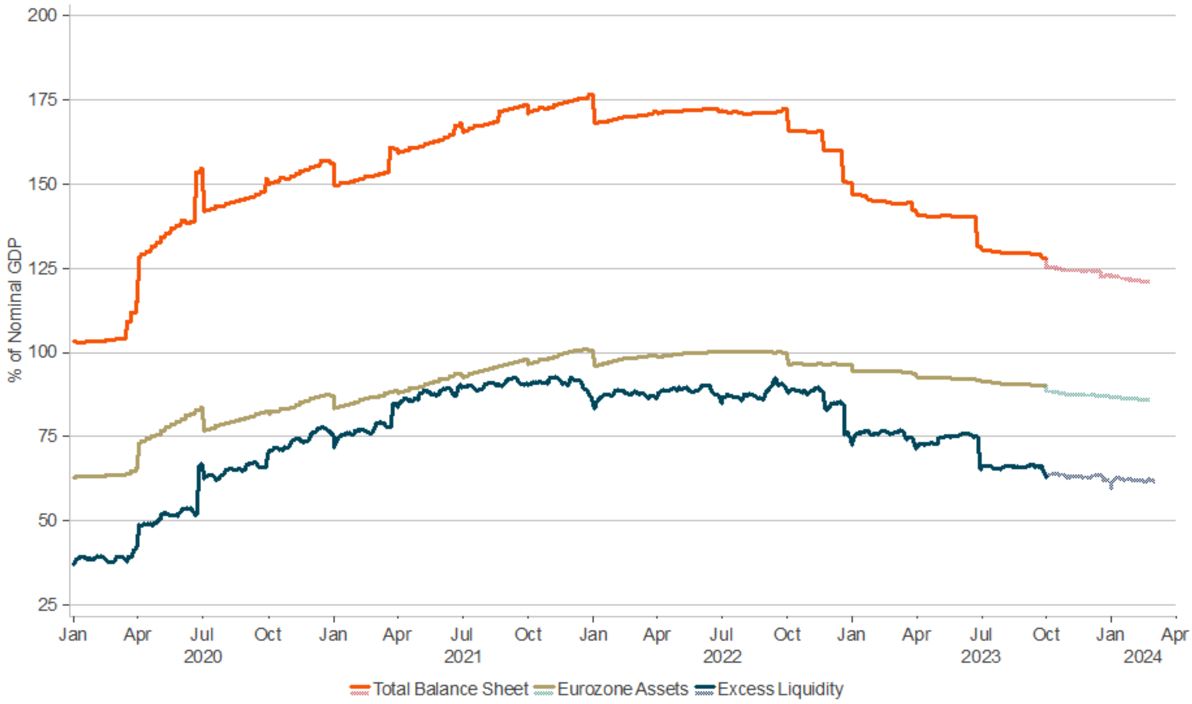
Exhibit #2: Germany Manufacturing vs. Services PMI



Source: Macrobond, BNY Mellon

We also expect President Lagarde on Thursday to give an update on the path for balance-sheet normalisation. As shown in exhibit 3, even with weak nominal GDP growth, quantitative tightening is proceeding apace – and there will likely be some acceleration assuming additional rolloffs in H2 at the pace highlighted in the January meeting. Similar to the Fed, the ECB will likely profess that there is no inconsistency between ongoing QT and interest-rate cuts, though the US may no longer serve as the best model with the decline in RRP balances now to a degree that appears to warrant a discussion on a QT slowdown at the FOMC meeting later this month. If President Lagarde's schedule is to be met as rate cuts take place before the PEPP portfolio begins its runoff, the liquidity framework for the ECB will move in the opposite direction to that of the Fed. This is a possible supportive factor in policy differentials, but execution will be highly variable and contingent on conditions. This is one other area where we expect scope for disappointment towards the dovish side, though it is perhaps too early to anticipate a change in messaging just yet.

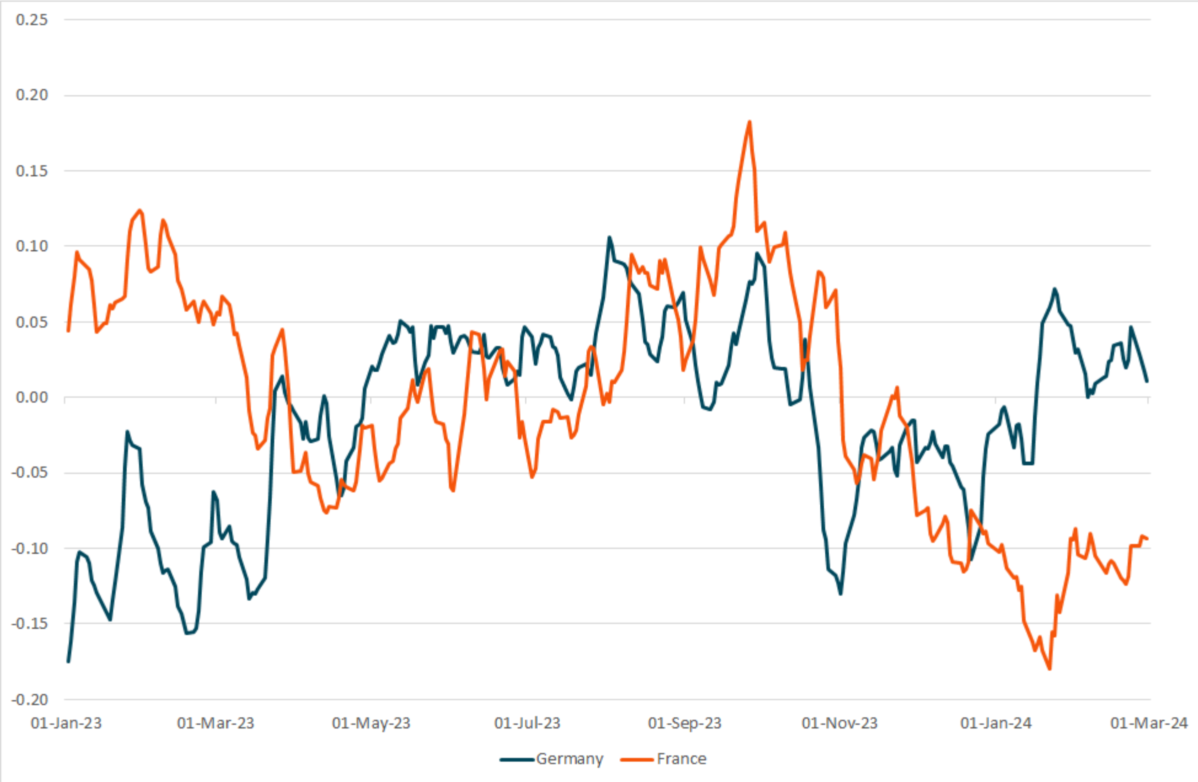
Exhibit #3: ECB Balance-Sheet Contraction Progress



Source: Macrobond, BNY Mellon

On the flow side, even with a hawkish ECB lean, the euro appears in no position to receive carry flows, especially from external parties. Based on iFlow tracking of Cash and Short-term Instruments (CAST) flow, we can see (exhibit 4) that demand for both front-end German and French securities struggled during the pricing-in of easing towards year-end, but only Germany benefited from the recovery flow while easing expectations were being pushed back so far in 2024. Yet, the strength of that flow has barely been able to match the initial declines. The opportunity cost of not owning USD paper at any point in curve is quite high at present – we expect that this will be reflected in euro performance in due course.

Exhibit #4: Germany & France CAST* Flow



Source: BNY Mellon; *Cash and Short-term instruments, measured in smoothed monthly flow

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