MARKET COMMENTARY

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ECB paving the way for rate cuts but denting speculations of swift action

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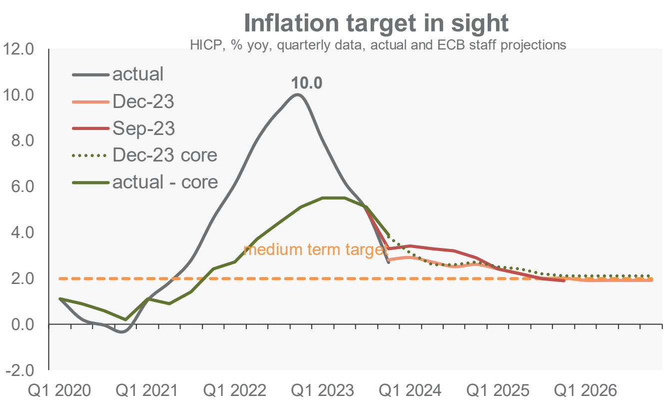
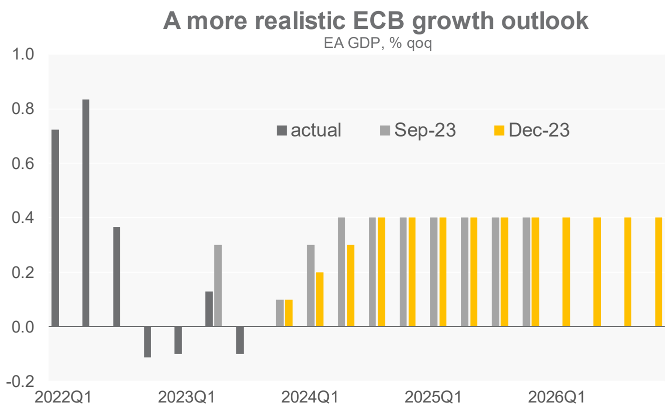
- **At today's meeting the ECB's Governing Council (GC) left its key rates unchanged, in line with expectations. However, it decided to phase out full PEPP reinvestments over H2 2024 and adopted a less hawkish stance.**
- **The updated staff projections lowered the near-term growth and inflation outlook. Headline inflation is expected to come back to target in 2025 and fall to 1.9% by 2026 while underlying inflation is seen as more stubborn averaging still 2.1% by 2026. Growth is expected to gain traction in 2024 again.**
- **The GC adopted a more balanced tone and no longer sees inflation as "*too high for too long*" but only domestic price pressure to "*remain elevated*". In the Q&A President Lagarde made clear that incoming wage data over the course of H1/24 will be of high importance.**
- **The GC decided to advance the end of full PEPP reinvestments as it "*intends to reduce the PEPP portfolio by €7.5 billion per month on average*" in H2/2024 and to fully stop these reinvestments at the end of 2024. The key reason provided was balance sheet normalisation, but we also sense confidence that PEPP reinvestments as a first line of defence to fight financial fragmentation will not be needed.**
- **All in all we got clear signals that the ECB is about to pivot in 2024 but Lagarde tried to dent speculations about swift rate cuts. We still deem a first rate cut by June 2024 most likely.**

No change in rates but PEPP QT to start in mid-2024: At today's meeting the GC unsurprisingly decided to again leave key rates unchanged, the deposit rate at 4.00% and the repo rate at 4.50%. It continues with APP non-reinvestments but announced that it "*intends to reduce the PEPP portfolio by €7.5 billion per month on average*" over the second half of 2024 and to fully stop reinvestments at the end of 2024.



Source: Datastream, ECB, GIAM calculations



Source: Datastream, ECB

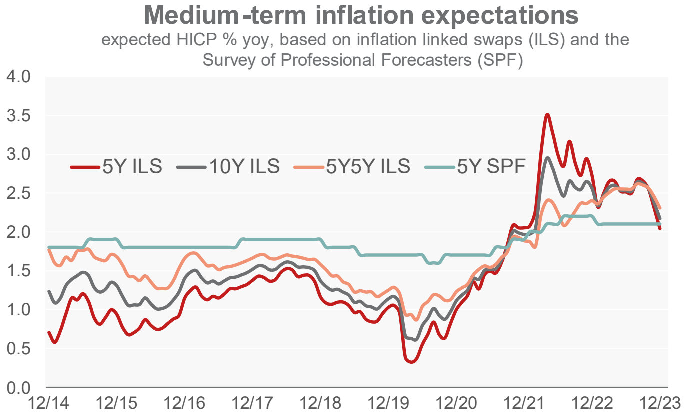
A more favourable growth and inflation mix ahead: The updated growth and inflation projections were extended to 2026 and all in all paint a much better picture than the previous ones. Key is the expected decline in inflation. The GC is aware of the fact that near-term inflation will temporarily rebound (base effects from energy prices, end of energy price support measures) as President Lagarde made clear. But looking beyond that, headline inflation is set to approach the 2% threshold already in 2025 and to average 1.9% in 2026. Core inflation is seen to come down more slowly and to still average 2.1% in 2026. However, compared to previous projections the adjusted path is much flatter. The new projections acknowledge some near-term weakness in growth but continue to see expansion around potential from H2/24 onwards. The projected 2024 annual growth rate of 0.8% (down from 1.0%) now looks more reasonable in our view but still a bit too optimistic (we expect 0.5%).

Wage increases remain a key concern, watch for H1/24 data: That said, the GC and Lagarde at the same time made very clear that this does not imply immediate policy action. The elephant in the room remains wage pressure. Domestic price pressure is expected to "*remain elevated*" and it comes down only slowly. In the Q&A Mrs Lagarde – as at the October press conference – hinted at wage agreements as crucial indicators and that a lot of data on employment, wage agreements, terms of conditions but also price lists for services will be published.

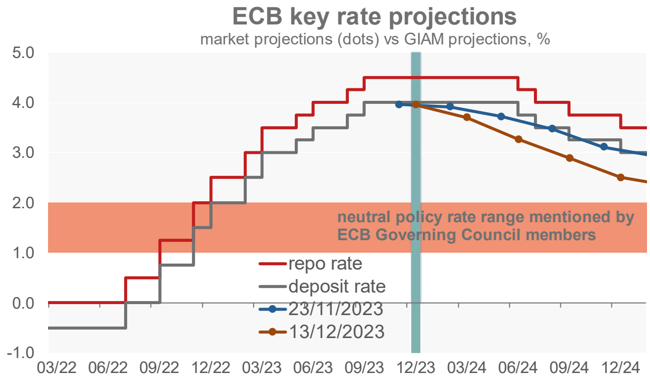
PEPP reinvestments to end earlier: The GC's decision to end full PEPP reinvestments by mid-2024 and to reduce the PEPP volume by € 7.5bn per month by then before ending reinvestments at all at the end of 2024 came as a surprise to us. While various ECB officials had already hinted at an earlier end of full PEPP reinvestments than year-end 2024, the topic had not even been discussed at the last meeting. But as we learned from Mrs Lagarde "*everybody was fine with stopping at the end of 2024*". The reason given was balance sheet normalisation. However, passive QT is also some form of monetary tightening and somewhat contradicts the signal from rate cuts. Hence by announcing PEPP QT already now, the ECB avoids potentially conflicting signals when embarking on rate cuts. PEPP reinvestments are also the first line of defence when fighting financial fragmentation. Stopping them in about one year also shows some confidence that the financial fragmentation issue will not prop up.

Easing cycle will not start swiftly: While at today's ECB meeting the way for rate cuts was paved, it also became clear that the easing cycle will not start swiftly. Lagarde was clear and stated that to lower the guard they "*need wage data*". Also, she cautioned that the inflation outlook was conditioned on the interest rate path as of November 23, which implied less favourable financing conditions compared to what has been priced most recently. Moreover, the GC "*did not discuss rate cuts at all*".

First rate cut in June 2024 is still our base case: We think that the ECB is clearly envisaging rate cuts now but deliberately wants to leave the start of the easing cycle open. The discussion has shifted from whether to hike again to when to cut. Given the ECB's failure to see the inflation tsunami and to act pre-emptively, we think it will prefer to err on the side of caution and wait for the crucial wage data until cutting. A first rate cut by June 2024 is our base case and we deem cumulative cuts of 100bps in 2024 likely. Risks are tilted to earlier cuts, especially if the Fed were – following yesterday's FOMC meeting – to cut maybe already by March.



Source: Datastream, ECB, GIAM calculations



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