Ebury What borders?

ECB December Meeting Preview: Recession fears to herald pivot?

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12th December 2023

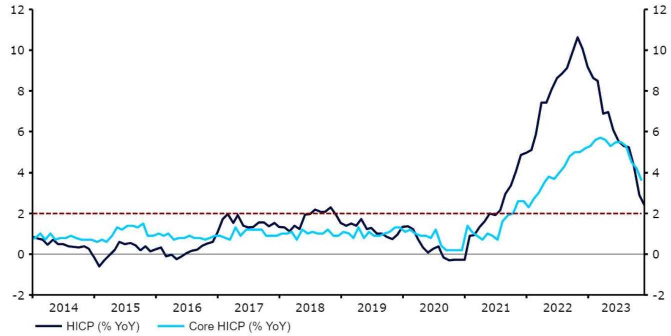
Recession fears to herald pivot?

Material changes in the economic environment since the October meeting suggest that the ECB may begin to sound a more dovish note on Thursday. A shift in communications is warranted, in our view, although the bank is likely to tread very carefully so as not to further ramp up market expectations for cuts, which have become quite aggressive.

Investor expectations for policy easing in the Eurozone have increased significantly in the past two months, following softness in economic activity data and a further drop in price pressures. A particularly sharp increase in rate cut bets materialised at the end of November, following the publication of the latest inflation report. As things stand, markets are anticipating the first rate reduction in March (60% priced-in), and a total of 130 basis points of cuts in 2024.

The November inflation report was noteworthy. Headline inflation slowed sharply, falling to 2.4% last month (down from 2.9%), with the core measure dropping to 3.6% (down from 4.2%), both much larger declines than expected. While these numbers are still too high for comfort, particularly the latter, with the headline rate now less than 0.5 p.p. away from the target, progress in the inflation fight is clear for all to see.

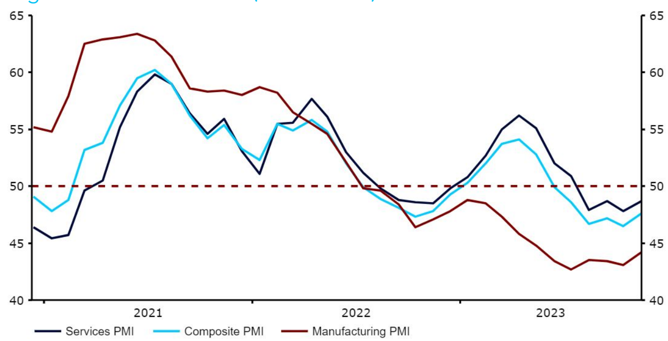
Figure 1: Euro Area Inflation Rate (2014 - 2023)



Source: LSEG Datastream Date: 12/12/2023

Indicators of economic activity in the bloc, while frustratingly lagging, point to an economy on the brink of, or already in, a shallow recession. A number of survey-based indicators have improved of late, albeit the key PMIs remain close to their recent lows and far below the level of 50 that separates expansion from contraction. Recent ECB lending data also confirmed that the bank's policy has been quite effective in curbing demand, which is bad news for growth, and positive for the inflation outlook. The fragile state of domestic demand, and the extent of the recent slowdown in inflation, suggest that a policy reversal could be in the offing in the not too distant future.

Figure 2: Euro Area PMIs (2020 - 2023)



Source: LSEG Datastream Date: 12/12/2023

To an extent, the ECB has already acknowledged the changing economic reality. The hawkish wing of the central bank has been rather quiet of late and, perhaps the most prominent representative of this faction, Isabel Schnabel, signalled that hikes are now off the table in her recent interview. The minutes from the central bank's October meeting also had dovish undertones. In addition to confirming that a further rate increase is not included in the bank's baseline scenario, they suggested that concerns over the economic outlook have increased.

Economic activity data released since the last ECB meeting is unlikely to ease the ECB's concerns over growth. The HICP report, however, may allow for more optimism on inflation and should, we believe, encourage the Governing Council to shift its tone slightly in a dovish direction. At the same time, we believe it is far too early for a significant turnaround in the bank's policy stance, and that the move towards an easing bias will be a very gradual one, particularly given that the ECB has a track record of being one of the most cautious central banks in the G10.

In our view, President Lagarde will attempt to keep a low profile during her press conference, and refrain from providing anything that could be considered forward guidance. While Lagarde cannot deny the progress on the inflation front, she may try to soften the message by suggesting that the inflation fight hasn't yet been won, while emphasising uncertainty about the outlook. On growth, she may also choose to not sound overly gloomy, noting tentative signals that the worst could be over or, at least, that some survey-based data is moving in the right direction. She also may decide to push back against aggressive market expectations for cuts, which could prove crucial for the euro's reaction. A clear indication that it is too early to consider rate cuts would likely support the common currency.

Comments regarding reinvestments under the Pandemic Emergency Purchase Programme (PEPP) may also catch the market's attention. Reinvestments are set to continue through the end of 2024, although recent comments from President Lagarde suggest that this will soon be discussed – we would not be surprised if the topic came up in the December meeting. In addition to the tone of Lagarde's communications, markets will also be focusing on the updated quarterly economic projections. The focus will be on the extent of the expected downgrades to the medium-term growth and inflation projections, and the new longer-term outlook, as the bank will include 2026 in its projections for the first time.

Given the dramatic shift in expectations for ECB cuts in the past few weeks, the bar for a dovish surprise appears very high. It is difficult to see how the ECB could significantly add to market expectations for policy easing, suggesting that the risks to the euro are skewed to the upside leading into the meeting. Nevertheless, we cannot entirely rule out some losses for the common currency, should Lagarde fail to eloquently emphasise the bank's policy stance, or should 'ECB sources' challenge the message from the meeting, as has been the case with alarming regularity in the recent past.

The ECB's policy decision will be announced at 13:15 GMT (14:15 CET) this Thursday, with the press conference to follow 30 minutes later.

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