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ECB gets ready for rate lift-off

Next week's European Central Bank meeting will finally mark the very first rate lift-off since 2011. The decision has been so well prepared that just delivering the expected could be a disappointment

The first rate hike since 2011 has been so well prepared and pre-announced by the ECB that it could trigger the same reaction in financial markets that kids show under the Christmas tree when they know exactly what the parent had gift wrapped: disappointment.

Economic outlook has worsened

The macro situation is clear: the economic outlook is worsening by the day and the number of downside risks are increasing by the week. At the same time, headline inflation is still increasing and in our view will only come down gradually towards the end of the year, if it comes down at all. To make things worse, it is not parity as such but the broad weakening of the euro exchange rate which adds to inflationary pressures. In hindsight, the very gradual and cautious normalisation process the ECB started at the end of last year has simply been too slow and too late.

What to expect from the ECB next week

When predicting what the ECB will do next week, we have to take the ECB and its communication at the June meeting as well as ECB president Christine Lagarde and vice-president Luis De Guindos by their words: the ECB "intends" to hike interest rates by 25bp next week and expects another rate hike by 25bp or more for the September meeting. Looks like a no-brainer. But still, we think that there is a small chance that the ECB might hike interest rates by 50bp next week. Why? Because the hawks could be getting cold feet. The minutes of the June ECB meeting showed that some ECB members were already willing to hike rates at the June meeting. The decision to pre-announce 25bp for the July meeting and a higher rate hike at the September meeting looked like a good compromise between doves and hawks. However, with the worsening economic outlook, the ECB runs the risk that at the September meeting it will be looking a recession into the eyes. Probably not the best moment to justify an acceleration of rate hikes. Also, the recent weakening of the euro is another argument in favour of a more aggressive rate hike next week, offering some support for the currency. This is why we expect the hawks to give it another try to push for a frontloading of rate normalisation at next week's meeting. It will be a balancing act between the ECB's credibility as being predictable and its credibility as a determined inflation fighter.

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With the government crisis in Italy, there will be even more focus on the ECB's anti-fragmentation tool (or: transmission protection mechanism as it will be called according to the latest news reports). We wrote before that the main issues for this new tool were how to define a 'neutral' or 'economically justified' spread, the size of such a tool and the degree of conditionality. Ideally, the ECB would refrain from disclosing details and would just make a strong 'whatever it takes' announcement as basically what financial markets are really after is a confirmation that the ECB is still willing to be the lender of last resort for the monetary union. However, repeating such a commitment when starting a rate hiking cycle is like hitting the brakes and the accelerator simultaneously. It doesn't work. Therefore, we expect the ECB to present some guidelines of its new tool, linking conditionality to the Next Generation EU reform programmes, presenting a vague definition of what constitutes fragmentation as it did with the Securities Markets Programme (SMP) and also sterilizing the purchases (as in the SMP). We could see the hawks trying to negotiate a trade-off between frontloading rate hikes and the strictness of conditionality in the new tool: frontloading against looser conditions.

Never forget to expect the unexpected

After months of debating, speculating and pre-announcing, the moment of the first ECB rate hike since 2011 has finally come. It still looks a bit odd to only see a 25bp rate hike when other central banks have already started hiking long ago and 75bp seem to be the new 25bp. However, given the ECB's official communication since the June meeting, our base case expectation for next week remains a rate hike by 25bp. Nevertheless, given that the ECB has surprised to the hawkish side at every single meeting since the start of the year and the fact that the hawks might secondguess the June compromise, we don't want to exclude a 50bp hike. It's a bit like kids who had been told by their parents that their will be only one gift under the Christmas tree, and they already know what it's going to be. These kids will hope for more until Christmas eve has really come.

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