

Three scenarios for the ECB's normalisation path

We think that the ECB's normalisation of monetary policy will be less aggressive than markets have currently priced in. However, the high degree of uncertainty for the economic and inflation outlook, as well as the ongoing debate within the ECB on the pace of normalisation, give rise to several scenarios. Here are the three most likely



Last week's European Central Bank meeting has paved the way for a further normalisation. Only a severe economic recession or sharp fall in headline inflation and inflation forecasts would now prevent the Bank from ending its net asset purchases. However, the exact timing of this end to net asset purchases and more importantly, the timing of a first rate hike are still unknown. As ECB President Christine Lagarde said last week, the third quarter has three months. In other words, the end of net asset purchases could come at any point in the third quarter. The timing of the first rate hike is even more unclear as Lagarde defined the ECB's official language of "some time after" the end of net asset purchases as between 'one week and several months'.

Our base case for the ECB

In our base case scenario, we expect the ECB to tread very carefully in these times of high

uncertainty, and emphasise an explicit distinction between policy normalisation and monetary policy tightening. Normalisation would include an end to net asset purchases and bringing the deposit rate back to zero. Tightening would be the start of a longer rate hike cycle, bringing rates close to, or even above, neutral levels (wherever these levels might be).

Once the deposit rate is back to zero, the longer-term inflation forecasts will be of even higher importance for any next step. Unless energy prices continue to accelerate, there will be negative base effects on headline inflation in the course of 2023, bringing headline inflation closer to 2% again. For the ECB, the main indicators to watch are wage developments and inflation expectations. As long as wage growth remains below 3%, an outright tightening cycle is unlikely. Add to this a further acceleration of government debt, driven by fiscal spending on defence and the green transition, and an outright tightening cycle becomes even more unlikely. The more general discussion the ECB will have to have at some point in time is how to react to structurally higher, but externally driven, inflation due to the first years of the green transition. We expect the ECB to only very cautiously engage in outright tightening once the so-called unconventional measures have been returned to the toolbox.

Three scenarios for how the ECB could normalise monetary policy

As much as we are convinced of our base case, other scenarios remain possible. The economic outlook could improve significantly, for example, and the mindset of the majority at the ECB could change. Here are three possible scenarios on the ECB's path to normalisation:

1. **Our base case:** The ECB ends net asset purchases in the second quarter of 2022 and starts hiking interest rates by 25bp in September with another 25bp in December. In this scenario, September forecasts point to a drop in headline inflation to around 2% over the medium term and the sheer fact that the ECB is committed to gradual normalisation bridges the gap between doves and hawks. A new asset purchase programme will be announced to tackle any unwarranted widening of spreads across eurozone countries. In this scenario, the ECB will make a clear distinction between policy normalisation, i.e. bringing an end to net asset purchases and negative deposit rates, and policy tightening, i.e. delivering a series of rate hikes in order to bring the policy interest rate to more neutral levels. Rate hikes beyond the normalisation level are difficult to deliver, as high energy and commodity prices are actually disinflationary, and at the same time, the US economy may start to lose momentum with the Fed perhaps looking to reverse policy tightening in 2023. We expect only two additional rate hikes, bringing the refi rate to 1.0% by the end of 2023, with no further hikes in 2024.
2. **Earlier and more aggressive normalisation:** inflation stays higher for longer and longer-term inflation expectations scare the ECB so much that it ends net asset purchases in June and hikes interest rates by 25bp in July with another 25bp in September. Alternatively, and given that the ECB prefers to link important decisions to new economic forecasts, the central bank could start hiking rates with a 50bp move in September. The war in Ukraine comes to an end, reducing uncertainty and improving the economic outlook, while more structural challenges like supply chain frictions and energy and commodity disruptions remain a problem for the eurozone. Still, the ECB follows in the Fed's footsteps, hikes rates by 25bp in December 2022, March, June and December 2023 with another 50bp in 2024, bringing the refi rate to 2%.
3. **The fear is back move:** the economic outlook worsens further, core inflation forecasts start

to fall and wage growth disappoints on the back of rising unemployment. The ECB still sticks to normalisation, hikes rates by 25bp in September and December but delivers no further rate hikes. Instead, slowing credit growth and capital flight out of the eurozone forces the ECB to restart net asset purchases, combined with new Targeted Longer-Term Refinancing Operations.

Rates, not much upside in all but the most hawkish outcomes

Our most hawkish scenario is roughly in line with the current market thinking on interest rates. If it were to materialise, we expect 10Y bund yields to convincingly cross 1.25% this year, and to stay at or above this level for the whole of 2023. This is above the current forwards but would be justified, in our mind, by swap spreads returning to their historic (tighter) norms. Assuming an eventual reduction in the ECB's balance sheet, both on the liquidity and bond portfolio side, higher rates would be possible.

Markets have a date with reality

An aggressive Fed-like ECB tightening cycle isn't our central scenario, however. The more cautious path for policy that we envision means markets have a date with reality sometime between now and early next year. This should prove most impactful for intermediate rates, with the 5Y coming in on the curve, though long-end yields will be affected too. The 10Y Bund would end 2022 around 0.90%, not far from current levels. Further evidence that the ECB is getting near the end of its hiking cycle next year should compress the term premium, resulting in a rally to 0.70% by end-2023. These numbers are low historically and reflect yields still compressed by heavily regulated bond demand, and constrained supply.

0.90%

Our end-2022 Bund yield forecast

declining to 0.70% by end-2023

In summary, the market's already hawkish assumptions limit the upside to rates across the curve but a tightening of swap spreads from current levels could still see 10Y Bund yields rise. In all other cases, we think upside to market rates is limited.

FX: Scenarios accentuate core trends

EUR/USD is being driven by developments at the short end of the interest rates curves and clearly the speed with which the ECB normalises policy will be important. Under our baseline scenario - and given the fact that the market virtually prices three 25bp hikes from the ECB this year - we look for EUR/USD to trace out a 1.05-1.10 range, ending the year at 1.10. In 2023, the emergence of Fed easing expectations could see the dollar turn around and EUR/USD end the year at 1.15.

Under the alternatives presented above, the hawkish scenario of a more pronounced, multi-year ECB tightening cycle would probably mean more for 2023 than 2022 EUR/USD forecasts. The

pair could be trading at 1.20-25 by end-2023 here. The more subdued ECB scenario would probably have more impact on EUR/USD this year and could see EUR/USD pinned down near 1.05. Preventing us from becoming too bullish on EUR/USD is our view that the war in Ukraine has damaged the [medium-term fundamental fair value of EUR/USD](#), meaning that the upside might prove far stickier than a hawkish ECB might suggest.

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