**Scotiabank**

GLOBAL ECONOMICS

**FLASH REPORT**
December 14, 2023
*Market Reaction (at time of writing, 9:50ET)*

**Contributors**


**Juan Manuel Herrera**
Senior Economist/Strategist
Scotiabank GBM
+44.207.826.5654
juanmanuel.herrera@scotiabank.com


# ECB Balances On-Hold Rates with PEPP Announcement

- **To no one's surprise, the ECB left its three benchmark rates unchanged, but with a collection of communications that looks more hawkish/less neutral than those of the BoE, and more so the Fed's.**
- **The decision was more hawkish than expected as it declared a firm start date to a partial roll off—and even end date to reinvestments! —of the PEPP portfolio. Although the announcement in itself was hawkish, the timing and pace may in a way look somewhat dovish.**
- **The ECB made no real attempt in its statement and updated forecasts to push back against priced-in rate cuts, but Lagarde said that at today's meeting they "did not discuss rate cuts at all. No discussion, no debate.", which prompted an additional trimming of cut bets.**
- **We project that the bank will begin rate cuts in Q2-24 (April or June) for a total of 100bps in each of 2024 and 2025. This is unchanged from before the decision. Markets are pricing in 150–155bps in cuts by December 2024.**

To no one's surprise, the ECB left its three benchmark rates unchanged, among them the deposit facility rate at 4.00%. On the heels of the respectively more- and less-hawkish-than-expected BoE and Fed decisions (earlier today and yesterday afternoon), the ECB chose to play it even more hawkish (or cautious), facing a more benign inflation forecast with a need to not let financial conditions loosen too much.

Although the ECB made no real attempt to push back against priced-in rate cuts in its statement (see **here**) and updated forecasts—which see the inflation target reached sooner than previously though, in 2025 (see **here**)—the decision was more hawkish than expected. The ECB declared a firm start date to a partial roll off—and even end date to reinvestments! —of the PEPP portfolio. The hazy consensus view going into the decision was that, today, the bank would tee up that they would bring forward the PEPP portfolio reduction, with the formal announcement due most likely at the January decision.

The PEPP decision has a bit for everyone, however. Starting in H2-24, the ECB will reduce its PEPP holdings by an average €7.5bn/month, and then allow a full passive roll off of maturing assets from January 2025. The ECB was hawkish in announcing the next chapter of QT today instead of waiting until one of its January or March meetings. It was also hawkish in giving a clear end date to PEPP reinvestments. In contrast to yesterday's Fed decision with lower dots, the ECB unveiling some non-policy rates action stands out.

From where this reads somewhat dovishly is that the H2-24 start date may have disappointed expectations that it would begin in Q2-24. The €7.5bn pace chosen for six months is also less than half of the ~€18bn that would passively roll off. And, perhaps, ECB officials judged that they had to get the PEPP roll off announcement out the door before they approach the first rate cut that we think may come as soon as April.

Lagarde reiterated that balance sheet normalization is unrelated to interest rates policy, but there may be a de-linking objective in announcing today rather than later when it could overlap with policy easing. Now, on net and from afar, the PEPP announcement is hawkish in itself, but the ~5bps narrowing of the 10yr Italian-German yield spread since the press release shows that the specifics likely aren't—at least as far as markets are concerned.

Setting aside the neutrality of the statement and the interpretation of the PEPP move, Lagarde's press conference, on the whole, pushed back against rate cut expectations. The clearest resistance to cuts bets and pivot in cuts pricing in markets this morning came when Lagarde said that at today's meeting they "did not discuss rate cuts at all. No discussion, no debate." This should not greatly surprise as the ECB had to put a stop to increasing speculation of rate cuts.

This morning, after the Fed, the ECB was looking at cuts-hungry markets that were pricing in 160–165bps in reductions over the next twelve months, where 75–80bps of these came since the ECB last met in October; 30bps of these were added on Wednesday and this morning. This was likely making them uncomfortable and challenging their intention to keep rates at "levels that, maintained for a sufficiently long duration, will make a substantial contribution" to returning inflation to target. It also contrasted with the Fed's Powell saying yesterday that regarding the appropriate timing of when to ease that it "was a discussion point in our meeting today."

The ECB faced a difficult task in striking a hawkish tone at the same time as it lowered its inflation forecasts to the point of showing an earlier return to on-target inflation. All-in-all, today's communications collection succeeded in at least preventing a continued increase in easing bets. We project that the bank will being rate cuts in Q2-24 for a total of 100bps in easing in each of 2024 and 2025.

**Market Reaction**

- Amid US data releases, the BoE's announcement, and the ECB's statement and presser, it is tricky to read the reaction in markets to the ECB's communications. But, on net, they were taken as hawkish.
- The EURGBP returned to pre-BoE levels (flat on the day, while the EUR gained 0.5% against the dollar since the decision was published—for a near 1% rise on the day.
- Two-year German yields are up about 5bps since the decision but still 10bps lower on the day given the gap lower at the open (catching up to USTs), versus a 3bps rise in 10s from pre-statement (down 5bps on the day; note that US 10s may be helping limit yield upside here).
- As for end-2024 cuts pricing, markets took out 5bps since the release, already carrying a 7/8bps reduction in cut bets from the intraday low, and now totaling net 13bps increase in cut bets on the day (Fed, again) that total 150–155bps by end-2024.