

FLASH REPORT

January 25, 2024

Market Reaction (at time of writing, 10:20ET)

Contributors

Juan Manuel Herrera

Senior Economist/Strategist

Scotiabank GBM

+44.207.826.5654

juanmanuel.herrera@scotiabank.com

ECB: Neutral Lagarde Surprises Markets that Expected Push-Back

- The ECB left all its policy levers steady today, as universally expected, but delivered a rather neutral set of communications that fell short of more hawkish expectations.
- Although the ECB was in no way dovish, it was also not hawkish. Lagarde did not push back, failing to make use of Middle East or wage negotiations risks to challenge the market's pricing of cuts. Accordingly, EGBs rallied across the curve in steepening fashion, markets added back some expected cuts by year-end, and the EUR lost ground against all of its peers.
- Today's ECB decision does not change our expectation for rate cuts to begin in June, as data have not motivated an outlook change. An April start is possible if data warrant such a move but the March decision seven weeks from today looks too soon for easing to begin. Markets pricing in 22bps in cuts by April may have got ahead of themselves.

The ECB left all its policy levers steady today, as universally expected, but delivered a set of communications that fell short of the hawkish expectations of markets and among the median economist. Today's ECB decision does not change our expectation for rate cuts to begin in June, with 25bps, as data have not motivated an outlook change, nor does it alter our view that the first rate cut could still come in April if data warrant—but not in March, unless the Eurozone economy absolutely collapses in the seven week meeting interim.

Although the ECB was in no way dovish, it was also not hawkish. Lagarde did not push back. Neutrality at policy announcements has tended to result in rates rallies in markets that are relishing the start of rate cuts but have had to swiftly curb their enthusiasm since end-2023. Accordingly, EGBs rallied across the curve in steepening fashion, markets added back some expected cuts by year-end, and the EUR lost ground against all of its peers.

Markets had been conditioned by pre-blackout ECB speakers to expect a hawkish statement and presser at today's policy decision. They did not get that, but instead a neutral-sounding and pragmatic policy statement and a non-committal Lagarde press conference. Louder hawks do not represent the view of the average Governing Council member that Lagarde attempts to represent at the presser and this was seemingly reflected in her non-committal answers to questions. Lagarde said there was a consensus (note not unanimous as she tends to highlight) that it was premature to discuss rate cuts.

Lagarde had two themes at her disposal to highlight as upside risks to inflation that could have helped her push out the expected start of rate cuts: wage negotiations and Middle East risks/disruptions. On Middle East risks, Lagarde did note the upside risks to inflation from geopolitical tensions and their influence on energy and freight costs, but she also pointed to the negative confidence effects of global conflicts that could hurt growth.

On wages, she did not want to point to a specific data series on compensation or the outcome of wage settlements in coming months as the main thing to evaluate—going as far as highlighting that they've seen a slight decline in wage growth. This is in contrast to chief economist Lane, who [on the 13th](#) hand-waved that by the April meeting they won't have the most complete dataset on wages, Q1 national accounts data. Markets had interpreted this as the ECB not being ready to begin easing in April. This remains a key upside risk to inflation, despite Lagarde not making much of wage negotiations specifically.

January 25, 2024

On top of not making use of the two main upside risks to inflation to push back against markets, when questioned on the possibility of a rate cut in April she pointed to the March forecast round as key. This implies that they could be happy enough with their inflation, wages, and growth projections in March to roll out a cut at the following meeting.

The ECB made minor changes to its statement beyond the obvious ones due to the December meeting coming with new forecasts. What few changes there were, they were not hawkish. In December, the ECB said that inflation would pick up in the near term, and so it did in December data as was expected. Now, the ECB says that “aside from an energy-related upward base effect on headline inflation, the declining trend in underlying inflation has continued”. The ECB is shrugging off headline inflation noise and seems at peace with how core inflation is evolving.

The ECB removed the sentence “domestic price pressures remain elevated, primarily owing to strong growth in unit labour costs.” This may simply be due to this being a non-forecasts meeting, but strong wages growth could have easily been incorporated into the new statement as a caveat to their opinion that “the declining trend in underlying inflation has continued”. Yesterday’s S&P PMI releases noted that firms continue to be pressured by higher wage expenses but have been able to pass on these increase costs to prices charged. Lagarde simply referred to their expectation that firms’ profit margins that had driven part of past inflation will continue to adjust.

Market reaction (at writing, 15.20UK):

- From pre-statement levels, markets have added 13bps in expected ECB rate cuts by December 2024, totaling 142bps from 129bps previously (but we ended 2023 with 165bps priced in). As for the April meeting, there are now 22bps priced in versus 15bps pre-decision (7bps increase), and markets now see a full two cuts (and then some) by June, pricing in 53bps from 42bps prior (11bps increase).
- German 2yr yields have fallen about 12bps from pre-meeting, to about 2.60% at writing, with 10s down 8bps to 2.28%. The spread of Italian over German 10yr yields has also fallen about 3bps on the communications.
- The EUR has shed about 50 pips versus the USD, from trading around 1.09 this morning to around 1.0850 at writing, on track for a small 0.3% drop on the day vs the USD, and also the GBP where on a EURGBP basis it sits at 0.8525—briefly trading at its lowest point in the cross since August 2023.
- Note that the release of mixed US data between the publication of the statement and Lagarde’s presser also supported rates markets and weighed on the USD somewhat broadly. US 2s are down 6bps and 10s are down about 4bps from pre-ECB statement levels, and markets added 7bps into year-end Fed pricing that sits at ~140bps.

January 25, 2024

This report has been prepared by Scotiabank Economics as a resource for the clients of Scotiabank. Opinions, estimates and projections contained herein are our own as of the date hereof and are subject to change without notice. The information and opinions contained herein have been compiled or arrived at from sources believed reliable but no representation or warranty, express or implied, is made as to their accuracy or completeness. Neither Scotiabank nor any of its officers, directors, partners, employees or affiliates accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or its contents.

These reports are provided to you for informational purposes only. This report is not, and is not constructed as, an offer to sell or solicitation of any offer to buy any financial instrument, nor shall this report be construed as an opinion as to whether you should enter into any swap or trading strategy involving a swap or any other transaction. The information contained in this report is not intended to be, and does not constitute, a recommendation of a swap or trading strategy involving a swap within the meaning of U.S. Commodity Futures Trading Commission Regulation 23.434 and Appendix A thereto. This material is not intended to be individually tailored to your needs or characteristics and should not be viewed as a “call to action” or suggestion that you enter into a swap or trading strategy involving a swap or any other transaction. Scotiabank may engage in transactions in a manner inconsistent with the views discussed in this report and may have positions, or be in the process of acquiring or disposing of positions, referred to in this report.

Scotiabank, its affiliates and any of their respective officers, directors and employees may from time to time take positions in currencies, act as managers, co-managers or underwriters of a public offering or act as principals or agents, deal in, own or act as market makers or advisors, brokers or commercial and/or investment bankers in relation to securities or related derivatives. As a result of these actions, Scotiabank may receive remuneration. All Scotiabank products and services are subject to the terms of applicable agreements and local regulations. Officers, directors and employees of Scotiabank and its affiliates may serve as directors of corporations.

Any securities discussed in this report may not be suitable for all investors. Scotiabank recommends that investors independently evaluate any issuer and security discussed in this report, and consult with any advisors they deem necessary prior to making any investment.

This report and all information, opinions and conclusions contained in it are protected by copyright. This information may not be reproduced without the prior express written consent of Scotiabank.

™ Trademark of The Bank of Nova Scotia. Used under license, where applicable.

Scotiabank, together with “Global Banking and Markets”, is a marketing name for the global corporate and investment banking and capital markets businesses of The Bank of Nova Scotia and certain of its affiliates in the countries where they operate, including: Scotiabank Europe plc; Scotiabank (Ireland) Designated Activity Company; Scotiabank Inverlat S.A., Institución de Banca Múltiple, Grupo Financiero Scotiabank Inverlat, Scotia Inverlat Casa de Bolsa, S.A. de C.V., Grupo Financiero Scotiabank Inverlat, Scotia Inverlat Derivados S.A. de C.V. – all members of the Scotiabank group and authorized users of the Scotiabank mark. The Bank of Nova Scotia is incorporated in Canada with limited liability and is authorised and regulated by the Office of the Superintendent of Financial Institutions Canada. The Bank of Nova Scotia is authorized by the UK Prudential Regulation Authority and is subject to regulation by the UK Financial Conduct Authority and limited regulation by the UK Prudential Regulation Authority. Details about the extent of The Bank of Nova Scotia's regulation by the UK Prudential Regulation Authority are available from us on request. Scotiabank Europe plc is authorized by the UK Prudential Regulation Authority and regulated by the UK Financial Conduct Authority and the UK Prudential Regulation Authority.

Scotiabank Inverlat, S.A., Scotia Inverlat Casa de Bolsa, S.A. de C.V., Grupo Financiero Scotiabank Inverlat, and Scotia Inverlat Derivados, S.A. de C.V., are each authorized and regulated by the Mexican financial authorities.

Not all products and services are offered in all jurisdictions. Services described are available in jurisdictions where permitted by law.