ECB Focus

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New scenario: 3.00% as a terminal rate

- **We are changing our scenario for the ECB's deposit rate.**
- **We add another rate hike to our previous scenario, and we see a terminal rate at 3.00% to be reached in March 2027.**
- **We still expect the ECB to start cutting its rates at the beginning of 2028, and cut to 2.25% by September 2028.**
- **Three weeks ago, we published a long and boring focus on our internal discourse regarding the ECB's scenario. This time, we will spare you the navel gazing and simply set out our scenario.**
- **That being said, we do review what has changed since our last paper and highlight the risks to our new scenario.**



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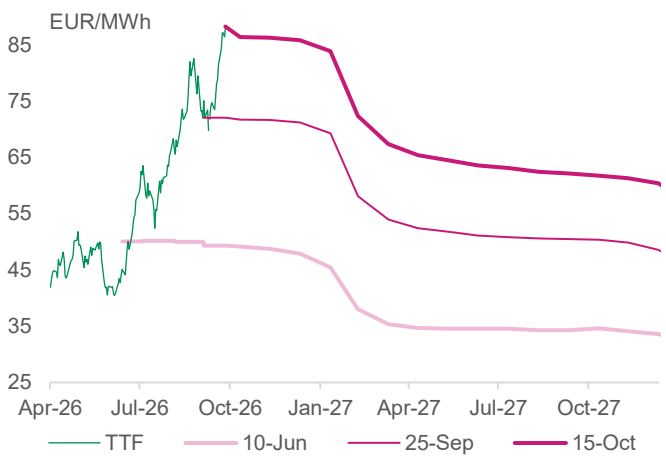
Update on recent trends

Energy prices

Since we published our previous focus on our scenario, oil and gas prices have continued increasing; the gas price is currently at its highest level since December 2022, whereas the oil price remains at lower levels than in March and April, but at levels comparable to H122.

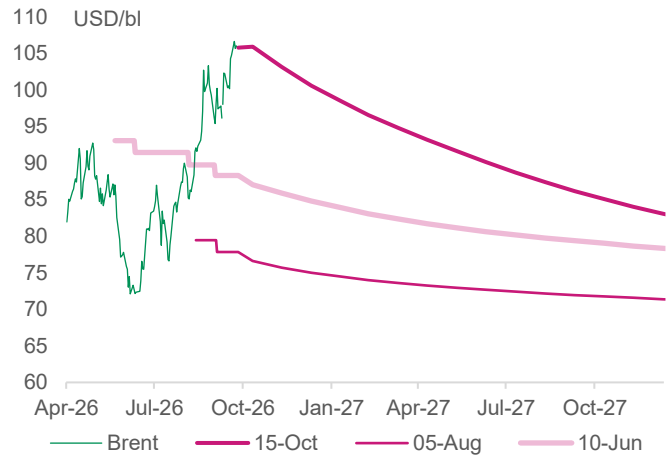
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Gas price



Source: Bloomberg, Crédit Agricole CIB

Oil prices



Source: Bloomberg, Crédit Agricole CIB

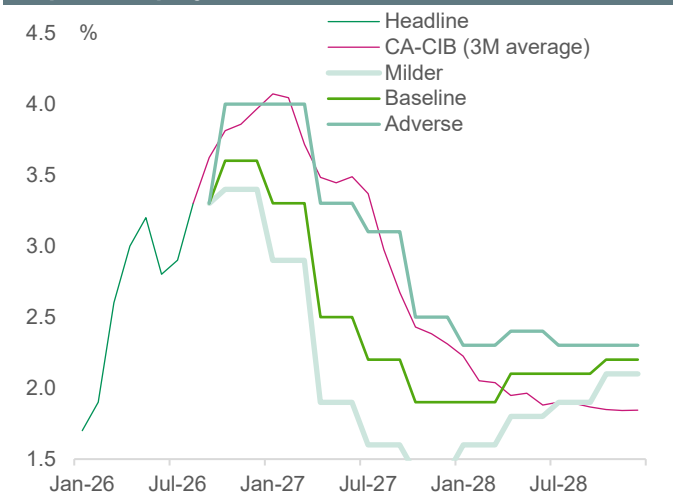
The futures curves have increased in parallel with spot prices, pricing level for oil and gas prices higher until the end of 2028.

Inflation

Accordingly, our inflation team has revised upwardly its forecasts for headline and core inflation. Our forecasts are now broadly in line with the ECB's adverse scenario released in September.

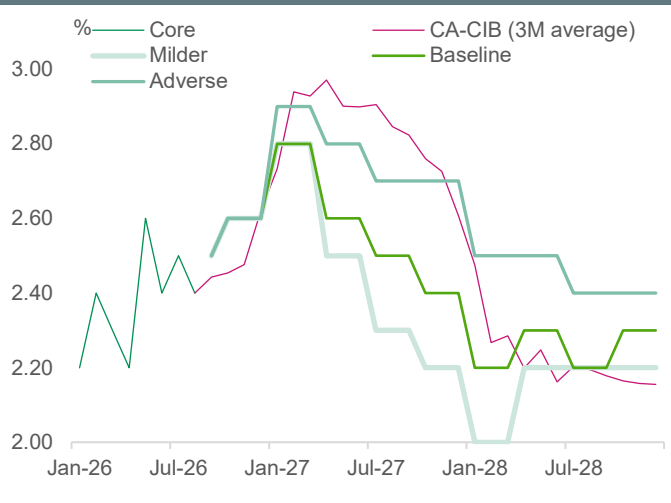
Nevertheless, under these forecasts, we still do not see core inflation above 3% – except in March 2027, because of seasonal factors. The quarterly inflation rate peaks at 2.95%, with a core inflation between 2.7% and 3.0% for the full year 2027, before a decline to 2.3% at the beginning of 2028.

Headline inflation, our latest forecasts and the ECB's September projections



Source: ECB, Crédit Agricole CIB

Core inflation

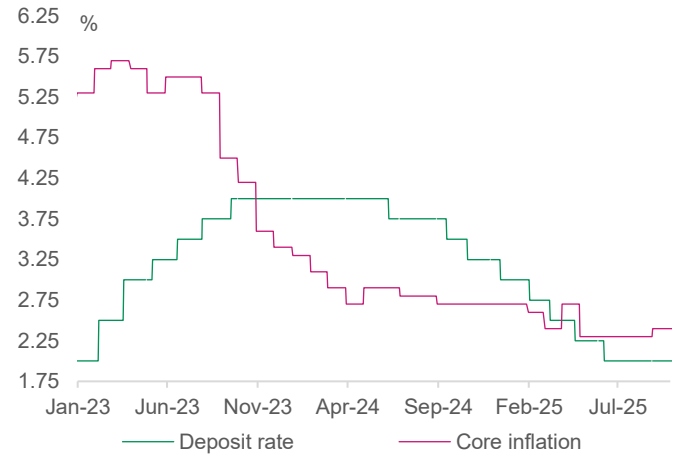


Source: ECB, Crédit Agricole CIB

Another interesting element is that the peak in core inflation remains exactly unchanged: in March 2027 (or in Q127), whatever the evolution of the gas price. Of course, it could be linked to the backwardation in the gas futures curve, but nevertheless, if core inflation declines from March 2027, then the ECB's decision to hike further could be challenged.

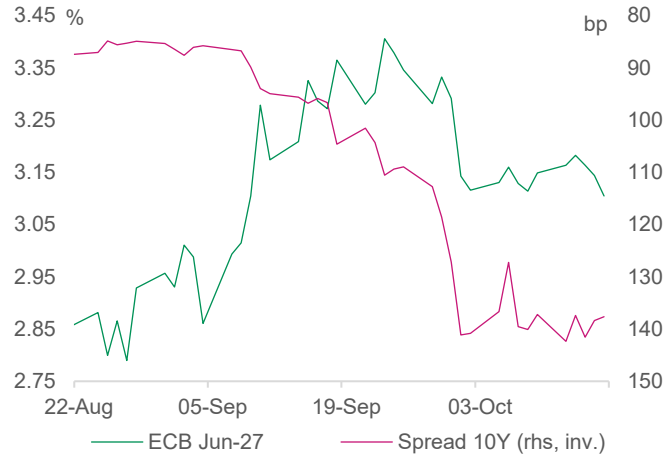
In 2023, the ECB stopped hiking slightly after core started declining; the peak for core inflation was in March 2023, the ECB hiked until September 2023. Nevertheless, the first strong decline was the September 2023 point, and core inflation was above 4% by then.

2023-24 cycle: the ECB started cutting with core inflation at 2.75%, on a declining trend



Source: Eurostat, ECB, Crédit Agricole CIB

De-pricing of the ECB's hikes and widening of the French spread



Source: Bloomberg, Crédit Agricole CIB

France

Our usual view on France is that the ECB should overlook France, and not just economically, as the ECB must look at the Eurozone as a whole. The ECB is also legally bound to not be influenced by the fiscal situation of any single country.

However, France could influence the ECB, via two channels.

1. Funding conditions: if France's developments continue widening spreads (for the sovereign, but also for private actors), it they continue triggering volatility, then it would tighten financing conditions, making the monetary stance de facto more restrictive.

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2. Economic outlook: if France were to enter into a sovereign debt crisis, then it would trigger an economic slowdown for the Eurozone as a whole. Alternatively, if France implements the fiscal policy required to improve its public finances, it will slow its economy. We will not discuss Ricardian equivalence; in the real world, fiscal consolidation has a negative impact on growth.

Recent developments in France pushed markets to significantly de-price their expectations for the ECB's hikes, from a terminal rate above 3.50% to slightly less than 3.25% currently.

The ECB's communication

The ECB's communication has remained non-committing regarding the future path of rate hikes. However, we have found – marginal – pushbacks against the recent market pricing.

At the hearing at the European Parliament, Christine Lagarde said: "we view a measures response as appropriate to keep inflation in check". Other members of the Governing Council have talked about rising rates gradually (Yannis Stournaras), whereas Pierre Wunsch talked about a "probable" future rate hike, Philip Lane about a "measured response".

Besides, most members of the governing council are highlighting that currently, there are no second round effects yet – something we totally share.

This communication – more balanced than the ECB's September press conference – has allowed markets to de-price some excessive hawkishness from the ECB.

Our new scenario

We will not rehash the entire discussion again, so we will go straight to the conclusions.

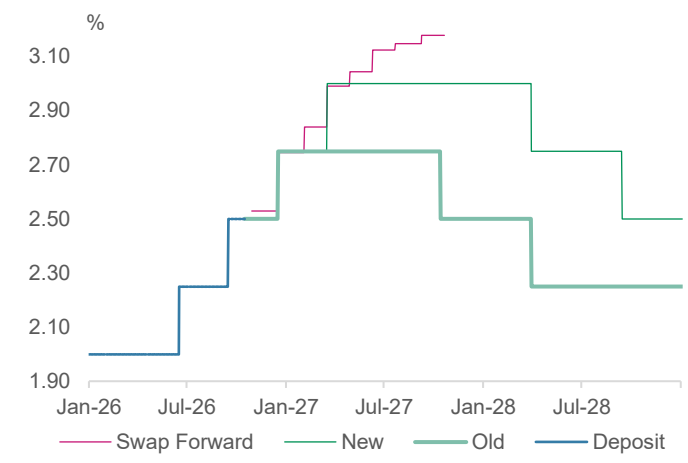
Hike to 3.0%

In our view, our new inflation forecasts warrant deposit rate hikes until 3.0%. But as things stand currently, we see no reason for the ECB to hike to 3.25%. Of course, if gas prices continue increasing, then our core inflation forecasts would change and accordingly our ECB scenario.

Besides, the ECB will unlikely hike in October – this is still a possibility, but looking at the current market pricing and the lack of pushback from central bankers, we see the probability as low. As a consequence, the ECB will implicitly confirm its pace of hikes: one per quarter since June 2026. Accordingly, the next hikes would happen in December 2026 and in March 2027.

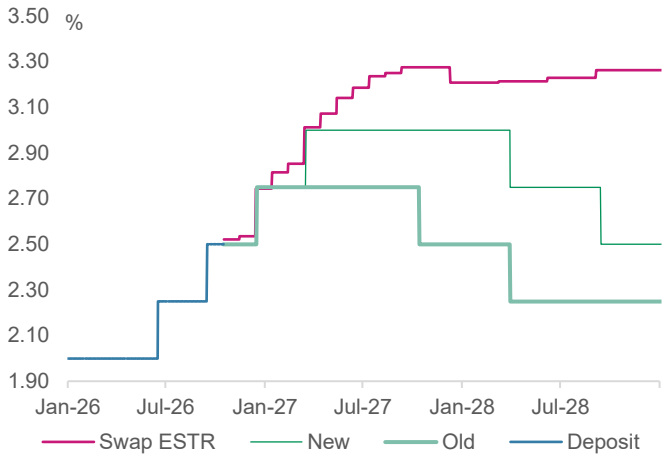
The following hike would happen in June 2027, to hike to 3.25%. In our current forecasts, core inflation in June 2027 would still be around 2.9%, but the following months would show a clear decline, not consistent with further hikes.

Our scenarios and the market pricing (swap forwards)



Source: ECB, Bloomberg, Crédit Agricole CIB

Over the longer run, swaps are not pricing any cut



Source: ECB, Bloomberg, Crédit Agricole CIB

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Cuts in Q128

As for the cuts, as our inflation team expects core inflation to stay above 2.0% until the end of the horizon projection, we expect the ECB to cut, later than previously expected (and as discussed in our last paper). We put the first cut in March 2028, and another one in September 2028.

When the ECB started cutting its rates, in June 2024, it expected core inflation to reach 2.0% in June 2026, two years later, and it expected core inflation to fall to 2.2% in June 2025, one year later.

When the ECB cut its rates below 3.0% (which would be the first cut in this cycle), core inflation was still at 2.7%, but it was expected to fall below 2.2% 12 months later.

Those considerations could encourage the ECB to cut earlier than our current expectation; however, including the discussion on the neutral rate and the fact that we do not see, in our forecasts, core inflation going back to 2.0%, we still think that the ECB could cut later than it did in the past cycle.

Risks

The key risk will remain energy prices – and this risk will remain even after this hiking cycle. Gas prices are, and will remain, the key risk to core inflation. An increase of gas prices could encourage the ECB to hike more, whereas a fall in gas prices could allow it to stop its cycle at 2.75%.

In the current situation, and in our view, the risks around our scenario are rather balanced: the probability that the ECB will stop at 2.75% is more or the less the same as the probability that it will hike to 3.25%.

Market pricing

Hikes

Until March 2027, we are more or less aligned with the current market pricing (as we have upwardly revised our call and the market has de-priced some hawkishness).

Beyond March 2027, markets expect one more hike – by around July 2027. Again, we see this pricing as too high, but 3.25% is still within the limits of what is possible.

Plateau

In terms of timing, however, we struggle to see the ECB continuing hiking its rates beyond June 2026 – barring the possibility of another upside shock on inflation (something different from the current Iran-war related shock). By June 2026, the ECB would have hiked to whatever level is required (3.00%, 3.25% or even 3.50% in an extreme scenario), and the need to hike more is really challenging. The fact that the pricing for September 2027 is higher than the pricing for June 2027 is hard to rationalise in our view. If there were to be a move from the ECB between June 2027 and the end of 2027, it would rather be a cut than a hike in our view.

Cuts

In contrast, markets are not expecting any cuts over the entire horizon – based on ESTR swap forwards or even on the swap curve. This is where we have the strongest disagreement with the current market pricing – as inflation will very likely start declining from H227, and should be below 2.50% by the end of 2027, on a downward trend, the ECB would likely start cutting its rates at some point in time.

Conclusion

With this update, we remain on the dovish side, vs the market pricing – for the first time since probably 2023. We are probably slightly hawkish vs the economists' consensus, as we have been since 2023.

In our view, the market is too hawkish with its current pricing – except if it believes that gas prices could continue increasing further, what is not expected by futures.

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As things stand today, we are quite comfortable with our current scenario, and as explained above, in our view, the ECB is just as likely to stop at 2.75% as it is to hike to 3.25%.

The key disagreement we have with the current market pricing is the absence of cuts expected by the end of 2028.

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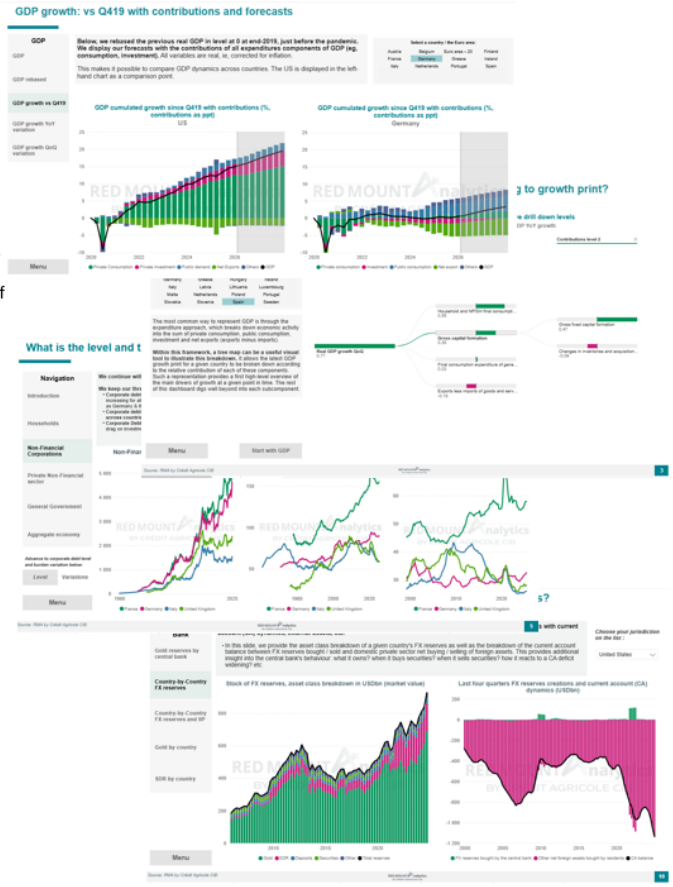
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