Week Ahead

Focus: Eurozone – Interest rates, yields, inflation and Spain

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New forecasts for the Eurozone

The economic slowdown in the euro zone in the second half of 2018 was significantly stronger than originally expected and lowered the starting position for 2019. This makes it unlikely that the economy will have gained enough momentum by autumn to trigger an initial interest rate hike by the ECB. At the same time, however, the weakness in growth can be traced back considerably to individual temporary factors, and it therefore appears likely that the economy will pick up in the coming quarters. All in all, this means for us that the first interest rate hike (deposit facility) will be postponed by six months to March 2020. The expectation of a slower rise in yields of German government bonds is also linked to this.

Uncertainty about the course of the Brexit was and is one of the factors mentioned above weighing on the economy. Our forecasts are based on the assumption that a hard brexit can be avoided. For the bond markets, this means that from the end of March a factor that is detrimental to the economy will cease to exist and should therefore brighten the outlook and with that increase yields.

The most important global issue is probably the trade war between the US and China. The outcome is particularly difficult to assess, as President Trump has far-reaching powers here. Recent reports on progress and an extension of the deadline for an agreement beyond 2 March give rise to hopes that an agreement can be concluded in the second quarter at the latest. This should boost sentiment in the markets - especially in the eurozone, where the economy was more affected by the trade jingles than the US - and thus also speaks in favour of a rise in yields.

The elimination of these political uncertainties should ultimately also be reflected in the macroeconomic indicators of the euro zone and thus slowly remove fears of a sustained massive economic slowdown from the market.

Finally, there is another factor that has an impact on our forecasts. A new long-term liquidity programme should not be decided at the forthcoming meetings of the ECB’s Governing Council. This means that banks - to whatever extent - will have to look for alternative sources of financing for the Net Stable Funding Ratio, as the maturities of the ECB's TLTROs will start to slide below one year from June. Since Italian banks have made heavy use of the TLTROs, "the disappointment" of no additional liquidity from the ECB could burden Italian and support German government bonds.

All in all, this means an ECB waiting until next year and an upwards movement in yields of German government bonds, which should be faster with the easing of political uncertainties in the second quarter but only very slow afterwards.

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Note: Past performance is not necessarily indicative of future results.

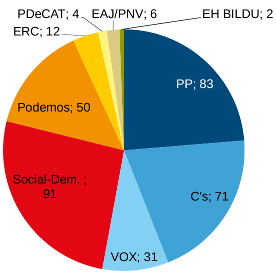
Slower growth dampens inflation

The European Commission's significantly lower GDP growth forecasts (2019e: +1.3%) dampen core inflation expectations. Lower utilisation of production factors (lower output gap) and a slower falling unemployment rate and thus lower wage pressure are delaying the build-up of domestic price pressure. For this reason, we expect core inflation to rise much less. On average, we are forecasting 1.2% for 2019. As no significant price pressure is expected from the energy component in 2019 either, we have revised our inflation forecast for 2019 from +1.7% to 1.4%. For 2020, we expect only slightly higher inflation of +1.6%.

Spain to vote on 28 April

After the fall of Prime Minister Rajoy in May last year, the socialist Sánchez formed a minority government, which since then has been dependent on the support of small parties such as the Catalan parties ERC and PDeCAT for majorities in the parliament. However, because Prime Minister Sánchez is unwilling to discuss Catalonian independence, the Catalan parties this week refused to approve Sánchez's draft budget for 2019. The situation is further aggravated by the start of the trial against the leaders of the Catalan independence movement in Madrid. The failed draft budget for 2019 sealed the end of Prime Minister Sánchez's minority government, which today called new elections for April 28.

Possible seat distribution based on current surveys

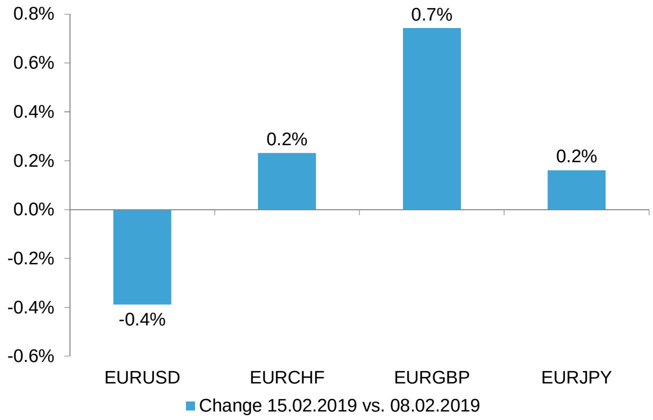


Source: electroPanel, electromania.es

The financial markets have hardly reacted to the political developments so far and Spanish risk premiums to Germany have remained largely unchanged. Given the country's above-average growth momentum (+2.1% GDP growth expected in 2019) and the clear pro-European orientation of the country's largest parties, we believe that the relaxed reaction of the financial markets is justified. However, it is possible that tension in the markets will increase during the election campaign. Based on current surveys, the right-wing conservative camp, consisting of PP (People's Party), Ciudadanos (C's, Civic Party) and VOX (right-wing populist party), which has not yet been represented in parliament, could gain a narrow majority in the new parliament. All three parties demand a centralization of competencies (above all education and health) and are united in their support for tax breaks. In view of an unchanged high structural deficit of around 3% of GDP, however, Spain has little room for tax cuts without credible counter-financing measures. Given the pro-European orientation of the PP and the Ciudadanos, we do not believe that an open confrontation with Brussels on budget issues, as recently occurred with Italy, could take place under a right-wing conservative government. However, the demand for more centralization could increase tensions with Catalonia and is therefore, in our view, the greatest factor creating uncertainty.

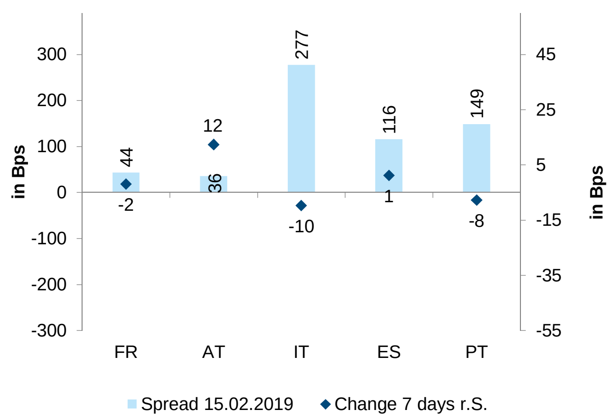
Forex and government bond markets

Exchange rates EUR: USD, CHF, GBP and JPY
Changes compared to last week



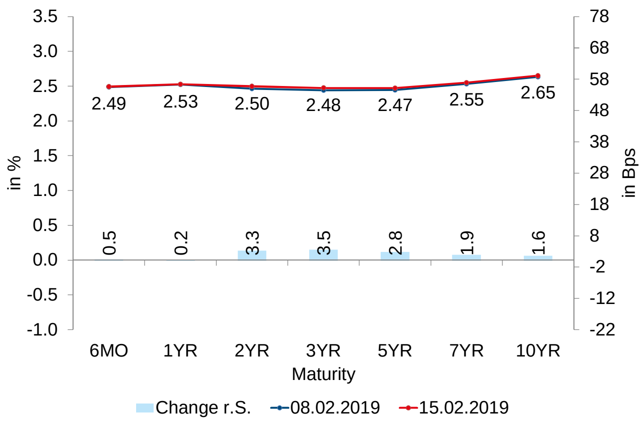
Source: Bloomberg, Erste Group Research

Eurozone spreads vs. Germany
10Y government bonds



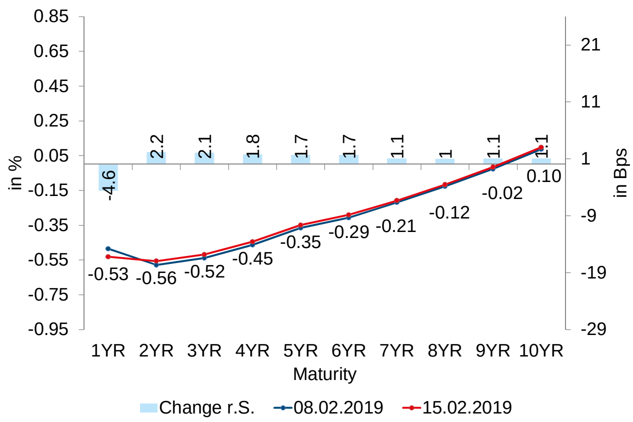
Source: Bloomberg, Erste Group Research

US Treasuries yield curve
Changes compared to last week



Source: Bloomberg, Erste Group Research

DE Bund yield curve
Changes compared to last week



Source: Bloomberg, Erste Group Research

Economic calendar

Date	Time	Ctry	Release	Period	Consens	Prior
15-Feb	**n.a.**	**CN**	**CNY new loans**	Jan	2903bn	3230bn
		CN	**M2 yoy**	Jan	8%	8%
		US	**Ind. Prod. y/y**	Jan		4.0%
	3:30	**CN**	**Inflation y/y**	Jan	1.9%	1.7%
		CN	**PPI y/y**	Jan	0.3%	0.1%
	10:00	**IT**	**Trade Balance**	Dec		3658m
	11:00	**EA**	**Trade Balance**	Dec	16m	15112m
	16:00	**US**	**Univ. Michigan Index**	Feb P	93.4 index	91.2 index
19-Feb	**10:00**	**IT**	**CA Balance (m)**	Dec		4806 m
		EA	**CA Balance (m)**	Dec		20 m
20-Feb	**8:00**	**DE**	**PPI y/y**	Jan		2.7%
	16:00	**EA**	**Consumer Conf.**	Feb A		-7.9 index
21-Feb	**8:00**	**DE**	**Inflation y/y**	Jan F		1.7%
		DE	**CPI m/m**	Jan F		-1.0%
	8:45	**FR**	**CPI m/m**	Jan F		-0.6%
		FR	**Inflation y/y**	Jan F		1.4%
	9:15	**FR**	**PMI Manufacturing**	Feb P		51.2 index
	9:30	**DE**	**PMI Manufacturing**	Feb P		49.7 index
	10:00	**IT**	**Inflation y/y**	Jan F		0.9%
		EA	**PMI Manufacturing**	Feb P	50.5 index	50.5 index
	14:30	**US**	**Durable Goods Orders**	Dec P	2.0%	0.7%
		US	**Jobless Claims**	-	224.7 thd	239.0 thd
	16:00	**US**	**Existing Home Sales**	Jan	5.0 m	5.0 m
22-Feb	**n.a.**	**AT**	**Inflation y/y**	Jan		1.7%
		AT	**CPI m/m**	Jan		0.1%
	8:00	**DE**	**GDP q/q**	4Q F	0.1%	0.0%
		DE	**GDP y/y**	4Q F	0.8%	0.6%
	11:00	**EA**	**CPI m/m**	Jan		-1.1%
		EA	**Inflation y/y**	Jan F	1.5%	1.4%

Source: Bloomberg, Erste Group Research

Forecasts[1]

GDP	2017	2018	2019	2020
Eurozone	2.4	1.8	1.3	1.4
US	2.3	2.9	2.3	2.1

Inflation	2017	2018	2019	2020
Eurozone	1.5	1.7	1.4	1.6
US	2.2	2.4	1.8	1.9

Interest rates	current	Mar.19	Jun.19	Sep.19	Dec.19
ECB MRR	0.00	0.00	0.00	0.00	0.00
3M Euribor	-0.31	-0.30	-0.30	-0.30	-0.30
Germany Govt. 10Y	0.11	0.30	0.60	0.70	0.80
Swap 10Y	0.66	0.60	0.90	1.00	1.10

Interest rates	current	Mar.19	Jun.19	Sep.19	Dec.19
Fed Funds Target Rate*	2.40	2.38	2.63	2.88	3.13
3M Libor	2.68	2.70	2.90	3.20	3.40
US Govt. 10Y	2.65	2.90	3.00	3.20	3.30
EURUSD	1.13	1.11	1.12	1.14	1.16

*Mid of target range

In case of changes to our forecasts compared to the previous issue, arrows show the direction of the change.
Source: Bloomberg, Erste Group Research

[1] Note: In accordance with regulations, we are obliged to issue the following statement: Forecasts are not a reliable indicator of future performance.

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