Week Ahead

Focus: ECB Council meeting, EU Recovery Fund

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ECB to take next step

The ECB's Governing Council is to meet next week. We expect the PEPP purchasing program to be increased by EUR 500bn. While the Governing Council is under no pressure to make this decision, the ECB economists' new forecasts provide a good reason to make a decision as early as next week, which the market expects.

Indeed, there is no hurry to increase the PEPP program. Therefore, should the Council, contrary to our expectations, decide to postpone the decision, there will still be enough time. In April, the ECB bought EUR 103bn in securities under the PEPP program, which, together with March, amounted to just under EUR 120bn. Even if the figure were the same in May, the ECB would still have more than EUR 500bn left, and the pressure to intervene on the markets is likely to decrease. This means that the ECB would probably get through until October. However, the central bank will want to signal its fact-based approach and the new forecasts of the ECB economists could not signal anything other than a further massive delay in achieving the inflation target. This would justify a further easing of monetary policy. We also expect the minimum duration of the PEPP program to be extended until mid-2021. This will also signal to the markets the ECB's intention to continue to support weak national borrowers beyond 2020 and provide funds to finance the EU's EUR 750bn recovery fund presented this week. While the nature and distribution of the "Next Generation EU" funds will still entail months of negotiations, there is no doubt that massive funding will be required in the future.

At the press conference, President Lagarde will emphasize, as she did in April, the flexibility of the PEPP purchase program, thereby signaling that the ECB can react accordingly should a (government) issuer or class of issuers come under pressure.

In addition to monetary policy measures, however, the press conference will focus on a second topic. At the beginning of May, the German Federal Constitutional Court ruled that the Bundesbank's purchases of German sovereign bonds within the framework of the ECB's APP program violated the German constitution, as the weighing up of the pros and cons had not been sufficient. The German government now has until the beginning of August to obtain and deliver this consideration from the ECB. That sounds easier than it is, as the ECB is independent, does not have to justify itself to any government, and is only subject to the jurisdiction of the European Court of Justice, which has confirmed the securities purchases at the end of 2018 as legal. So, the question is how the ECB can meet the requirements of the German Constitutional Court or the German Federal Government without submitting to its authority. A succinct reference to the ECB's home page, where a wealth of analysis is available, will probably not be sufficient. At the press conference, Lagarde will probably have to find a way to keep her mind

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open to the German demands without, however, damaging the independence of the ECB or even fueling the conflict.

If no satisfactory solution to the conflict can be found by the beginning of August, the Bundesbank would no longer be able to participate in the securities purchases, which would above all be a loss of confidence in the foundations of monetary union. However, if we look just at the volume of purchases affected, the effects are likely to be minor. This is because the ruling only affects the APP program, which currently has a monthly volume of only EUR 20bn, and of which only German government bonds are affected. During the first few months of this year, German Bunds were bought up by an average of EUR 1.5bn per month, which is an almost negligible amount, given the size of this market and the measures taken by the ECB in total. However, in the event of such an outcome, the Bundesbank would probably also be obliged to slowly reduce its holdings of Bunds. The ECB's PEPP program is not affected by the ruling of the Federal Constitutional Court.

EU – Recovery Fund: crisis as opportunity!

Following the mobilization of EUR 540bn on the European level for immediate crisis management, the EC this week presented details of a European recovery fund. The 'Next Generation EU' fund with a total volume of EUR 750bn is to be mainly used in a targeted manner to support reforms and investments in ecological and digital change. The funds are to be made available to Member States between 2021 and 2024. To finance the fund, the EU intends to place long-term bonds (maturities 2027-2058) on the capital market. In the short term, an increase in the EU's own resources ceiling should serve as a security for the capital market. In the long term, the bonds are to be repaid via new taxes (among others, a CO2 border tax and digital tax). Since the EU is by the most important rating agencies predominantly rated with the highest credit rating, it should be possible to place the bonds at very attractive conditions.

The EU Commission's proposal is intended as a response to the justified concern that the coronavirus crisis could widen the differences in prosperity between the countries and regions of the EU. As a result, a substantial part of the funding (EUR 500bn) is intended to be given in the form of grants; moreover, the distribution of the funds is linked to a key that strongly favors regions with lower levels of prosperity and high unemployment. Accordingly, Italy, Spain, Portugal and Greece in particular would benefit disproportionately from this recovery fund.

Until autumn, there will be a tough struggle between the EU states over the final modalities of the fund. In particular, the question of what proportion of the funds will be granted in the form of subsidies and also the calculation key for distribution. From the point of view of the Eurozone, the fund is to be welcomed, because it should improve the medium-term growth prospects of structurally weak regions (especially in Italy and Spain). By increasing prosperity, far-right and far-left parties that often call into question the cohesion of the Economic and Monetary Union should be deprived of their breeding ground. In this way, the fund can be an important factor in the political stabilization of the Eurozone in the medium term. A stable Eurozone can raise capital on the global financial markets more easily and under favorable terms. This in turn would have an additional positive effect on the growth prospects of the Eurozone.

Economic calendar

Ctry	Date	Time	Release	Period	Consens	Prior
Eurozone						
FR	1-Jun	9:50	PMI Index	May F	40.6 Index	40.3 Index
IT	1-Jun	9:45	PMI Index	May	34.5 Index	31.1 Index
DE	1-Jun	9:55	PMI Index	May F	36.9 Index	36.8 Index
EA	1-Jun	10:00	PMI Index	May F	39.6 Index	39.5 Index
USA						
	1-Jun	16:00	PMI Index	May	43.1 Index	41.5 Index
	3-Jun	14:15	ADP Employment	May	-9691.7 Tsd	-20236.1 Tsd
	5-Jun	14:30	Wages y/y	May	8.7%	7.9%
	5-Jun	14:30	Unempl. Rate	May	19.5%	14.7%
	5-Jun	14:30	Chg. Non-Farm Payrolls	May	-7846.1 Tsd	-20537.0 Tsd
China						
	1-Jun	3:45	PMI Index	May	49.7 Index	49.4 Index

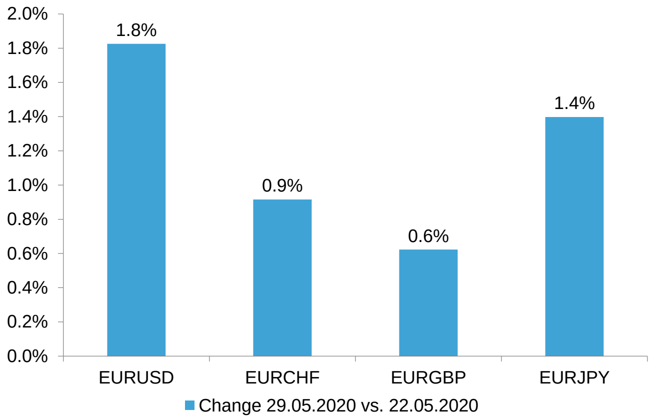
Central bank events

	Date	Time	Event
ECB	4-Jun	13:45	Publication of monetary policy decisions
	4-Jun	14:30	Christine Lagarde, press conference after the Governing Council meeting, Frankfurt
Fed			No monetary policy relevant events

Source: Market Data Provider, ECB, Federal Reserve, Erste Group Research

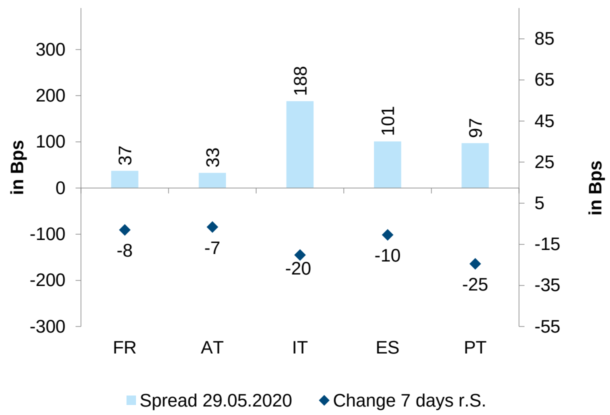
Forex and government bond markets

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



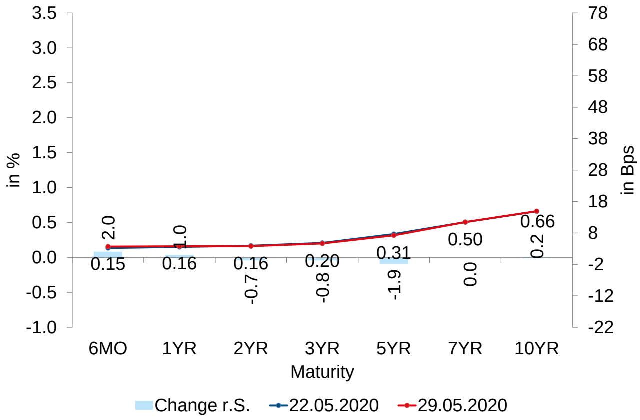
Source: Market Data Provider, Erste Group Research

Eurozone spreads vs. Germany
10Y government bonds



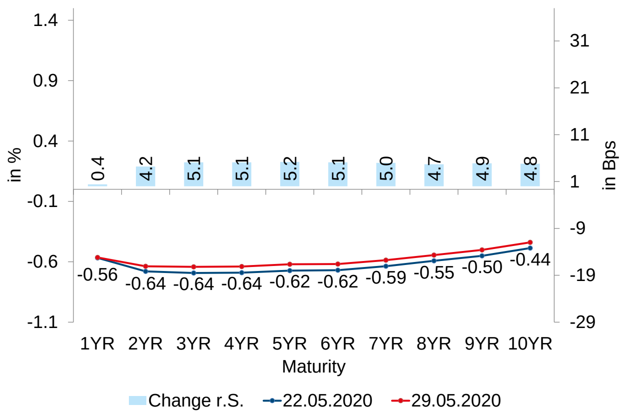
Source: Market Data Provider, Erste Group Research

US Treasuries yield curve
Changes compared to last week



Source: Market Data Provider, Erste Group Research

DE Bund yield curve
Changes compared to last week



Source: Market Data Provider, Erste Group Research

Forecasts[1]

GDP	2018	2019	2020	2021
Eurozone	1.9	1.2	-4.7	3.9
US	2.9	2.3	-5.5	5.4

Inflation	2018	2019	2020	2021
Eurozone	1.7	1.2	0.3	1.2
US	2.4	1.8	0.7	2.0

Interest rates	current	Jun.20	Sep.20	Dec.20	Mar.21
ECB MRR	0.00	0.00	0.00	0.00	0.00
3M Euribor	-0.29	-0.40	-0.40	-0.40	-0.40
Germany Govt. 10Y	-0.44	-0.50	-0.40	-0.20	-0.10
Swap 10Y	-0.13	-0.20	-0.10	0.10	0.20

Interest rates	current	Jun.20	Sep.20	Dec.20	Mar.21
Fed Funds Target Rate*	0.05	0.13	0.13	0.13	0.13
3M Libor	0.36	0.40	0.40	0.40	0.40
US Govt. 10Y	0.66	0.70	0.80	1.00	1.10
EURUSD	1.11	1.10 ↑	1.10	1.10	1.12

*Mid of target range

In case of changes to our forecasts compared to the previous issue, arrows show the direction of the change.
Source: Market Data Provider, 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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