Week ahead

Euroarea – Inflation set to increase in October
US – FOMC should leave interest rates unchanged next week
ECB – How much monetary policy support does the improved environment need?

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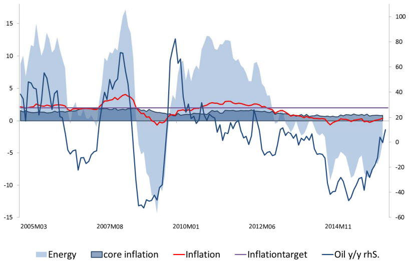
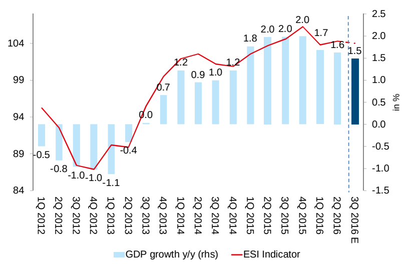
Eurozone Inflation vs. Oilprice



Source: Eurostat, Bloomberg, Erste Group Research

Eurozone GDP-growth vs. ESI-indicator



Source: Eurostat, EC, Erste Group Research

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Euro area – headline inflation expected to increase to 0.6% y/y in October

On October 31, the first inflation (HICP) flash estimate for October will be released. We expect an increase from 0.4% y/y reported in September to 0.6% y/y in October. The oil price, which is a crucial driver of the energy component, trades at a higher level compared to October of last year. As a result of this, for the first time this year the annual rate of change in the oil price is clearly positive, which should be reflected in an increase in the energy component (rising energy prices). The core inflation rate responds more sluggishly, as it does not contain the energy component and we therefore estimate it to remain at a low level of slightly below 1% y/y. Apart from a slightly rising oil price, the weak euro has an impact on the trend in the inflation rate as well. In the short term it drives up import prices. In the medium term the weaker euro is making exports more affordable, which supports the export sector and with that economic growth.

*The economic recovery we expect is the reason we are forecasting a **moderate increase in the core inflation rate**. We are forecasting core inflation to rise slightly to 1.3% on average in 2017. In combination with the uptrend in oil prices we anticipate an **increase in headline inflation to 1.5% - 1.6% y/y on average in 2017**.*

Euroarea: 3Q 2016 GDP growth expected at 1.5% y/y

Next week (Oct. 31), a first 3Q16 GDP flash estimate for the euro zone will be released. In 2Q16, growth of the Eurozone (1.6% y/y) cooled slightly. Consumption as well as investments lost some of their momentum and foreign trade continued to weigh on growth.

*Based on leading indicators, **we expect a further slight slowdown in growth in the euro zone in 3Q16 to 1.5% y/y**. Economic sentiment suffered especially in July and August from the Brexit vote, but has recovered markedly since September. For 2016 as a whole, we continue to expect GDP growth of 1.5%.*

We expect further hints regarding a US rate hike in December

At the meeting of the Federal Open Market Committee (FOMC) next week we don't expect any change in policy rates. There will be no press conference by Fed chair Janet Yellen after the upcoming meeting. This is no reason to rule out a rate hike, but in conjunction with economic data releases in recent weeks which haven't increased the pressure to act and a generally cautious FOMC, it suggests all in all that the next rate hike will likely be implemented in December. At its last meeting the FOMC stated that it wanted to wait for additional evidence indicating progress toward achieving its goals. Since then the data have by and large shown that existing trends are continuing. Economic growth appears to have accelerated in the third quarter compared to the second quarter. Payrolls grew at approximately the same pace in September as in the previous month. While this represented a slowdown in jobs growth compared to June and July, it is still sufficient to trigger a decline in the unemployment rate over the medium term. However, the unemployment rate has failed to decline lately, which at least some FOMC members should regard as evidence for additional slack in the labor market. This removes pressure from the FOMC to take immediate action. Thus we expect that the wording of the FOMC statement will be slightly more hawkish, so as to reinforce expectations regarding a December rate hike. This should have fairly little effect, since the federal funds futures market is already pricing in a very high rate hike probability. Looking beyond the short term factors currently determining US monetary policy, we regard the level of policy interest rates as too low for the current stage of the business cycle. With full employment achieved and the federal funds rate only slightly above zero there is considerable risk of a surprise surge in inflation, which would force the markets to abruptly adjust their interest expectations.

A wide range of decisions is possible for the ECB Council in December

In the wake of the meeting of the ECB Council last week, the future course of monetary policy remains uncertain. Once again a decision over the fate of the securities purchase program has been postponed. It was announced though that a decision would be taken in December, in conjunction with possible changes to the program's specifications.

Mario Draghi confirmed in his statements that the ECB would maintain its extremely loose monetary policy beyond March 2017. Draghi referred to hitherto not detectable signs of a revival in inflation apart from energy prices and emphasized that he and the ECB Council were looking for a lasting, self-sustaining increase in the pace of inflation.

It has never been in doubt that the ECB's extremely accommodative monetary policy would continue beyond March 2017. The question is though, what is really meant by substantial amount of monetary support, as the ECB puts it? This can mean many things. The possibilities range from an extension of the purchases at their full current size, to a gradual tapering of the purchases beginning March, as well as possibly the adaptation of other existing programs (TLTRO). In addition to this, the purchase program's specifications have to be changed. These changes will obviously have to be consistent with the ECB Council's medium term intentions with respect to monetary policy.

It is therefore highly uncertain what decision the ECB Council will take in December. It could well be that Draghi failed to provide clear guidance regarding the future course of monetary policy because the opinion-forming process within the Council hasn't officially concluded yet. Draghi mentioned that changes to monetary policy and with that the potential extension of the duration of the asset purchase program were not even discussed at the meeting.

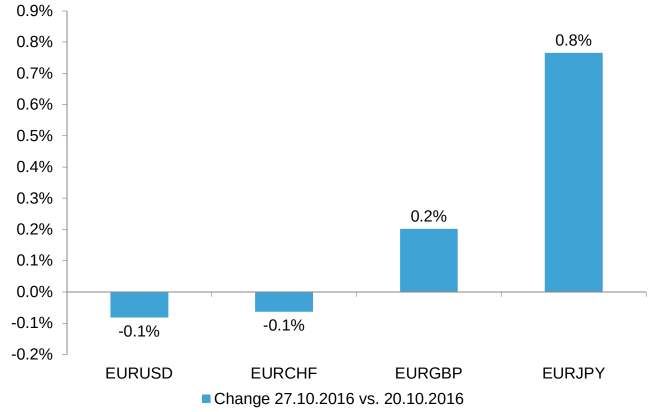
This should change at the December meeting though. The Council will have to take into account a plethora of factors on that occasion.

Undoubtedly progress toward achieving price stability (an inflation rate close to, but below 2%) – and this is clear from Draghi's statements – is exceedingly slow. At the same time, it has to be questioned whether an improved economic environment justifies the same extent of monetary policy support as a weaker one. And the environment has improved. The economy has held up well in the course of the year despite facing headwinds (China, Brexit referendum), inflation is set to increase, and the risk of second round effects on prices due to low oil prices has disappeared. ECB economists are highly likely to raise their inflation forecasts for coming years, as a higher oil price and a weaker euro exchange rate enter into their analysis (prices in early November will be decisive in this context). Moreover, the Council has to take into account that as the combination of negative interest rates and securities purchases continues, the pressure on banks keeps growing, which could potentially have a negative impact on credit availability. In addition to this, the available supply of securities in the bond markets will - sooner or later - inevitably place limits on what is possible in terms of asset purchases.

Up until the press conference our assumption was that a gradual reduction in the ECB's securities purchases would begin in April, with the program concluding in the fall. Draghi's recent statements, particularly with respect to the trend in inflation, have however increased the probability that the ECB will adopt a more cautious approach. The ECB might for example stretch out the tapering process over an entire year, or decrease the volume of its monthly purchases in an initial step, but subsequently leave it unchanged for the time being. What we continue to regard as unlikely is that the purchases will be extended by six months at their full size of EUR 80 bn. per month. This appears to be the opinion of a majority of market participants though, which should eventually be adjusted. We therefore continue to expect an increase in bond yields, although we are revising our yield forecast slightly downward in light of the shift in risks. The eventual bond market correction could be quite jarring, considering very high starting levels and the one-sided positioning of market participants.

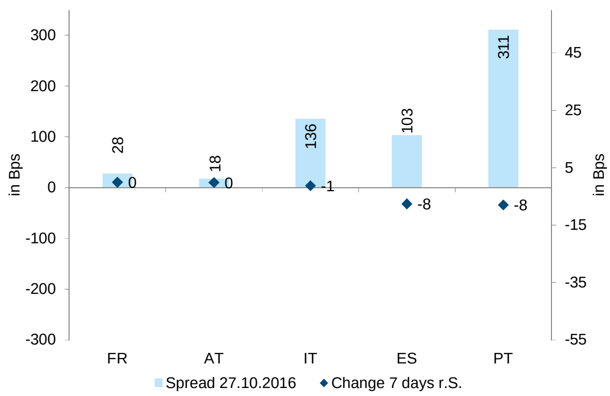
Forex and government bond markets

Exchange rates EUR: USD, CHF, GBP and JPY
change last week
(+ stronger euro / - weaker euro)



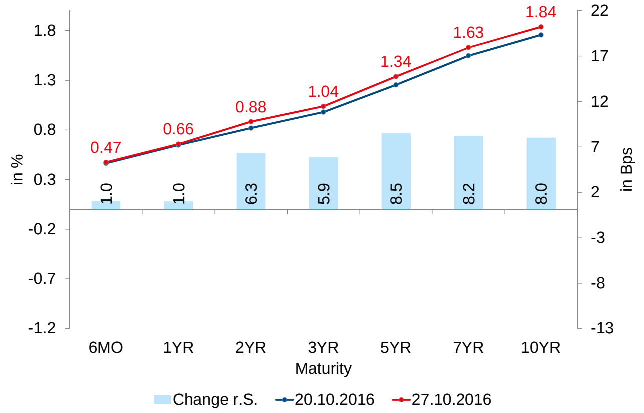
Source: Bloomberg, Erste Group Research

Eurozone – spreads vs. Germany
10Y government bonds



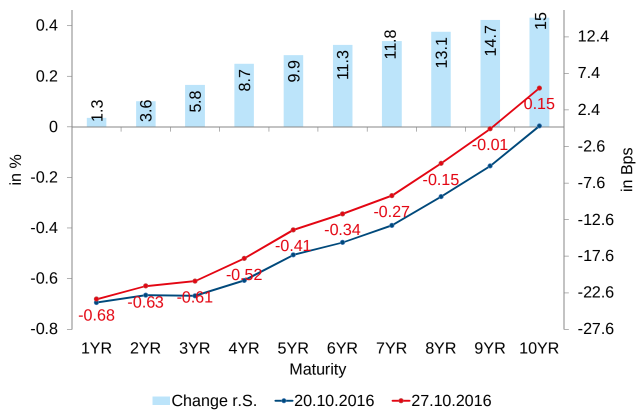
Source: Bloomberg, Erste Group Research

US Treasuries yield curve
change last week



Source: Bloomberg, Erste Group Research

DE Bund yield curve
change last week



Source: Bloomberg, Erste Group Research

Economic calendar

Date	Time	Ctry	Release	Period	Consens	Prior
28-Oct	7:30	FR	GDP y/y	3Q A	1.2%	1.3%
		FR	GDP q/q	3Q A	0.3%	-0.1%
	8:45	FR	CPI m/m	Oct P	0.2%	-0.2%
		FR	PPI y/y	Sep		-2.0%
		FR	Inflation y/y	Oct P	0.6%	0.5%
	9:00	AT	PPI y/y	Sep		-1.8%
		AT	GDP q/q	3Q		0.3%
		AT	GDP y/y	3Q		1.2%
	10:00	AT	PMI Manufacturing	Oct		53.5index
	11:00	EA	Consumer Conf.	Oct F	-7.0index	-8.0index
		EA	Business Conf.	Oct	104.8index	104.9index
	14:00	DE	Inflation y/y	Oct P	0.6%	0.5%
		DE	CPI m/m	Oct P	0.1%	0.0%
	14:30	US	GDP q/q	3Q A	2.5%	1.4%
	16:00	US	Univ. Michigan Index	Oct F	88.4index	87.9index
31-Oct	n.a.	DE	Retail Sales y/y	Sep	2.1%	3.7%
	11:00	IT	Inflation y/y	Oct P		0.1%
		EA	GDP q/q	3Q A		0.3%
		IT	CPI m/m	Oct P		1.9%
		EA	GDP y/y	3Q A		1.6%
	12:00	IT	PPI y/y	Sep		-1.1%
	13:30	US	PCE Deflator	Sep	1.3%	1.0%
1-Nov	3:45	CN	PMI Manufacturing	Oct	50.1index	50.1index
	15:00	US	PMI Manufacturing	Oct	51.6index	51.5index
2-Nov	9:500	FR	PMI Manufacturing	Oct F	50.0index	51.3index
	9:45	IT	PMI Manufacturing	Oct F		51.0index
	9:55	DE	PMI Manufacturing	Oct F	54.3index	55.1index
	10:00	EA	PMI Manufacturing	Oct F		53.3index
	13:15	US	ADP Employment	Oct	158.5thd	154.0thd
	19:00	US	Target Rate	-	0.50%	0.50%
3-Nov	11:00	EA	Unempl. Rate	Sep		10.1%
	15:00	US	ISM Non-Manufacturing	Oct	56.2index	57.1index
4-Nov	11:00	EA	PPI y/y	Sep		-2.1%
	13:30	US	Wages y/y	Oct	2.6%	2.6%
		US	Trade Balance	Sep	-42m	-41m
	13:30	US	Unempl. Rate	Oct	4.9%	5.0%
	13:30	US	Chg. Non-Farm Payrolls	Oct	168.1thd	156.0thd

Source: Bloomberg, Erste Group Research

FORECASTS[1])

GDP	2013	2014	2015	2016	2017
Eurozone	-0.2	1.1	1.9	1.5	1.7
US	1.9	2.4	2.4	1.7	1.9

Inflation	2013	2014	2015	2016	2017
Eurozone	1.3	0.5	0.1	0.3	1.5
US	1.5	1.6	0.1	1.3	1.9

	current	Dec.16	Mar.17	Jun.17	Sep.17
ECB MRR	0.00	0.00	0.00	0.00	0.00
3M Euribor	-0.31	-0.30	-0.30	-0.25	-0.03
Germany Govt. 10Y	0.17	0.30	0.50	0.80	0.80
Swap 10Y	0.51	0.60	0.80	1.10	1.10

	current	Dec.16	Mar.17	Jun.17	Sep.17
Fed Funds Target Rate*	0.41	0.63	0.88	1.13	1.38
3M Libor	0.89	0.94	1.19	1.44	1.70
US Govt. 10Y	1.85	2.10	2.30	2.60	2.70
EURUSD	1.09	1.10	1.12	1.14	1.16

*Mid of target range

	current	Dec.16	Mar.17	Jun.17	Sep.17
Austria 10Y	0.35	0.50	0.70	1.00	1.00
Spread AT - DE	0.18	0.20	0.20	0.20	0.20

Source: Bloomberg, Erste Group Research

[1] By regulations we are obliged to issue the following statement: Forecasts are no reliable indicator for future performance

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