

Week ahead

ECB – How much more?

EZ – Will high spirits seen in industry last in October?

Italy – Elections as early as March 2018?

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ECB decision next week will determine Eurozone bond markets for foreseeable future

Next week, a huge event is scheduled for financial markets. On Thursday, the ECB Council is set to decide on how to proceed with the central bank's asset purchase program next year. Conceivably, not all related questions might be answered and details may be announced only at the meeting in December. However, **the main parameters of the purchase program as of January 2018** should be set next week.

Generally, there is great uncertainty over what the changes might be. Only the reduction of monthly purchases from the current EUR 60bn in the course of next year has a degree of certainty. However, the question at what pace the ECB plans to proceed is open. In this regard, the ECB has multiple options concerning the start date, the pace of reduction and thus the end of the purchases. Regarding the latter, the question arises whether the ECB Council will commit to an end date in advance, or if it will only decide on a first reduction and keep further steps open.

So far, there have hardly been any hints as to what direction the ECB Council is leaning on all these specifications. This may be due to the fact that opinions are quite diverse within the committee. It seems almost certain to us that the ECB Council will not set a fixed termination date for the purchases. Were it to do so, the Council would lose its scope of action, without winning much with this action. Conversely, there is **great uncertainty concerning the pace of reduction**. Statements from important representatives of the central bank, among them President Draghi, indicate a rather slower proceeding. It was highlighted repeatedly that the progress of inflation towards a durable and self-sustained convergence to the ECB's target has not yet been sufficiently convincing.

*We currently assume that the monthly purchases will remain unchanged until next March and then will be reduced to EUR 40bn. The ECB will try to signal their determination to still maintain support by way of monetary policy until inflation approaches the requirements of durability and self-sustainability. A first smaller reduction in the amount of EUR 10bn monthly already in January seems possible as well. The average market expectation, which is a reduction to EUR 40bn monthly, starting already in January, according to a survey by Reuters, **seems rather unlikely, in our view**. We expect purchases totaling EUR 360bn next year and seem to be above market expectations in this regard, although there is no specific data available and variation among estimates seems to be high.*

*Only if the ECB overshoots this value significantly, and hence plans to purchase more, would we have to change our forecast of rising yields of German government bonds. We think that the foreseeable **start of the reduction of purchases will be the actual impulse for a rise in yields***

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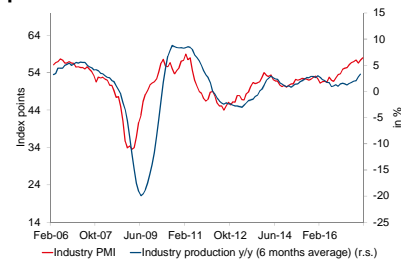
Indications of past performance are no guarantee of a positive performance in the future

and only secondarily the pace.

Aside from all these decisions, the ECB might also change some current specifications of the purchase program, as it might be getting more and more difficult to meet the required volumes in the current circumstances. Higher shares of so-called supranational issuers as well as more flexible management of the distribution among Eurozone countries or an increase of emission limits are conceivable.

EZ – Slight decline in industry sentiment expected for October

EZ – manufacturing-PMI vs. industry production



Source: Bloomberg, Erste Group Research

Next week (October 24), the first flash estimate for October's manufacturing-PMI data will be released for Germany, France and the Eurozone. In September, sentiment continued to rise against expectations and even climbed to a 6½ year high, reflecting the Eurozone's strong economic dynamics. Germany, the Netherlands and Austria are presently the leaders in sentiment ranking. A clear upturn in sentiment was recorded even in France and Italy. The continued sentiment improvement in September was mainly driven by domestic demand within Europe. In addition, the favorable global environment was a decisive factor.

In light of the multiannual highs reached in September, we expect sentiment to cool somewhat in October. Nevertheless, the outlook for the Eurozone economy remains good. In our assessment, it is of crucial importance that the ongoing upswing has also entered France and Italy. In terms of growth, both countries were significantly below the Eurozone average for several years for structural reasons. Due to the French government's ambitious reform agenda, there is currently a good chance that France might be able to fix some of its structural deficiencies. The French government stands on the threshold of passing comprehensive reform of the labor market (targeting a lasting decrease in structural unemployment; comprehensive reforms in the area of education and training are also planned) as well as tax law. This is a very timely moment for reforms, as the government has the budgetary scope for action due to the cyclical upswing. If France continues its reform-oriented path, the chances are increasing that French potential growth will rise. This should also affect the Eurozone's growth potential (currently approx. 1.2% according to estimates by the European Commission) positively. In contrast, we expect no substantial reforms for the moment in Italy, due to the lack of a government capable of action as well as with elections on the horizon, probably for spring of 2018. Thus, Italy's sustainable growth prospects remain limited in our assessment. Nevertheless, the Italian economy will benefit from the current cyclical upswing as well. Based on the present leading indicators, we expect sustained high GDP growth of around +2.1% y/y for the Eurozone in 4Q17.

Italy – Parliament passes reform of electoral law, (almost) paves way for new elections

Last week, Italy's Parliament approved a reform of the electoral law (so-called 'Rosatellum'). The new law is a mixture of proportional and majority voting systems and favors parties that have already made alliances ahead of the elections. Since the protest party **5-star-movement** refuses to make any alliances with existing parties, the **new electoral law diminishes its chances of success**. Currently, the 5-star-movement leads the polls in a neck-and-neck race with the Socialist Party of current Prime Minister Gentiloni. The new law still needs to pass the second chamber of the Italian parliament – the Senate. Once this is achieved,

Italy's President Mattarella could dissolve the Parliament at the end of December 2017 and thus pave the way for new elections already in early March 2018, according to media reports,

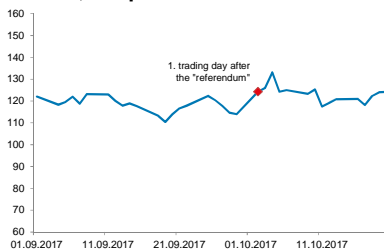
*The markets **reacted positively to the news** and risk premiums of Italian government bonds declined slightly, as the chances of the euro-critical Five Star Movement forming a government worsened. Elections in March next year would also mean the start of campaigning relatively soon. The Five Star Movement is not the only political party discussing the euro. Some representatives of Forza Italia and Lega Nord have brought up the issue of a parallel currency in Italy next to the euro. This discussion could heat up in the coming campaign and the markets **might become concerned.***

Spanish government to trigger Article 155

It was of little surprise that the conflict between the Spanish and the Catalan governments escalated this week. The Catalan head of government, President Puigdemont, refused to clarify the current status of Catalonia and to explicitly revoke any declaration of independence. The consequence will be that the Spanish government will trigger procedures under Article 155 of the Spanish constitution on Saturday. Puigdemont even threatened to explicitly declare independence if the central government does not engage in negotiations. Article 155 foresees the partial or complete handover of control from the local to the central government. Before implementation, the Spanish senate will debate the proposals of the government, which are highly likely to pass a vote to be held by the end of next week. If by then the parties involved have not agreed to negotiate, the Spanish government will have to find the right dosage in which to implement the measures. Any escalation, as on the day of the "referendum", would clearly **play into the hands of the separatists.**

*We consider any segregation of Catalonia from Spain as highly unlikely, but do expect the conflict to heat up temporarily in the coming weeks. Early elections in Catalonia as part of the measures imposed through Article 155 look sensible, but are likely to meet resistance from the separatists. Accordingly, we see a high probability that **risk premiums of Spanish securities could rise in the coming weeks.** The probability is even greater because the markets have currently hardly priced in any heightened risks.*

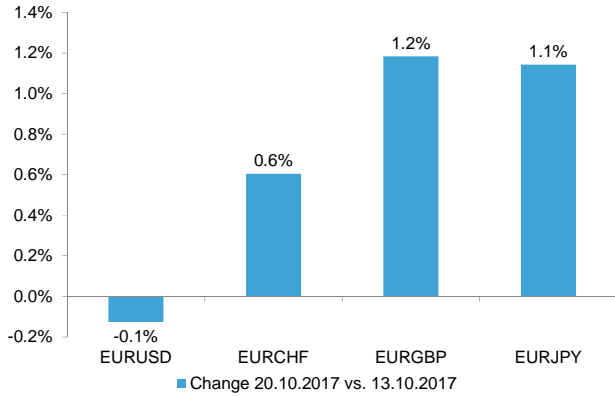
Spread of 10y Spanish Govt. over German, in bps



Source: Bloomberg, Erste Group Research

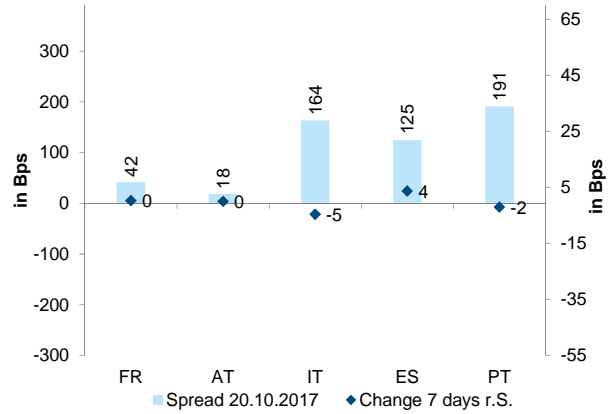
Forex and government bond markets

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



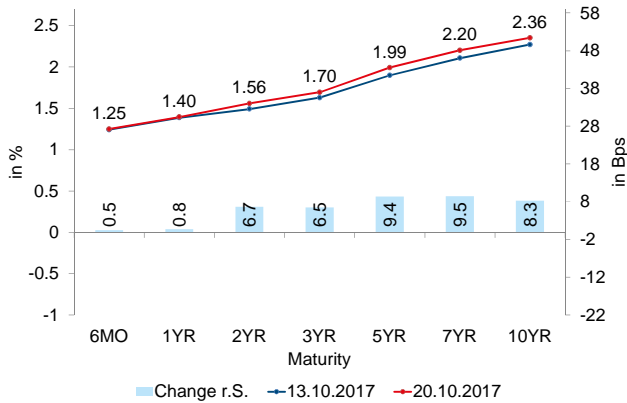
Source: Bloomberg, Erste Group Research

Eurozone – spreads vs. Germany
10Y government bonds



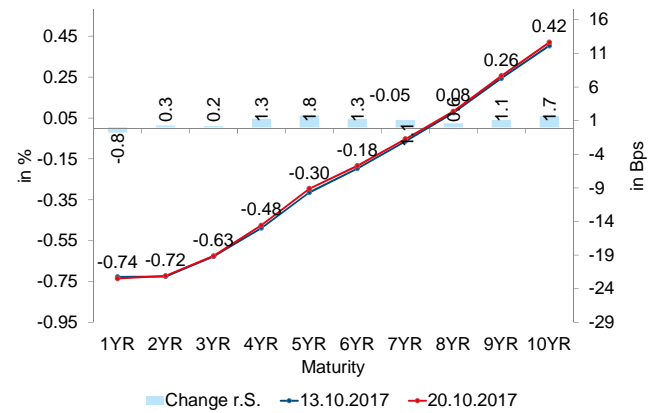
Source: Bloomberg, Erste Group Research

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
20-Oct	8:00	DE	PPI y/y	Sep	2.9%	3.1%
	10:00	IT	CA Balance (m)	Aug		8625 m
		EA	CA Balance (m)	Aug		25 m
	16:00	US	Existing Home Sales	Sep	5.3 m	5.4 m
23-Oct	16:00	EA	Consumer Conf.	Oct A	-1.0 index	-1.2 index
24-Oct	9:00	FR	PMI Manufacturing	Oct P		56.1 index
	9:30	DE	PMI Manufacturing	Oct P	60.1 index	60.6 index
	10:00	EA	PMI Manufacturing	Oct P	57.8 index	58.1 index
25-Oct	9:00	AT	Ind. Prod. y/y	Aug		5.7%
	14:30	US	Durable Goods Orders	Sep P	1.5%	2.0%
	16:00	US	New Home Sales	Sep	554.1 thd	560.0 thd
26-Oct	13:45	EA	Target Rate (lending)	-	-0.40%	-0.40%
		EA	Target Rate	-	-1.7 index	0.00%
	14:30	US	Jobless Claims	Oct 21	241.2 thd	222.0 thd
27-Oct	n.a.	DE	Retail Sales y/y	Sep	3.2%	2.8%
	14:30	US	GDP q/q	3Q A	2.5%	3.1%
	16:00	US	Univ. Michigan Index	Oct F	100.2 index	101.1 index

Source: Bloomberg, Erste Group Research

FORECASTS¹⁾

GDP	2014	2015	2016	2017	2018
Eurozone	1.2	2.0	1.8	2.0	1.8
US	2.6	2.9	1.5	2.1	2.2

Inflation	2014	2015	2016	2017	2018
Eurozone	0.5	0.1	0.2	1.5	1.5
US	1.6	0.1	1.2	2.1	1.9

Interest rates	current	Dec.17	Mar.18	Jun.18	Sep.18
ECB MRR	0.00	0.00	0.00	0.00	0.00
3M Euribor	-0.33	-0.30	-0.30	-0.30	-0.30
Germany Govt. 10Y	0.42	0.70	1.00	1.20	1.30
Swap 10Y	0.88	1.00	1.30	1.50	1.60

Interest rates	current	Dec.17	Mar.18	Jun.18	Sep.18
Fed Funds Target Rate*	1.16	1.38	1.63	1.88	2.13
3M Libor	1.36	1.70	1.90	2.20	2.40
US Govt. 10Y	2.35	2.50	2.80	2.90	3.00
EURUSD	1.18	1.15	1.13	1.14	1.16

*Mid of target range

Source: Bloomberg, Erste Group Research

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

Erste Group Research

Week ahead | Macro, Fixed Income | Eurozone, USA

20 October 2017

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