07 December 2018

ECB Preview

A new chapter of dovish tightening

- The new reinvestment strategy could be the most interesting part of next week's ECB meeting, when a formal announcement about the end of the net asset purchases is set to be made.
- Although the stakes are high at the meeting, we expect Draghi to try to be as 'dull' as possible in order not to move the markets.
- Growth assessment as well as new forecasts (including 2021) will be closely monitored. We will pay close attention to the wage growth assessment.
- Given the current dovish market pricing we have a hard time seeing how the ECB can deliver a message that would lead to a dovish market reaction.

In conclusion:

We expect Draghi to repeat his 'glass half full' message, thereby acknowledging that economic developments are broadly on track. Therefore, despite a (on paper) hawkish policy move of ending the net asset purchases, we expect a dovish tightening as a confirmation and reassurance of an accommodative monetary policy stance going forward. We expect no new guidance on a first rate hike.

We also expect Draghi to voice concerns about the growth outlook but to still keep the broadly balanced risk assessment, which in our view is needed to end the asset purchase programme (APP). We expect a cautiously optimistic tone from Draghi on the (core) inflation, but a relative upbeat and confident wording on the wage growth developments.

Danske Bank checklist - In a nutshell

	We expect:	Market reaction if we are right:	If otherwise:
APP:	Ending net purchases announced	None	Strong dovish signal
Reinvestments:	Wording: 'for an extended period of time ... and in any case for as long as necessary.' to remain	None	If conditioned on first rate hike, hawkish signal, but only because of first hike mentioned
Capital key:	Capital key to be the guiding principle on reinvestments. As vague as possible with flexible	None	
TLTRO:	Tasked committees	Limited (dovish if any)	Hawkish
Growth:	Broadly balanced risk assessment. Lower staff proj profile	Lower profile expected, but balanced risk assessment may be seen hawkishly	If balance of risk on downside, its a clear dovish sign
Wages:	Confident and upbeat language on wage growth	Hawkish tilt	If not putting strong wage development forward, such as in Germany and Spain, it is a dovish signal
Core inflation:	2019 core revised 0.1pp lower	Dovish tilt	None
2021 HICP forecast:	Close to 2% (i.e. >=1.8%)	Limited (hawkish if any)	Dovish signal
Our market view:	From a risk reward perspective; we like to be positioned for a marginal hawkish surprise (short-term), in particular due to too dovish ECB related pricing. We find it difficult to see how Draghi can surprise on the dovish side (given pricing). See also FX and FI section below.		

Source: Danske Bank

ECB meeting 13 December

- Announcement at 13:45 CET
- Press conference at 14:30 CET

Senior ECB/ Euro Area Analyst
Piet P. H. Christiansen
+45 45 13 20 21
phai@danskebank.com

Analyst
Aila Mihr
+45 45 12 85 35
amih@danskebank.com

Chief Analyst
Christin Kyrme Tuxen
+45 45 13 78 67
tux@danskebank.dk

Chief Analyst
Jens Peter Sørensen
+45 45 12 85 17
tux@danskebank.dk

Ending QE is given – look for the reinvestment strategy

The ECB Governing Council (GC) meeting on Thursday next week has been the most anticipated meeting since the June decision when the ECB implicitly already announced an end to QE. Therefore, fully aligned with market consensus, we expect a formal end to the QE programme next week. However, given ECB's 'patience and prudence' view on monetary policy, we expect a 'dovish tightening' to fit with ECB's narrative in the recent period. Therefore, we also expect ECB to confirm and reiterate its accommodative monetary policy stance.

Consequently, the future of the QE programme (the reinvestment strategy) will take centre stage. We expect ECB to outline its future strategy albeit it being relatively vague, as we doubt that we will get much new colour on duration, and to repeat its intention to reinvest 'for an extended period of time (…) and in any case for as long as necessary.' The important job for Draghi, however, is to convince markets that no balance sheet reduction will take place before the first hike. A stronger version could be date dependent, such as 'through summer 2020' but we doubt it will commit to this already, as we have to get used to the new style of Aesopian forward guidance (as introduced by board member *Benoit Coeuré* in September).

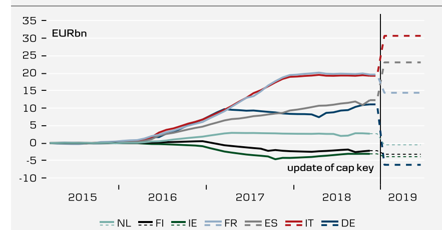
We do not expect ECB to announce an 'operation twist' to its holdings (favouring longer-dated bonds to shorter-dated ones), which was mentioned by some media outlets.

Capital key

This week ECB announced its new capital key structure as of 1 January 2019. While this is normally not something that catches the markets' attention, it has received attention from market participants given that the capital key has been used to guide the PSPP. The update contained the revision of the German capital key by +0.82pp and Italy was revised down by 0.53pp.

The verdict is still out whether ECB will adopt the new capital key or stick to the old capital key for the reinvestments. Last week, a Reuters story reported that two possibilities were considered: (1) taking a snapshot of the cumulative capital key deviations by the end of this year and 'reset' the deviation or (2) applying the new capital key to the existing stock and gradually fading the deviation over multiple years. We expect the latter, but importantly a flexible implementation is warranted as, in essence, the ECB wants to avoid a significant market impact.

PSPP purchases - cumulative dev from capital key



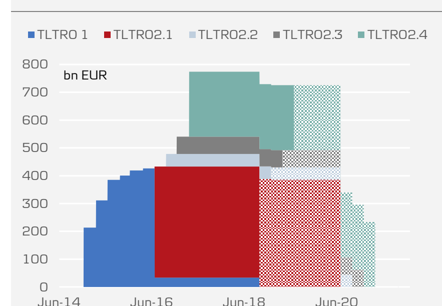
Source: ECB, Macrobond Financial, Danske Bank

TLTRO – it will come, but 'hold your horses'

As we discussed in *ECB Research - TLTRO3: Italy to be main beneficiary*, 9 November 2018, we expect the ECB to offer a new Targeted Longer Term Refinancing Operation. While the discussion has started in the market, ECB has not discussed it much. Previously, chief economist Praet said that the ECB is aware of the liquidity situation given the new regulation as of summer next year.

The modalities for such a new round are highly uncertain, but we argue in the piece mentioned above that the extension of the maturity date is more important than any potential additional take up. We also find it premature to announce a new round at the December meeting next week but we expect the ECB to acknowledge a risk of tightening liquidity conditions next year and consequently to have asked 'tasked committees' to study this. TLTRO is a natural tool in response to that. We expect a formal announcement in Q1, most likely March, and implementation in Q2, most likely June.

Maturity profile of TLTRO



Source: ECB, Danske Bank

Since the last meeting

Since the latest GC meeting on 25 October, we have received a number of data, mainly on the downside. However, during the past few days, we have seen some stabilisation of the surprise index after moderate positive surprises.

Activity / confidence

After PMI misses early in the month, final PMI and euro area economic confidence data were less bad than expected, which is encouraging. Industrial confidence and business climate have edged up slightly as well, which could be seen as a first sign of a bottoming out of macro data in the coming months. The PMI service sector growth remained more resilient, with sales reportedly buoyed by strong labour markets in some countries, linked in turn to higher consumer spending.

The GDP figures for Q3 were disappointing across the board and early indications for Q4 GDP could suggest that the German car-related backlog will not disappear already in this quarter (see also *Euro Area Macro Monitor*, 5 December 2018).

Inflation

November HICP inflation fell back below 2% for the first time since May this year, as the boost from higher energy prices increasingly starts to wane. A slowdown in headline inflation was widely expected, but core inflation declining back to 1.0% (-0.1pp) in November was a clear disappointment, as higher wages yet have to show up in durably higher services prices.

Early releases of country level data show an upside risk to the Q3 wage growth data for the euro area as a whole from 2.3% in Q2, to be released later today. For example, Germany rose 3.2%, while Spain rose 1.7% in Q3.

Euro area negotiated wages released this month indicated a small easing to 2.15% in Q3 from 2.20% in Q2, but remains significantly above the growth rates observed in 2016 and 2017.

Higher wages to feed core inflation optimism

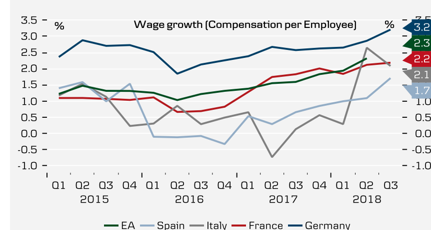
The December meeting will also be an interesting one in another respect: the new staff projections will include the 2021 forecasts for the first time. A downward revision in the 2018 core inflation and growth forecasts is a done deal, given that momentum on both fronts has disappointed since September. The boost from the higher oil price to headline inflation is waning and core inflation will likely end the year where it started at 1.0%. Q3 growth was less than half the rate the ECB expected back in September and so far forward-looking indicators do not point to a rebound in Q4 activity.

With lower oil price assumptions feeding into the projections, we also see scope for a downward revision in the 2019 core inflation forecast. However, we expect Draghi to downplay recent core inflation misses and point instead to upside surprises on the wage front (Germany 3.2% y/y and Spain 1.7% y/y in Q3). Accelerating wage growth will keep the ECB's inflation confidence alive and we therefore expect the ECB to release a 2021 core inflation forecast close to the 2% target, although it seems on the high side at the current juncture.

Standardised euro surprise index

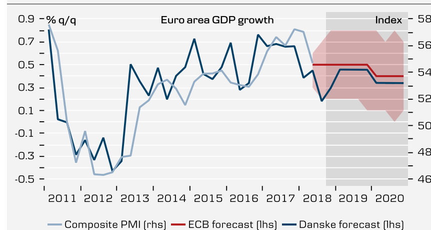
Source: Bloomberg, Macrobond Financial, Danske Bank

Wage growth has picked up further in Q3



Source: ECB, Macrobond Financial, Danske Bank

Weaker activity data warrants downward revision of GDP projections



Source: Markit, ECB, Macrobond Financial, Danske Bank

Clouds are increasingly gathering on the euro area growth horizon and consequently we expect the ECB to revise down its GDP forecasts to 1.7% in 2019 and 1.6% in 2020 but importantly to maintain the 'balanced' growth risk assessment (a pre-requisite to end the QE programme). Markets will also keep a close eye on the 2021 forecasts. From tradition, we expect the ECB to forecast HICP inflation 'close but below 2%' at the end of the forecast horizon, as we argue that if that was not the case, the ECB should change its current monetary policy stance. Further, we expect the ECB to project growth returning to potential.

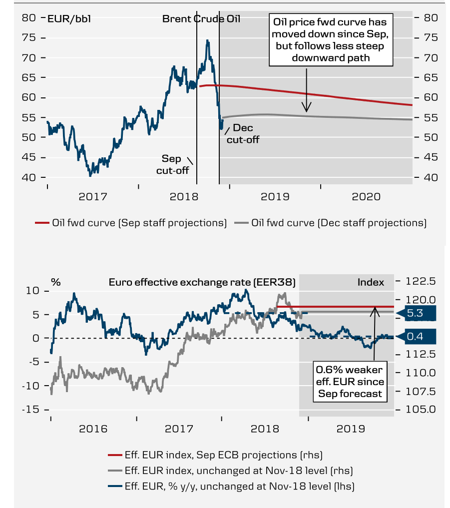
Weaker growth outlook, but inflation close to target in 2021

ECB projections December 2018	2018		2019		2020		2021
GDP growth	1.9% (2.0%)	↘	1.7% (1.8%)	↘	1.6% (1.7%)	↘	1.5%
HICP inflation	1.8% (1.7%)	↗	1.6% (1.7%)	↘	1.7% (1.7%)	→	1.8%
Core inflation	1.0% (1.1%)	↘	1.4% (1.5%)	↘	1.8% (1.8%)	→	1.9%
Wage growth	2.3% (2.2%)	↗	2.3% (2.2%)	↗	2.7% (2.7%)	→	2.5%

Parenthesis are the old ECB projections (from September 2018)

Source: ECB, Danske Bank

Lower oil price warrants downward revision in 2019 inflation forecast

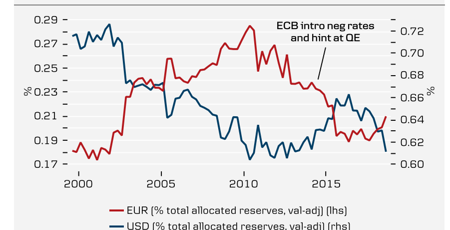


Source: ECB, Macrobond Financial, Danske Bank

FX: getting closer to the EUR rebound – but not there just yet

While we maintain that the ECB is priced too softly, the fact that we expect no new rate guidance at this meeting implies that FX markets should take their cue from the ECB's stance on the cyclical position of the euro zone. Despite recent loss of growth momentum, if Draghi strikes an upbeat tone due to recent constructive wage developments, it could make room for some EUR support. We do stress, however, that any EUR/USD rally is likely to prove temporary as USD support remains in place in our view from a now rather dovishly priced Fed. We reiterate our long-held view that as we get closer to the first ECB hike, capital flows will become less EUR-negative as reserve managers are lured back to the euro zone. Indeed, both euro-zone portfolio investment flows and reserve-allocation data (see chart) suggest interest in EUR assets declined as QE and negative rates were introduced. This could reverse swiftly as the ECB 'normalises'. We are long USD carry at present but positioned for a EUR/USD rebound beyond Q1 in our *FX Top Trades 2019 - our guide on how to position for the coming year*, 4 December 2018.

Reserve managers' allocation to EUR declined as ECB went 'unconventional'



Note: data shown here are valuation-adjusted.
Source: IMF COFER, Macrobond Financial, Danske Bank

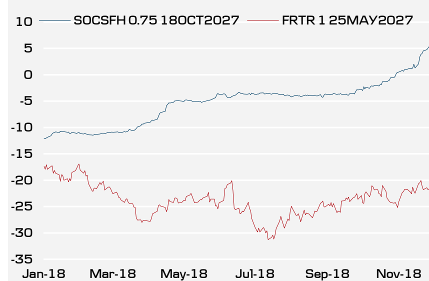
Bunds are expensive

The ECB December meeting has previously been bearish for rates. In 2016, 10Y German government bond yields rose some 20bp at the start of December. In 2017, 10Y German government yields rose some 50bp. Today we are back below the bottom in December 2017 and the ECB is about to end QE. Furthermore, market pricing is currently very dovish as there is very little priced into the curve. Currently, only 7bp is priced in by December 2019 and consequently, in our top trades published earlier this week, we recommend to pay Mar-20 and receive Sep-19 Euribors, see *Danske Bank 2019 Fixed Income Top Trades*, 4 December 2018.

When we look at the European government bond markets, there has been very limited impact from the tapering seen during 2018, where the ECB has gone from EUR60bn to EUR30bn and down EUR15bn in the PSPP programme. The ASW-spread for the core markets has tightened in the long end of the curve, where we would have expected underperformance of core and semi-core EU government bonds. However, in the covered bond and credit markets we have seen an underperformance versus swaps as shown in the chart below, where we look at an example of a 9Y French government bond and a 9Y French covered bonds relative to swaps.

Given that net supply is set to rise in 2019 as we do not have the QE, we expect to see some underperformance in core and semi-core EU government bonds and with market pricing being very dovish, we expect to see the same pattern on the outright level for yields as in 2016 and 2017. However, we do not expect that the sell-off will be as violent as in late 2017 and early 2018, when rates moved some 50bp. We expect that Bunds will be back up to 0.5% by the end of January.

ASW-spreads for 9Y French government bonds relative to the ASW-spread for a 9Y French covered bond



Source: Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Piet P. H. Christiansen, Senior Analyst, Aila Mihr, Analyst, Christin Kyrme Tuxen, Chief Analyst and Jens Peter Sørensen, Chief Analyst.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from, and do not report to, other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

Ad hoc

Date of first publication

See the front page of this research report for the date of first publication.

General disclaimer

This research report has been prepared by Danske Bank (a division of Danske Bank A/S). It is provided for informational purposes only and should not be considered investment advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided herein.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/A, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Report completed: 6 December 2018, 20:22 CET

Report first disseminated: 7 December 2018, 07:00 CET