10 July 2020

ECB Research

Steady course, but cautiously optimistic

- **At next week's ECB policy meeting we expect a repetition of recent comments from various governing council members, thereby striking a cautiously optimistic tone compared to the June projections. We also expect they may decide not to use the EUR1,350bn PEPP envelope in full. No new initiatives are expected next week.**
- **We do not rule out a discussion about adjusting the tiering multiplier taking place, although our baseline remains that any decision to increase the tiering multiplier would occur at a later stage.**
- **Markets may not be prepared for a 'less dovish' message and with abundant liquidity, PEPP and APP still ongoing, we would use the opportunity to buy into risk on trades in the EGB/Euro fixed income space.**

Steady course, but cautiously optimistic

Confidence indicators have pointed to an improvement in the recovery but we are not out of the woods yet (see economic outlook on the next page). As a result, we expect the ECB to strike a cautiously optimistic tone, which suggests that the recession may turn out somewhat milder than it had projected in June but still with quite a serious drop in growth. With the inflation mandate over the medium term, the ECB will not call for a victory yet. That also means we expect the ECB to reiterate the numerous comments from governing council members (such as Schnabel, Villeroy, Knot) that the full EUR1,350bn PEPP envelope may not be needed. Furthermore, Schnabel said that a further expansion of the PEPP may not be needed.

Up until last week, the ECB had been buying at a relatively steady pace of EUR5.7bn/trading day in the PEPP. Last week, PEPP holdings rose only EUR20.2bn, equivalent to EUR4bn/trading day, which is the lowest rate to date under the PEPP. That said, the purchase rate last week corresponds to the required purchase limit to be hit only by end-June 2021. As of now, the ECB is EUR98bn ahead of schedule (average daily purchase rate of EUR5.6bn/trading day) and continuing at this pace would lead to the EUR1,350bn PEPP envelope being exhausted in March 2021. **Based on the recent communication, we do not expect the ECB to scale up PEPP again if no further financial fragmentation appears and would expect financial conditions to continue to decline gradually. Therefore, we expect the ECB to slow down its daily PEPP implementation quite markedly.** We highlight that should the ECB see the need to scale things up again, it could build a case around a too low/dampened inflationary outlook. Continued flexible PEPP implementation will be reiterated, in our view.

ECB pricing and excess liquidity

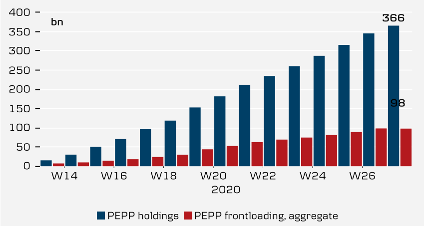
Markets continue to price in a rate cut by the ECB and as we do not expect one. We maintain our 1y6m EONIA paying position, as initiated ahead of the June ECB meeting. Markets are pricing 7bp of rate cuts at the trough by the end of next year.As negative interest rates are likely to be with us for a very long time, the ECB has addressed this by introducing the tiering system for reserve remuneration and TLTRO incentives via dual interest rates.

16 July 2020 (CEST)

13:45 ECB decision

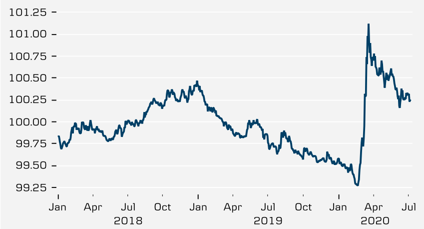
14:30 Press conference

PEPP well ahead of schedule



Source: ECB, Danske Bank

Euro area Financial Conditions Index



Note: Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.

Source: Bloomberg, Macrobond Financial, Danske Bank

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The TLTRO allotment in June resulted in a jump in excess liquidity of around EUR550bn, as widely anticipated. In *ECB Research - Flooding euro markets with TLTRO liquidity. Implications for excess liquidity, tiering and markets*, 12 June, we discussed the new modalities of the TLTRO3s and argued for a tiering multiplier increase to 10 later this year. With the strong take-up of EUR1,308bn of TLTRO in the June operation, where the majority will likely be remunerated at -1%, the ECB is aware of the side effects of negative interest rate policies. For now, we see the pressure to adjust the tiering multiplier as limited but ongoing awareness and discussion is warranted in our view, as excess liquidity will rise. We continue to expect the tiering multiplier to be changed later this year.

The ECB already successfully implemented the tiering system for reserve remuneration in October 2019. As such, we do not expect changes to the tiering multiplier to impact the front-end market pricing on an aggregate basis, as the ECB will be very much aware of the potential negative side effect of a change to the tiering multiplier. The relevant policy rate will depend on the individual banks whether they fulfil their tiering allowance (currently 6x the reserve requirement).

Economic outlook – more data is needed

The incoming data in June strengthened the signs of recovery in most European economies as they returned to business, but not normal business. Both the service and manufacturing PMIs continued to rebound in June from May and closed in on the important 50 threshold that marks expansion territory. Although on the face of it PMIs remained in contraction territory, the unique nature of the corona crisis might have made the PMI signal less reliable (see discussion *here*). Generally, the components of forward-looking expectations in a range of leading indicators and high frequency data still signal that we continue on the road to recovery but also that activity is not yet back to pre-crisis levels. With consumers showing a renewed willingness to spend after restrictions have been lifted, signs of strengthening domestic demand are clearly visible. However, with export orders still at subdued levels, it seems unlikely that Europe can export its way out of this crisis as it did in 2009. The verdict is also still out on the labour market. Some 735,000 people lost their job in the euro area's four biggest economies ing May. Although job losses seem to have abated in June, the worst of the impact may still be to come, as firms remain in retrenchment mode according to business surveys (especially in manufacturing) and short-time working schemes are likely to be gradually phased out in H2 20.

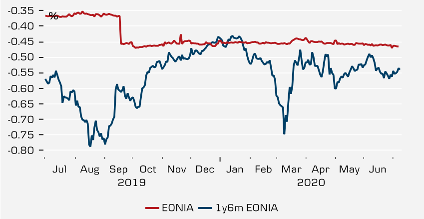
Inflation – low, but limited deflation risk

At 0.8%, euro area core inflation remained surprisingly resilient in June. The ambiguous effect of the corona crisis on inflation was again illustrated by some service providers *raising* prices on the back of the stricter hygiene requirements, while discounting campaigns from retailers pulled in the other direction. Going forward, we expect euro inflation to lose some of its stickiness, as the effects from Germany's temporary VAT cut will weigh on core inflation for the remainder of this year (see *Euro Area Research: Germany's VAT cut sends euro inflation on a roller coaster*, 11 June).

FI: Value in spread compression trades

We expect the current carry-friendly risk-on environment to prevail, beyond the ECB meeting next week, but we look to buy into dips on potential underperformance. We remain constructive on spreads, notably on Ireland and Spain. This week, we published a screener that looked for value post-corona. In the core EU space, Germany is actually cheap in the 30Y segment versus Finland, the Netherlands and Austria relative to pre-corona levels. In the semi-core space, 10Y Ireland is cheap versus Germany, while the front end of the

ECB pricing points to 7bp cut in 18m

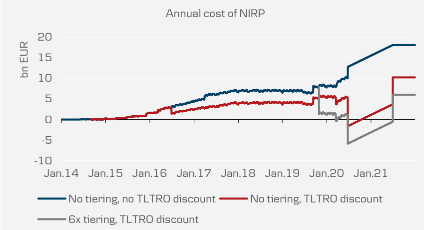


Note: Past performance is not a reliable indicator of current or future results.
Source: Danske Bank

Excess liquidity jumped after the TLTRO allotment

Source: Macrobond Financial, Danske Bank

Annual cost of negative interest rate policy



Source: ECB, Danske Bank

Periphery is cheap versus German. See more in *EGB and ASW spreads back to pre-corona levels*, 8 July.

FX: Upside risk in EUR/USD to persist – we target 1.15 in 3M

For EUR/USD, our key expectation is that the ECB will reiterate its stance towards supporting a recovery, with, not least, a focus on sovereign spreads. For spot FX, the direction and stance of the ECB and euro area fiscal politics are, in our view, quite well priced and communicated (though to a lesser extent when it comes to the outcome for Brexit). In turn, it will be the breath and speed of the global recovery that sets the tone in EUR/USD, and mostly through the USD leg. We remain constructive and expect the broad USD to decline over the coming months. In turn, our 3M forecast is 1.15. See more in *FX Strategy - EUR/USD to 1.15 on repricing inflation* (6 July).

Disclosures

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Expected updates

Ad hoc.

Date of first publication

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