ECOWEEK

No. 18-46, 14 December 2018

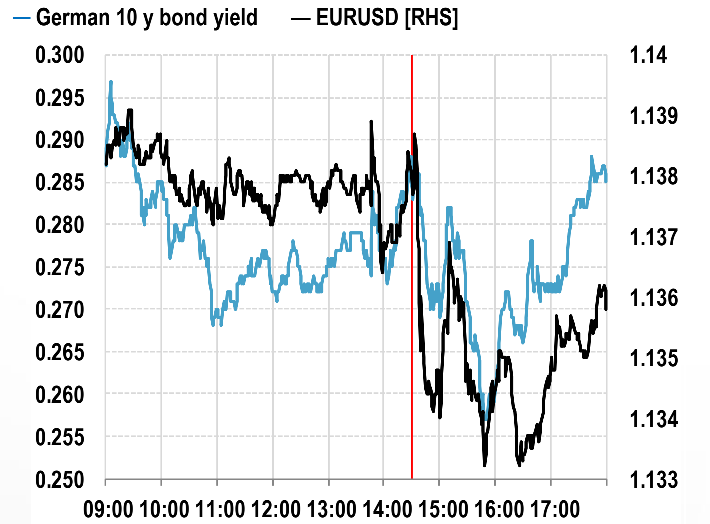
ECB: From quantitative easing to quantitative pausing

■ As expected, the ECB Governing Council has decided to end the net purchases in the context of its asset purchase program ■ This new phase can be called quantitative pausing, before eventually moving to quantitative tightening, i.e. to shrink the size of the balance sheet ■ The end of net purchases increases the role of forward guidance as an instrument to control interest rate expectations ■ The enhanced forward guidance, i.e. continuing to reinvest for an extended period past the first rate hike, should be welcomed

At its June meeting, the ECB had announced that, subject to incoming data confirming its medium-term inflation outlook, it would end its net purchases by the end of this year. Yesterday's decision was widely expected, so the focus was on the accompanying comments and the technical parameters of the reinvestment. Concerning the latter, flexibility and gradualism seem to be key words so as to safeguard orderly market conditions. This relates to the timing of the reinvestment (the allowed timeframe is now one year) and the changes in the country allocation so as to reflect the changes in the national central banks' subscriptions to the ECB capital[1]. On the other hand, there was no detail on the maturity allocation of reinvestments although the adherence to the principle of market neutrality via smooth and flexible implementation was mentioned. This would indicate that the control of the yield curve will operate via the enhanced forward guidance: reinvestment will continue for an (obviously undefined) extended period of time past the first rate hike. The immediate market reaction (chart) was limited although the slight weakening of the euro probably reflects a more dovish reading by investors based on the forward guidance and on the assessment of the economic environment and outlook, marked by "continuing confidence with increasing caution" and an emphasis on "general uncertainty".

The ECB is now moving from quantitative easing to what could be called quantitative pausing. 'Pausing' because one would expect that as inflation converges sufficiently towards its objective, the ECB would start quantitative tightening by shrinking the size of its balance sheet. However, based on where we are today it is way too early to start focusing on this.

EUR/USD AND 10 YEAR BUND YIELD (INTRADAY, 13 DECEMBER 2018)



Source: Bloomberg, BNP Paribas.
The ECB press conference started at 14.30 Frankfurt time and lasted for one hour.

[1] The shares of the national central banks in the ECB's capital are weighted according to the share of the respective Member States in the total population and gross domestic product of the European Union (EU), in equal measure. Following the regular five-yearly adjustment, the new key for subscription to the ECB's capital will enter into force on 1 January 2019. 16 central banks will have a higher share in the ECB's capital than before and 12 central banks will have a lower share. The share of the Banca d'Italia declines from 12.3108% to 11.8023% (source: ECB website).

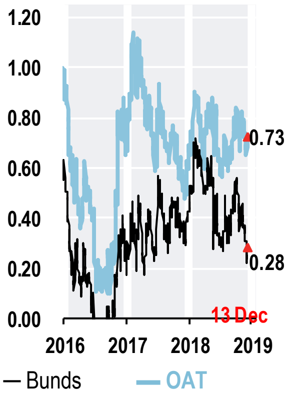
Markets overview

The essentials

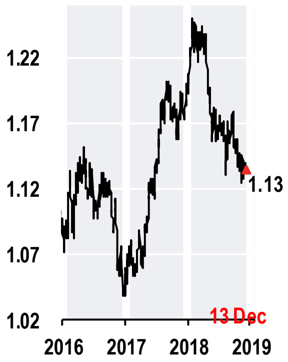
Week 7-12 18 > 13-12-18

↗ **CAC 40**	4 813	▸	**4 897**	**+1.7**	%
↗ **S&P 500**	2 633	▸	**2 651**	**+0.7**	%
↘ Volatility (VIX)	23.2	▸	20.7	-2.6	pb
↗ **Euribor 3M (%)**	-0.32	▸	**-0.31**	**+0.4**	bp
↗ Libor $ 3M (%)	2.77	▸	2.78	+0.6	bp
↗ OAT 10y (%)	0.69	▸	0.73	+3.9	bp
↗ Bund 10y (%)	0.25	▸	0.28	+3.0	bp
↗ US Tr. 10y (%)	2.85	▸	2.91	+6.2	bp
↘ **Euro vs dollar**	1.14	▸	**1.13**	**-0.4**	%
↘ Gold (ounce, $)	1 246	▸	1 243	-0.3	%
↘ **Oil (Brent, $)**	63.0	▸	**60.6**	**-3.7**	%

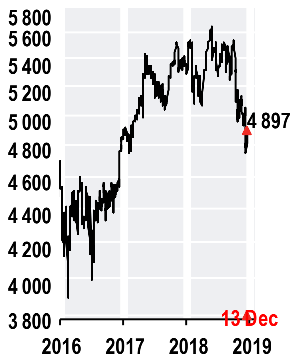
10 y bond yield, OAT vs Bund



Euro-dollar



CAC 40



Money & Bond Markets

Interest Rates		highest' 18		lowest' 18	
€ ECB	**0.00**	0.00	at 01/01	0.00	at 01/01
Eonia	**-0.36**	-0.34	at 31/10	-0.37	at 18/05
Euribor 3M	**-0.31**	-0.31	at 13/12	-0.33	at 01/01
Euribor 12M	**-0.13**	-0.13	at 13/12	-0.19	at 19/02
$ FED	**2.25**	2.25	at 27/09	1.50	at 01/01
Libor 3M	**2.78**	2.78	at 11/12	1.69	at 01/01
Libor 12M	**3.10**	3.14	at 09/11	2.11	at 01/01
£ BoE	**0.75**	0.75	at 02/08	0.50	at 01/01
Libor 3M	**0.90**	0.91	at 10/12	0.52	at 04/01
Libor 12M	**1.15**	1.17	at 14/11	0.76	at 03/01

At 13-12-18

Yield (%)		highest' 18		lowest' 18	
€ AVG 5-7y	**0.67**	1.06	at 19/10	0.41	at 18/04
Bund 2y	**-0.58**	-0.50	at 25/09	-0.79	at 29/05
Bund 10y	**0.28**	0.72	at 15/02	0.22	at 06/12
OAT 10y	**0.73**	0.91	at 08/02	0.57	at 13/07
Corp. BBB	**2.07**	2.13	at 10/12	1.17	at 08/01
$ Treas. 2y	**2.76**	2.97	at 08/11	1.89	at 01/01
Treas. 10y	**2.91**	3.23	at 08/11	2.41	at 01/01
Corp. BBB	**4.70**	4.77	at 29/11	3.59	at 01/01
£ Treas. 2y	**0.77**	0.91	at 05/10	0.40	at 01/01
Treas. 10y	**1.29**	1.73	at 10/10	1.18	at 10/12

At 13-12-18

10y bond yield & spreads

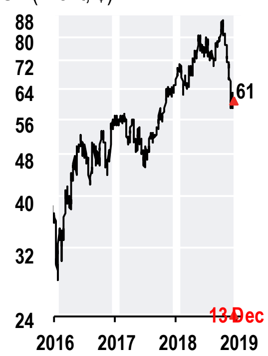
4.97%	Greece	468 pb
2.97%	Italy	268 pb
1.68%	Portugal	139 pb
1.43%	Spain	115 pb
0.77%	Belgium	48 pb
0.73%	France	44 pb
0.65%	Ireland	36 pb
0.58%	Finland	29 pb
0.55%	Austria	27 pb
0.42%	Netherland	13 pb
0.28%	Germany	

Commodities

Spot price in dollars		lowest' 18			2018(€)
Oil, Brent	**60.6**	58.7	at	30/11	**-3.7%**
Gold (ounce)	**1 243**	1 179	at	17/08	**+0.9%**
Metals, LMEX	**2 885**	2 820	at	15/08	**-10.7%**
Copper (ton)	**6 159**	5 759	at	15/08	**-9.6%**
CRB Foods	**329**	316	at	30/08	**+3.5%**
wheat (ton)	**206**	155	at	16/01	**+37.4%**
Corn (ton)	**138**	115	at	18/09	**+15.0%**

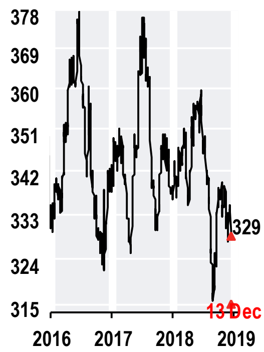
At 13-12-18 *Variations*

Oil (Brent, $)



Gold (Ounce, $)

CRB Foods



Exchange Rates

1€ =		highest' 18			lowest' 18			2018
USD	**1.13**	1.25	at	25/01	1.13	at	12/11	**-5.5%**
GBP	**0.90**	0.91	at	28/08	0.86	at	17/04	+1.3%
CHF	**1.13**	1.20	at	19/04	1.12	at	07/09	-3.6%
JPY	**128.95**	137.29	at	02/02	124.96	at	15/08	-4.7%
AUD	**1.57**	1.63	at	11/09	1.53	at	09/01	+2.3%
CNY	**7.79**	8.10	at	25/09	7.42	at	29/05	-0.3%
BRL	**4.40**	4.88	at	14/09	3.87	at	08/01	+10.6%
RUB	**75.25**	81.62	at	10/09	68.06	at	09/01	+8.9%
INR	**81.34**	85.66	at	11/10	75.92	at	08/01	+6.1%

At 13-12-18 *Variations*

Equity indices

	Index	highest' 18			lowest' 18			2018	2018(€)
CAC 40	**4 897**	5 640	at	22/05	4 742	at	10/12	-7.8%	**-7.8%**
S&P500	**2 651**	2 931	at	20/09	2 581	at	08/02	-0.9%	**+4.9%**
DAX	**10 925**	13 560	at	23/01	10 622	at	10/12	-15.4%	**-15.4%**
Nikkei	**21 816**	24 271	at	02/10	20 618	at	23/03	-4.2%	**+0.5%**
China*	**74**	101	at	26/01	68	at	30/10	-15.9%	**-11.0%**
India*	**540**	642	at	29/01	487	at	26/10	-0.8%	**-6.6%**
Brazil*	**1 953**	2 393	at	26/01	1 561	at	11/09	+12.9%	**+2.1%**
Russia*	**601**	707	at	26/02	551	at	23/08	+12.4%	**+5.2%**

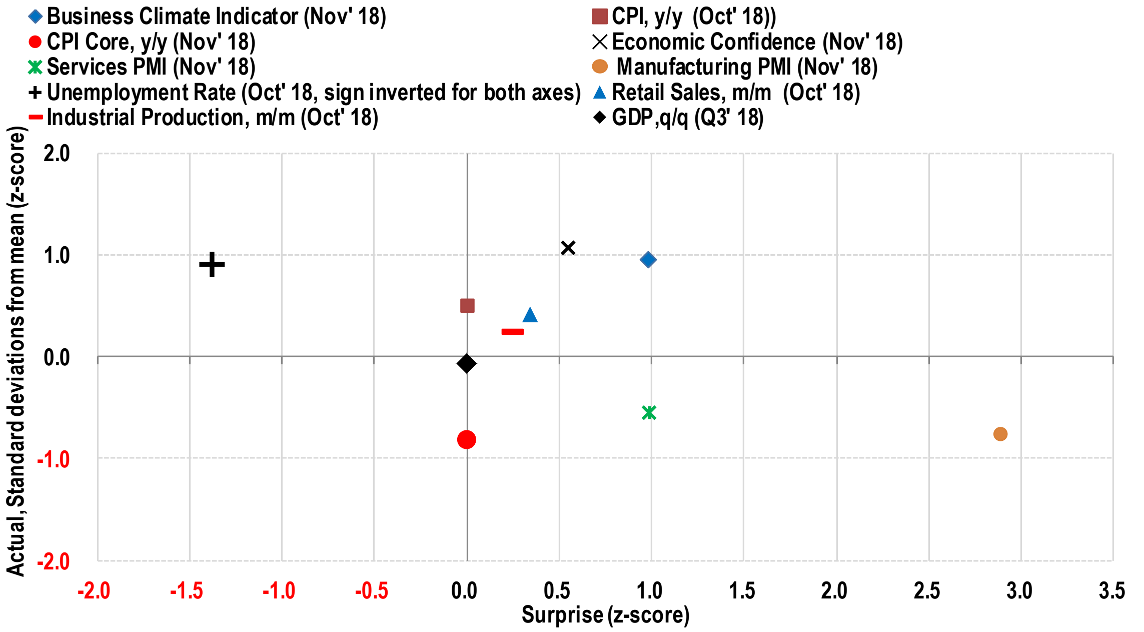
At 13-12-18 *Variations*

* MSCI index

Pulse

Eurozone: Signals less negative than expected, but downside risks to growth

Even though most headline indicators exceeded downbeat expectations in November 2018, they remain on a declining trend. The PMIs for Manufacturing (51.4) and Services (51.4), pulled down by the sharp decrease in the French PMI related to heightened social tensions, just managed to stay above the expansion line (50). Economic activity slowed to 0.2 % in Q3 2018, which actually reflects some divergent developments. In particular, in Germany, growth contracted by 0.2 %. Core inflation (+1.0 %), in line with the Consensus, is still well below the ECB's medium-term price objective, but could inch up in the coming months because of the observed acceleration in wages.



Source: Markit, Bloomberg, BNP Paribas calculations

Indicators preview

The highlight of the week will be the FOMC meeting. The market expects a rate hike but is wondering whether the tone with respect to 2019 will soften considering recent cautious statements coming from the corporate sector. Several data will be published in the US related to the housing market, which has been losing momentum as of late. The manufacturing-sensitive Philadelphia Fed business outlook will also be watched with great attention, as well as the University of Michigan confidence data. The Bank of England and the Bank of Japan are also meeting. Several data releases will allow us to gauge how the UK is coping with Brexit uncertainty. In the eurozone we have eurozone inflation and confidence data, the German IFO index and business confidence in France.

Date	Country	Event	Period	Survey	Prior
12/17/18	United States	NAHB Housing Market Index	Dec	60	60
12/18/18	United States	Housing Starts	Nov	1.23e+06	1.228e+06
12/18/18	United States	Building Permits	Nov	1.265e+06	1.263e+06
12/18/18-12/24/18	United Kingdom	GfK Consumer Confidence	Dec	-14	-13
12/19/18	United Kingdom	CPI MoM	Nov	0.2%	0.1%
12/19/18	United Kingdom	CBI Trends Total Orders	Dec	7	10
12/19/18	United States	Existing Home Sales	Nov	5.2e+06	5.22e+06
12/19/18	United States	FOMC Rate Decision (Upper Bound)	Dec 19	2.50%	2.25%
12/19/18	United States	FOMC Rate Decision (Lower Bound)	Dec 19	2.25%	2.00%
12/20/18	United Kingdom	Retail Sales Ex Auto Fuel MoM	Nov	0.5%	-0.4%
12/20/18	United Kingdom	Bank of England Bank Rate	Dec 20	0.750%	0.750%
12/20/18	United States	Philadelphia Fed Business Outlook	Dec	15.0	12.9
12/21/18	United States	University of Michigan Sentiment	Dec	97.5	97.5

Source: Markit, BNP Paribas

Economic scenario

UNITED STATES

- Economy is expected to expand at approximately 2.8% this year on the back of tax cuts, booming profits and credit. However, weaker international trade as well as tighter monetary and financial conditions promise a slowdown.
- Inflation has passed its peak, as oil prices are now falling.
- The monetary tightening is coming closer to its end. We forecast the Fed funds target rate to reach 3% in Q2 2019, the stalling.

CHINA

- Economic growth will decelerate in 2018-2019 due to both structural and cyclical reasons. The export outlook is significantly darkened by US tariff hikes. Private domestic demand should be affected by the worsening performance of the export manufacturing sector and the continued moderation in the property market.
- In order to contain the slowdown, the central bank is easing liquidity and credit conditions. At the same time, the reduction in financial instability risks via regulatory tightening should remain a top policy priority. Fiscal policy is also turning expansionary (tax cuts, increased infrastructure spending).

EUROZONE

- The slowdown is becoming increasingly evident, especially in the German economy, which encounters capacity constraint and suffers from reduce demand coming from the EMEs.
- Inflation is now expected to decelerate with falling oil price, while core CPI trend remains subdued. We do not expect the ECB to move rates before 19Q4 (see below)

FRANCE

- Growth slows down but remains above potential. Households' consumption should get a boost from the tax cuts and the jobs recovery but inflation reduces purchasing power gains. Business investment dynamics remain favourable. The global backdrop is less supportive. A slight rise in core inflation is appearing but remains to be confirmed.

INTEREST RATES AND FX RATES

- In the US, ongoing strong growth and a very low unemployment rate pave the way for more rate hikes. We expect 1 more this year and 2 in the first half of 2019 after which the Fed will want to see how the economy reacts. As a consequence, US treasury yields should increase, although to a limited degree: the market expects that the tightening cycle is already well advanced. The ECB has announced it intends to stop its net asset purchases at the end of 2018. A first hike of the deposit rate is expected after the summer of 2019. As a consequence, bond yields should increase. No change expected in Japan.
- The narrowing bond yield differential between the US and the eurozone should cause a strengthening of the euro, all the more so considering it is still below its long-term fair value (around 1.34).

SUMMARY

	GDP Growth			Inflation		
%	2018 e	2019 e	2020 e	2018 e	2019 e	2020 e
Advanced	**2.2**	**1.7**	**1.3**	**2.0**	**1.7**	**1.8**
United-States	2.9	2.1	1.5	2.4	1.8	2.0
Japan	0.9	0.7	0.3	1.0	0.6	1.4
United-Kingdom	1.3	1.8	1.6	2.4	2.0	2.0
Euro Area	**1.9**	**1.4**	**1.2**	**1.8**	**1.8**	**1.5**
Germany	1.6	1.5	1.3	1.9	2.2	1.6
France	1.7	1.6	1.3	2.1	1.7	1.6
Italy	1.0	0.6	0.5	1.3	1.5	1.2
Spain	2.5	2.2	2.0	1.8	1.7	1.3
Emerging	**5.9**	**5.9**	**5.7**	**2.8**	**2.7**	**3.1**
China	6.6	6.2	6.0	2.2	1.9	2.5
India	7.4	7.6	7.8	3.8	4.0	4.1
Brazil	1.3	3.0	2.5	3.7	3.8	3.6
Russia	1.8	1.7	1.6	2.8	3.6	4.2

Source : BNP Paribas Group Economic Research (e: Estimates & forecasts)

INTEREST RATES & FX RATES

Interest rates, %		2018	2019						
End of period		Q4e	Q1e	Q2e	Q3e	Q4e	2018e	2019e	2020e
US	Fed Funds	2.50	2.75	3.00	3.00	3.00	2.50	3.00	3.00
	Libor 3m $	2.65	2.90	3.05	3.05	3.05	2.65	3.05	2.80
	T-Notes 10y	3.20	3.30	3.40	3.45	3.50	3.20	3.50	3.25
Ezone	ECB Refi	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.20
	Euribor 3m	-0.30	-0.30	-0.25	-0.20	-0.15	-0.30	-0.15	0.00
	Bund 10y	0.55	0.55	0.60	0.80	1.00	0.55	1.00	0.90
	OAT 10y	0.90	0.95	1.00	1.10	1.25	0.90	1.25	1.15
UK	Base rate	0.75	0.75	1.00	1.00	1.25	0.75	1.25	1.50
	Gilts 10y	1.20	1.70	1.85	2.00	2.10	1.20	2.10	2.10
Japan	BoJ Rate	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
	JGB 10y	0.14	0.15	0.15	0.15	0.14	0.14	0.14	0.08

Source : BNP Paribas GlobalMarkets (e: Estimates & forecasts)

Exchange Rates			2019						
End of period		Q4e	Q1e	Q2e	Q3e	Q4e	2018e	2019e	2020e
USD	EUR / USD	1.14	1.15	1.17	1.21	1.25	1.14	1.25	1.34
	USD / JPY	111	110	108	105	100	111	100	90
	GBP / USD	1.27	1.32	1.36	1.41	1.47	1.27	1.47	1.58
	USD / CHF	0.99	1.01	1.00	0.98	0.96	0.99	0.96	0.93
EUR	EUR / GBP	0.90	0.87	0.86	0.86	0.85	0.90	0.85	0.85
	EUR / CHF	1.13	1.16	1.17	1.18	1.20	1.13	1.20	1.25
	EUR / JPY	127	127	126	127	125	127	125	121

Source : BNP Paribas GlobalMarkets (e: Estimates & forecasts)

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