Flash

Tuesday, 23 January 2018

Too early to change communication policy

Hawkish ECB Minutes trigger speculation that ECB thinking may be shifting

Changes to forward guidance on APP expected in March

Euro strength emerging as a reason for concern and a notable constraint on policy?

Draghi unable to prevent higher European rates and stronger euro?

Dovish December press conference…

Not surprisingly, the ECB kept its policy unchanged in December after outlining a new strategy on asset purchases as recently as October. Important elements of these changes are only now coming into effect with net asset purchases halved to €30bn/month from the start of this year while the APP cut-off date was extended to September 2018 at the earliest.

ECB president Draghi acknowledged the current momentum in the Euro area economy at the December press conference, but suggested this had no immediate implications for ECB policy by emphasizing the lack of any notable follow through from stronger growth to higher inflation. The December **ECB projections** further re-assured a decoupling of growth and inflation that could allow '*an ample degree of monetary stimulus*' to remain in place for some considerable time.

These new ECB projections entailed material upward revisions to the outlook for economic growth for each year from 2017 to 2019 (2.4% v 2.2%, 2.3% v 1.8% and 1.9% v 1.7%). Although growth moderates to 1.7% in the ECB's initial projection for 2020, this remains well above most estimates of the EMU's potential growth rate. So, this implies we are now in a period of particularly strong growth. Critically, however, new inflation projections saw only a modest pick-up in consumer prices. As a result, inflation is projected to remain below the ECB's target rate out to 2020.

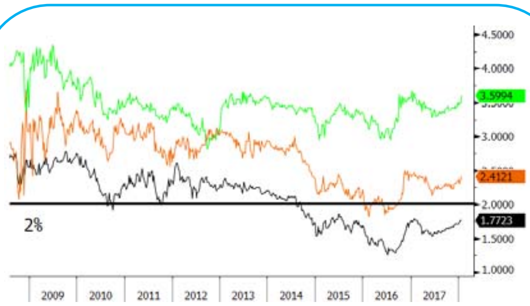
… but hawkish Minutes!

ECB Minutes published mid-January revealed that there was more to the December policy meeting than ECB president Draghi had suggested. There were two striking elements. First, **ECB members acknowledged the stretched position between the current strong EMU growth momentum and the crisis-era monetary policy that's still in place.** Second, Minutes showed some willingness from the ECB to change its forward guidance. While it was felt this should be done gradually, some adjustments might be contemplated as soon as **early 2018. Recent** comments from several ECB governors indicate a possible change to guidance on QE net purchases which currently states that *"our net asset purchases are intended to continue at a monthly pace of €30bn until the end of September 2018, **or beyond, if necessary,** and in any case until the GC sees a sustained adjustment in the path of inflation consistent with its inflation aim."*

We don't envisage any dramatic change in ECB signalling this week although there may be some pointers to when and how this may happen. We expect the ECB to drop the possibility of an APP extension beyond September 2018 at its March 8 policy meeting and tie the inflation outlook to general, very easy, monetary policy instead. By September 2018, the ECB will than have bought in excess of €2.5 tn assets of which more than 80% are sovereign bonds. The guidance on interest rates – *"we continue to expect them to remain at their present levels for an extended period of time, and well past the horizon of our net asset purchases"* is expected to remain in place at least until June, but in the absence of a marked pick-up in inflation it will probably continue until September. We would highlight that notable changes will be required to prepare the way for a first rate hike in 2019. Like other main central banks, the ECB will be anxious not to surprise the markets as it begins what may be an extended exit from ultra-accommodative policy. We expect no changes to guidance on QE reinvestments – *"for an extended period of time after the end of net asset purchases, and in any case for as long as necessary"* in 2018 and probably not even in 2019.

Strong growth; inflationary green shoots

Recent EMU economic indicators suggest that last year's exceptional growth momentum will be extended into the new year. Economic growth in 2017 was the strongest in a decade. Current growth forecasts suggest we're in a very positive economic climate, matching the strength of the mid-2000s as the best in the EMU's 20-yr history. As ECB Coeuré amongst others pointed out: *"it's not a recovery anymore, it's an expansion"*. PMI's are well above the 50 boom/bust mark (composite at 58.1; the strongest level since 2006) and the forward looking "new orders" component rose to the highest level since April 2000.



5y5y forward inflation swap (EMU black; US orange; UK green): global signs of bottoming out

There's less confidence on the inflation front, even if there are some green shoots. Headline CPI declined from 1.5% Y/Y in November to 1.4% Y/Y in December while core inflation stabilized at 0.9% Y/Y and still doesn't show any signs of a meaningful acceleration. This, the ECB argues, means that a very substantial degree of monetary accommodation is still needed. That said, market-based measures of inflation expectations are now showing some encouraging signs. **The 5y5y EMU forward inflation swap shows signs of bottoming out,** rising from 1.5% mid-2017 to 1.77% currently. **A second positive element could come from German wage negotiations.** The ECB closely monitors these as German wages could be pivotal to start an upward spiral in EMU price dynamics.

Euro strength: source of concern?

ECB governors Constancio, Villeroy de Galhau and Nowotny all warned in recent days that the stronger euro might harm the ECB's efforts to return inflation to its 2%-target. Constancio added that recent moves in the single currency didn't reflect changes in fundamentals. We expect that ECB Draghi will be grilled on the topic during the Q&A session after the press conference.

The dilemma posed by the exchange rate brings the September 2017 meeting to mind. Between April 2017 and September 2017, the trade-weighted euro rose by about 7%. **Unusually, the ECB's press statement then highlighted FX developments - in its opening assessment** of the economic environment, noting that '*the recent volatility in the exchange rate represents a source of uncertainty which requires monitoring with regard to its possible implications for the medium-term outlook for price stability'.* Draghi mentioned several times that the exchange rate is not a policy target, but that it is very important for growth and inflation.

While academic studies differ in their detailed findings, a range of analysis suggests a 1% movement in the exchange rate prompts a movement in consumer prices in the opposite direction of about 0.1% within a year and about twice that in three years. However, as the ECB has indicated on a number of occasions, the precise extent of this pass-through will be significantly influenced by prevailing economic conditions.

The trade-weighted euro moved broadly stable since that September policy meeting, suggesting that a similar stark warning is less likely this week even if we do expect some efforts by the ECB president to try to talk the euro down by downplaying any early rate hike speculation.

Trade-weighted euro broadly stabilized after surge between April and September 2017

Hard to prevent higher rates and euro?

ECB president Draghi will probably keep a soft tone, by stressing the continuing absence of inflationary pressures. This is seen justifying the ECB's easy monetary policy. Despite all expected efforts to delay normalisation bets, we think that it will be very difficult to prevent the euro and especially European rates from rising further. Strong global economic growth, rising inflation (expectations) and even a gentle central bank turn towards policy normalisation are bearish factors for bonds. German yields are close to resistance levels, respectively at -0.55% (2-yr), -0.06% (5-yr), 0.62% (10-yr) and 1.38% (30-yr). We expect a break higher to be only a matter of time with a steepening curve throughout the year.

EUR/USD is close to the 1.23 area. A new test is likely. Euro strength will probably need to be countered by a comeback of the dollar (break US yields above key technical levels, shutdown averted,… ?) to prevent a break higher.

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