Sunrise

Thursday, 08 December 2016

Rates: To taper down QE purchases or not?

Today is all about the ECB. We think that the market reaction will depend on one word and one word only: tapering. Any scenario that doesn't involve tapering, which we expect (3-month APP extension at €80B/month) will be considered dovish. We would then change our Bund bias from sell-on-upticks to neutral.

Currencies: Dollar slightly in the defensive as rise in core yields eases

Yesterday, the dollar was initially little affected by the congruent rise of bonds and equities, but finally the decline in yields weighed. Today, the impact of the ECB decision on global yields will probably guide overall USD trading. EUR/USD is holding near important resistance at 1.0795/1.0809. Will the ECB cause a further EUR/USD correction?

Calendar

Headlines

S&P	↗
Eurostoxx50	↗
Nikkei	↗
Oil	↘
CRB	→
Gold	↗
2 yr US	→
10 yr US	↘
2 yr EMU	→
10 yr EMU	↘
EUR/USD	↗
USD/JPY	↘
EUR/GBP	↗

- **US equities** had a very strong run yesterday, eking out up to 1.5% gains with **new highs for S&P, Dow and Russell 2000.** Overnight, **Asian stock markets** copy yesterday's positive risk sentiment from Asia and Europe.
- **Chinese exports** defied expectations of contraction in November by rising at the fastest rate in three months in local currency terms, as the renminbi value of **imports ballooned** in the face of a strengthening dollar.
- **Italy is demanding the ECB give it more time to rescue Monte dei Paschi di Siena (mid-Jan instead of end 2016)** and is preparing to blame the bank for losses imposed on bondholders if Rome is forced into an urgent state bailout.
- **Moody's changed the outlook on Italy's rating to negative from stable** arguing that the no vote in the referendum had diminished the likelihood of structural and economic reforms needed to stabilise the government's credit profile and improve its capacity to absorb shocks.
- **Japan's economy grew much slower than initially estimated in the third quarter (0.3% vs. 0.5% Q/Q),** as capital expenditure dried up and companies ran down inventories - renewing concerns about Japan's growth prospects.
- **The Bank of Canada** pointed to a "significant" amount of slack in the Canadian economy as it held interest rates steady yesterday, but also used language suggesting a rate cut is off the table as global growth picks up.
- **President-elect Trump** chose Oklahoma Attorney General Scott Pruitt to lead the Environmental Protection Agency, according to a transition official, turning to **a climate-change skeptic** and sharp critic of the agency to take its helm.
- **Today's eco calendar contains US weekly jobless claims, but focus turns to the ECB's policy meeting.**

Rates

Constructive bond/equity sessions ahead of ECB

	US yield	-1d
2	1,1082	-0,0159
5	1,8044	-0,0379
10	2,3492	-0,0432
30	3,0313	-0,0459

	DE yield	-1d
2	-0,6860	0,0090
5	-0,3620	-0,0200
10	0,3540	-0,0230
30	1,0278	-0,0184

Global core bonds had a constructive session, which resulted in modest (German) to moderate (US) gains across the curve. Data played no role, neither did a decent Schatz auction. **Increased optimism that the ECB wouldn't disappoint markets today by keeping its accommodative APP alive for longer, likely supported the move in combination with short covering after a month of core bond selling.** In this respect, it shouldn't surprise that equities profited as well, with the banking sector and other cyclical sectors outperforming. The **Dax** broke through the upper boundary of a three month sideways range and the **S&P (Dow and Russell)** surged to a new all-time high. US and European equity gains ranged between 1 and 2%. **In a daily perspective**, the **US curve bull flattened** with yields up to 5.6 bps (30-yr) lower. **In Germany, the belly outperformed** with 5- and 10-yr yields down 1.8 and 2.7 bps and the 2- and 30-yr yields respectively 1.8 higher and 1.3 bps lower. The post Italian referendum rally **on intra-EMU bond markets lost momentum but spreads still narrowed 3 to 4 bps for** Italy, Spain and Greece while Portugal outperformed (-10 bps).

ECB day: Fasten your seatbelts

ECB to extend programme for 3 months with pace purchases unchanged

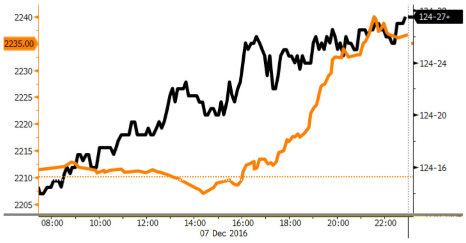
Thereafter programme will become data instead of time-dependent…

Allowing start tapering around mid-2017

Issue and possibly issuer limit to be raised, but no change capital key

Some measures to solve collateral

We expect the ECB to extend the APP programme by 3 months and keep it at the current €80B/month purchase pace. Some technical parameters will be changed to give the ECB enough room to implement the programme for eventually longer than these three months and avoid scarcity. For the various possible technical changes, see our preview flash. **We favour an increase of the issue limit and eventually issuer limit, but no change in the capital key.** The ECB is expected to announce that APP will become data-dependent instead of time-dependent after the three month extension, **allowing a potential tapering from mid-2017 onwards.** We think that the timing for an announcement of a gradual retrenchment from APP isn't right yet. The low headline and core inflation rates pose communication issues. The announcement of an near term end of APP could also trigger another bond sell-off and eventually a further re-widening of peripheral yield spreads, which would be risky given the recent market volatility. **Finally, there is no hurry for the ECB as the business cycle is still in its infancy contrary to the US.** The ECB will probably take action to solve the **problems of collateral scarcity** in the repo-market. Its bond lending facility doesn't work well. It isn't obvious the ECB will succeed in solving this problem. The rules of the bond lending programme differ across various jurisdictions as national banks are responsible for collateral lending. The shift to reverse repos would be a good solution, but diminishes excess liquidity, a signal the ECB probably doesn't want to give.



T-Note future (black) and S&P future (orange) (intraday): Bunds go higher and march further also when equities rally. Main driver: hope central banks will remain the friend of markets

S&P: jumps higher to new all-time highs after some days of hesitation. Is this the start of another post-election leg higher? Fed remains hurdle before end-of-year buying may kick in

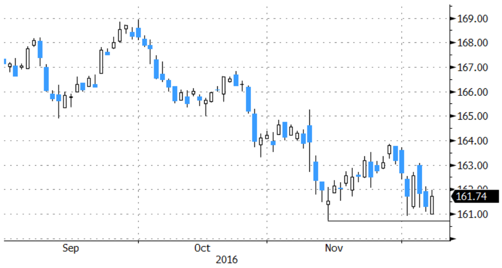
R2	163,19	-1d
R1	162,08	
BUND	**161,63**	0,9400
S1	159,14	
S2	158,67	

To taper down QE-purchases or not?

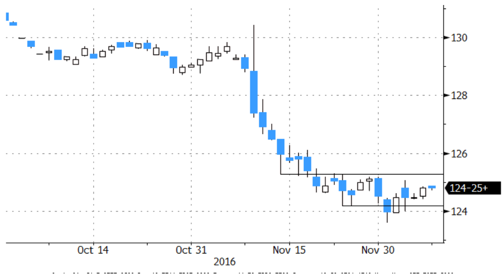
Overnight, most Asian equity markets trade positive in line with positive risk sentiment in Europe and the US yesterday. The US Note future and Brent crude trade sideways, suggesting a neutral opening for the Bund.

The only thing that matters today is the **ECB meeting.** We think that the market reaction will depend on one word and one word only: **tapering. Any firm commitment by the ECB to taper down asset purchases, irrespective of an initial extension of the QE-programme beyond March 2017, will be considered hawkish and a turning point in the ECB's monetary policy cycle.** Such scenario would strengthen the technical bottoming out of European yields, confirm the Bund's sell-on-uptick environment and trigger bear steepening. **Any scenario that doesn't involve tapering, ie an open-ended/limited extension of asset purchases while keeping the option open to do even more if necessary, will be considered dovish.** In this respect, it's important to point out that most analysts (including us; see above) favour the second scenario (3-6 month extension QE without tapering commitment). **This implies that the market reaction might be less outspoken than in case of a hawkish ECB. We would nevertheless changes our Bund bias from sell-on-upticks to neutral in this scenario.** The announcement of technical measures to widen the scope of the QE-programme are of marginal importance for trading.

Technically (US), the US 2-yr yield broke above 1.1% resistance. The test of the US 5-yr yield to break above the 1.85% area and the test of 2.5% resistance in the US 10-yr yield currently didn't succeed. The US 30-yr yield remains below a similar 3.25% mark. We wait for specific news (e.g. a hawkish Fed next week) before anticipating a break higher (5yr & 10 yr). We hold our sell-on-upticks approach in US Treasuries.



German Bund: ECB meeting will decide whether or not the sell-on-upticks environment will be extended



US Note future (March contract): consolidation ahead of the Fed?

Currencies

EUR/USD near key resistance ahead of ECB meeting

Dollar declines as core bond yields drop going into the ECB meeting

USD/JPY ignores broad-based equity gains

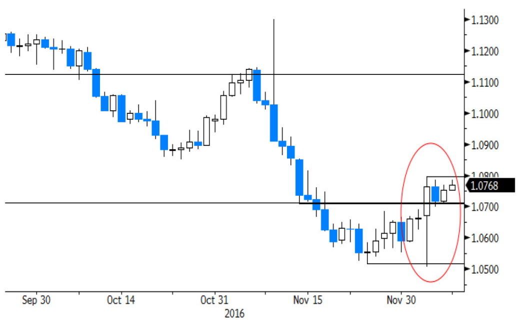
On Wednesday, equities rallied sharply, while core bonds were also well bid as investors prepared for a soft ECB today. Initially, there were no spill-overs to currencies. Later, the decline in core bond yields gradually took its toll on the dollar. EUR/USD trended higher in the 1.07 big figure, but the recent highs were left intact. EUR/USD closed the session at 1.0753 (from 1.0718). USD/JPY also declined in US trading despite a sharp rise of US equities. The pair finished the day at 113.77, from 114.02

Dollar remains slightly in the defensive in Asia

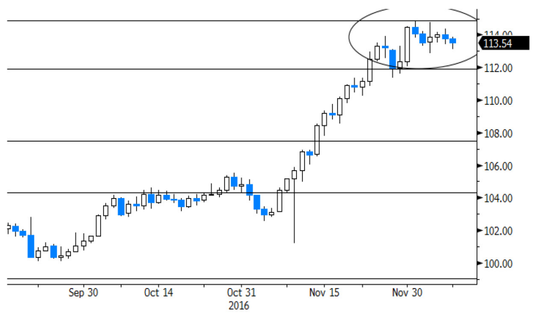
Overnight, most Asian equity markets join the rally in Europe and the US yesterday. Chinese indices underperform. The November Chinese trade surplus narrowed as imports (+13% Y/Y in CNY terms) rose more than exports (5.9% Y/Y). **The Japanese Q3 GDP** was revised down from 0.5% Q/Q to 0.3%; but consumption was upward revised. Global bonds are trading sideways and the dollar remains in the defensive. **The trade weighted dollar trades again in the 100 area (compared to a post Trump top slightly north of 102).** USD/JPY is changing hands in the 113.55 area (intraday low in the 113.13 area). EUR/USD came close to the recent highs and trades in the 1.0771 area.

R2	1,0851	-1d
R1	1,0809	
EUR/USD	**1,07645**	0,0047
S1	1,0506	
S2	1,0458	

There are no eco data of interest for release (see rates section). **Regarding the ECB, we expect them to extend the APP at the current €80B/month pace by 3 months.** A the same time, some technical parameters will be changed to give them enough room to implement the programme for eventually longer than these three months. The ECB will announce that afterwards the programme is data-dependent instead of time-dependent, allowing a potential tapering of the purchases from mid-2017 onwards. For an in depth analysis of our ECB assessment **see the fixed income part of this report and our KBC flash.**



EUR/USD: holding near the 1.0795/1.0809 resistance going ECB policy decision



USD/JPY tested key resistance just below 115, but test is rejected, for now

ECB policy statement to decide whether EUR/USD rebound has further to go.

Yesterday's bond (and equity) rally suggests that markets are expecting a soft ECB (and probably also a soft Fed). Regarding the ECB decision, anything less than a 3 or 6 month prolongation of APP will be seen as hawkish. The market will also look for any (subtle) hints on tapering/scaling back unconventional policy tools. Even a prolongation by just 3 months might already cause some nervousness in the interest rate markets as markets could see it as an indication that tapering is coming closer. **So, it won't be easy for the ECB to surprise on the soft side.** Such an outcome might be euro supportive. However, if a rise in European bond yields spills over to global bond bonds, the positive impact on the euro might be limited.

Yesterday and on Tuesday, **the EUR/USD rebound took a breather after the short squeeze on Monday. However, the recent top (1.0796) and the 38% retracement of the post Trump-rally (1.0809) are still within reach. We look out whether these levels hold.** A break beyond these levels (regardless of the reaction on the bond markets) would be an indication that some further repositioning on the USD rally/euro decline is needed. We wait how the test of this level turns out before reconsidering new/additional EUR/USD shorts

The technical picture for USD/JPY improved for late. The pair took out the key resistance at 111.45/91. Next key resistance at 114.50/115 was tested last week and earlier this week, but the test was rejected. **The pair has moved well into overbought territory. The rally might be ripe for a some consolidation/a modest correction.**

EUR/GBP stays away from the recent low

R2	0,8708	-1d
R1	0,8578	
EUR/GBP	**0,8507**	0,0041
S1	0,83	
S2	0,8117	

Sterling's fortune might have changed a bit yesterday. Monday's rise of EUR/USD pushed EUR/GBP higher. Brexit also returned as a factor for sterling trading. The UK currency used to profit when markets anticipated parliamentary involvement in the Brexit process which would reduce the risk of a hard Brexit. However, this week, it looked that the UK government could remain in control even if parliamentary approval is needed to start Brexit negotiations. **PM May asked Parliament to allow the government to trigger Brexit by March2017. In return the government will give (limited?) insight in its Brexit intentions.** Sterling faced more pressure yesterday. In addition to the Brexit noise, the UK October production data were also weaker than expected. EUR/GBP jumped north of 0.85, while cable dropped temporary below 1.26 going into the Parliamentary Q&A which **didn't bring much info.** The opposition wants clarity on the government's position first. So, the political stalemate persists. EUR/GBP set an intraday top of 0.8550 and close the session at 0.8517 (from 0.8454). Cable finished the day at 1.2626.

This morning, **the UK RICS House price balance improved from 23% to 30%.** Sterling regains slightly ground this morning, but this is rather due to global factors (USD weakness) than anything else. There are no other eco data in the UK today. **Sterling sentiment eased earlier this week. The UK currency didn't profit anymore from the USD rally and Breixt returned as a factor for trading. For now, it is unclear whether both factors will last.** That said, we have the impression that the recent comeback of sterling ran its course and that at least some consolidation m:ight be on the cards. The topside in sterling might become tough. EUR/GBP extensively tested the 0.8333 support on Monday, but a sustained break didn't occur. The 0.8333/05 area has become an important point of reference. We assume that it won't be easy for EUR/GBP to drop below this area. We look for confirmation on the bottoming out process.

EUR/GBP: tentative signs of a bottoming out process

GBP/USD: running into resistance?

Calendar

Thursday, 8 Dec		Consensus	Previous
US			
14:30	**Initial Jobless Claims**	**257k**	**268k**
14:30	Continuing Claims	2048k	2081k
China			
04:41	Trade balance CNY (Nov) CNY	A 298.11B	325.25B
04:41	Exports (Nov (Y/Y) CNY	A 5.9%	-3.2%
04:41	Imports (Nov) (Y/Y) CNY	A 13%	3.2%
Japan			
00:50	BoP Current Account Adjusted (Oct)	A¥1928.9b	¥1477.3b
00:50	Trade Balance BoP Basis (Oct)	A ¥587b	¥642.4b
00:50	GDP SA QoQ / Annualized QoQ (3Q F)	A 0.3%/1.3%	0.5%/2.2%
00:50	GDP Deflator YoY (3Q F)	A -0.2%	-0.1%
06:00	Eco Watchers Survey Outlook (Nov)	A 49.1	49.0
UK			
01:01	RICS House Price Balance (Nov)	A 30%	23%
EMU			
13:45	**ECB Main Refinancing Rate**	**0.000%**	**0.000%**
13:45	**ECB Deposit Facility Rate**	**-0.400%**	**-0.400%**
13:45	**ECB Marginal Lending Facility**	**0.250%**	**0.250%**
13:45	**ECB Asset Purchase Target (Dec)**	**EU80b**	**EU80b**
France			
07:30	Non-Farm Payrolls QoQ (3Q F)	0.3%	0.3%
08:30	Bank of France Bus. Sentiment (Nov)	100	99
Sweden			
09:30	Household Consumption (MoM) / (YoY) (Oct)	--/--	-0.2%/1.5%

Contacts

10-year	td	-1d	2 -year	td	-1d	STOCKS		-1d
US	2,35	-0,04	US	1,11	-0,02	DOW	19550	19549,62
DE	0,35	-0,02	DE	-0,69	0,01	NASDAQ	for Exch - NQI	#VALUE!
BE	0,67	-0,04	BE	-0,61	0,01	NIKKEI	18765	18765,47
UK	1,36	-0,06	UK	0,09	-0,03	DAX	10986,69	10986,69
JP	0,05	0,01	JP	-0,16	0,01	DJ euro-50	3142	3142,24

							USD	td	-1d
IRS	EUR	USD (3M)	GBP	EUR	-1d	-2d	Eonia EUR	-0,349	0,002
3y	-0,065	1,501	0,733	Euribor-1	-0,37	0,00	Libor-1 USD	0,26	0,26
5y	0,140	1,790	0,921	Euribor-3	-0,32	0,00	Libor-3 USD	0,38	0,38
10y	0,748	2,179	1,314	Euribor-6	-0,22	0,00	Libor-6 USD	0,54	0,54

Currencies		-1d	Currencies		-1d	Commoditie	CRB	GOLD	BRENT
EUR/USD	1,07645	0,0047	EUR/JPY	122,33	-0,15		190,8515	1174,9	52,91
USD/JPY	113,66	-0,65	EUR/GBP	0,8507	0,0041	-1d	-1,67	6,54	-0,85
GBP/USD	1,2647	-0,0007	EUR/CHF	1,0837	0,0018				
AUD/USD	0,7483	0,0047	EUR/SEK	9,764	-0,02				
USD/CAD	1,3227	-0,0055	EUR/NOK	8,9845	-0,03				

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