Week ahead

ECB – Markets interpret meeting accounts one-sidedly
USA – Budget negotiations: Deja vu and more

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ECB Council indicates changes ahead, but course remains uncertain

The release of the account of the ECB Council meeting from December 8 triggered a significant market reaction this week. Both government bond yields as well as the euro rose. Markets reacted to those parts of the accounts that pointed to a change of the ECB's guidance relatively soon. Markets concluded that there would be an earlier than expected end of monthly net asset purchases and yields rose to levels seen for the last time in summer of 2017.

The ongoing good economic data is definitely starting to have an impact on Council members. At the same time, it is important that progress towards the ECB's inflation goal was disappointing during the last several months, which was also mentioned in the accounts and seen as a concern. Further, it was reiterated again that the favorable economic conditions remained dependent on an ample degree of monetary accommodation. So, from our perspective, markets overreacted. We expect the ECB to change its communication with markets only slightly after one of the next meetings. Very likely, the option to increase net asset purchases in case the outlook becomes less favorable will be dropped. However, this should not come as a surprise to anybody, as nobody expects the ECB to increase its asset purchases. Rather, speculation turns exclusively around the end date.

We expect the ECB Council to decide only in summer on net asset purchases after September and at the same time to decide on any major changes to its guidance. More progress towards the ECB's inflation goals will be a prerequisite for any changes to either. We expect net asset purchases to end in September, and while the wording of the guidance should be changed, the ECB will continue to signal that any interest rate hikes are distant.

We expect yields of Eurozone sovereign bonds to rise continuously in the course of this year, but the most recent move looks exaggerated, based on the new information released. The strong advance of the euro also looks exaggerated, as the coming interest rate hikes in the US favor the dollar, in our view.

US congress has to agree not only on budgeting and debt limit, but also on increase of spending limits

Once more, the financing of the US public household is pending next week. Once again, frantic negotiations to the end – January 19 – are likely, to prevent a partial payment default (interest rate payments and spending on security would not be affected) of public authorities ('government shutdown'). And once again, the market is likely to react in a relaxed manner and to expect an eventually positive outcome. As already

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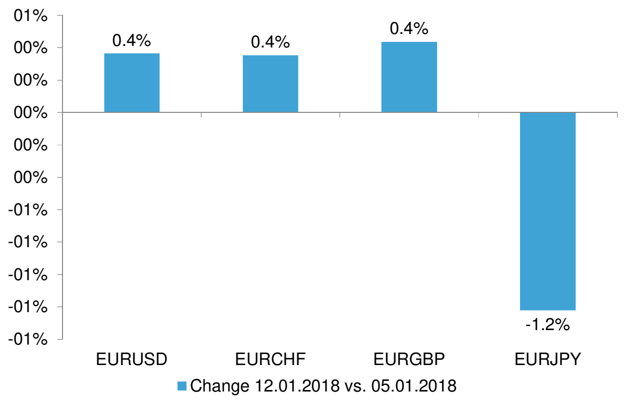
happened in September and twice in December, the US Congress may also only agree on a short-term solution (continuing resolution) next week and not on a budget for the ongoing fiscal year. And again, an increase in the debt ceiling is on the agenda. An expiry of this deadline would have no immediate impact, as in this case the US Treasury department would be able to maintain solvency for another 3-4 months. But still, the situation is slightly different this time. Apart from the two issues already mentioned, this time an agreement on a raise of the spending limits must be reached as well. Otherwise, it might even result in a slight reduction of the discretionary spending, including everything apart from social spending. These spending limits were resolved in 2011; since then, agreements could be reached consistently only on temporary increases. For 2018, such an agreement could not be reached yet. In case it will not be reached, this would – among other things – mean the end of the Trump Administration's plans to massively increase military expenditures.

The whole process is quite difficult, as the Republicans, holding a majority in both chambers, need some of the Democrats' votes at least in the Senate. Both parties are attaching their permission of the budgeting to other political topics. The Republicans want to increase defense spending massively, whereas the Democrats request equally large increases of other discretionary spending. Additionally, there are other issues of interest, like the building of a wall between Mexico and the US and the expiring protection of people who illegally immigrated to the US when they were children.

Thus, once more a politically eventful week is about to begin. From our perspective, it is completely uncertain whether an agreement on a budget for the fiscal year or only a temporary solution can be reached. Markets are likely to remain calm. Nevertheless, the progress should be followed closely, as the danger of escalation exists.

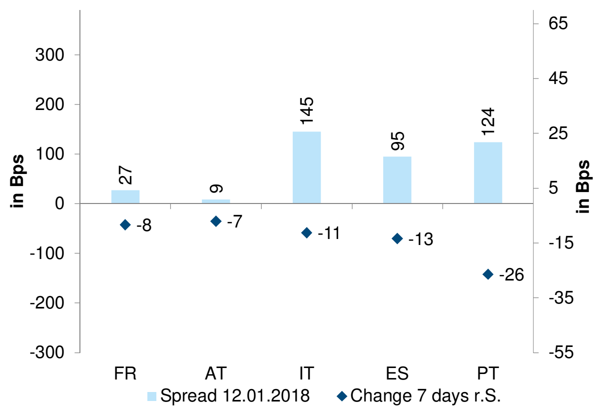
Forex and government bond markets

Exchange rates EUR: USD, CHF, GBP and JPY
change last week
(+ stronger euro / - weaker euro)



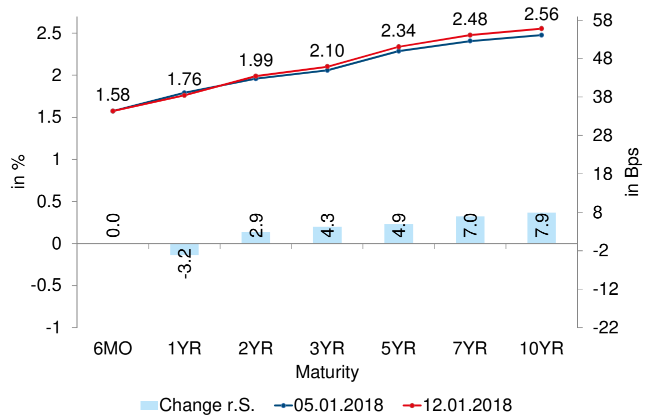
Source: Bloomberg, Erste Group Research

Eurozone – spreads vs. Germany
10Y government bonds



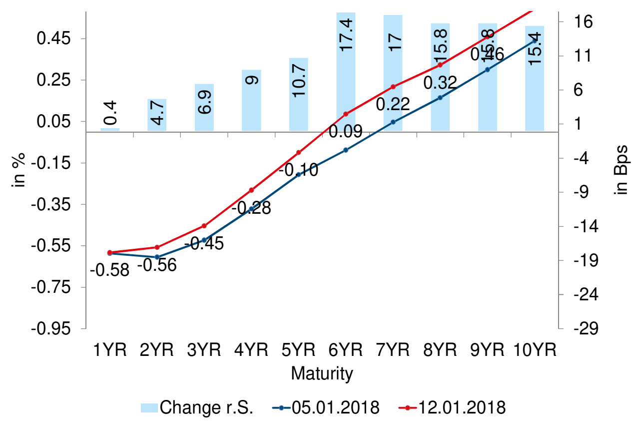
Source: Bloomberg, Erste Group Research

US Treasuries yield curve
change last week



Source: Bloomberg, Erste Group Research

DE Bund yield curve
change last week



Source: Bloomberg, Erste Group Research

Economic calendar

Date	Time	Ctry	Release	Period	Consens	Prior
12-Jan	n.a.	CN	CNY new loans	Dec	998bn	584bn
		CN	M2 yoy	Dec	9%	8%
	8:45	FR	CPI m/m	Dec F	0.4%	0.4%
		FR	Inflation y/y	Dec F	1.3%	1.2%
	10:00	IT	Ind. Prod. y/y	Nov	3.6%	3.1%
	14:30	US	Retail Sales mom	Dec	0.4%	0.8%
		US	Inflation y/y	Dec	2.1%	2.2%
		US	CPI m/m	Dec	0.1%	0.4%
15-Jan	11:00	EA	Trade Balance	Nov		19038m
16-Jan	8:00	DE	Inflation y/y	Dec F	1.6%	1.6%
		DE	CPI m/m	Dec F	0.8%	0.8%
	10:00	IT	Inflation y/y	Dec F		1.0%
	11:00	IT	Trade Balance	Nov		4953m
17-Jan	n.a.	US	Ind. Prod. y/y	Dec		3.4%
	11:00	EA	CPI m/m	Dec	0.3%	0.4%
		EA	Inflation y/y	Dec F	1.4%	1.4%
18-Jan	n.a.	CN	Ind. Prod. y/y	Dec	6.1%	6.1%
		CN	Unempl. Rate	4Q		4.0%
	9:00	AT	Inflation y/y	Dec		2.3%
		AT	CPI m/m	Dec		0.2%
	14:30	US	Jobless Claims	Jan 13	245.8 thd	261.0 thd
19-Jan	8:00	DE	PPI y/y	Dec	2.3%	2.5%
	10:00	EA	CA Balance (m)	Nov		31 m
	10:30	IT	CA Balance (m)	Nov		6551 m
	16:00	US	Univ. Michigan Index	Jan P	96.8 index	95.9 index

Source: Bloomberg, Erste Group Research

FORECASTS[1])

GDP	2015	2016	2017	2018	2019
Eurozone	2.0	1.8	2.4	2.4	2.2
US	2.9	1.5	2.2	2.4	1.9

Inflation	2015	2016	2017	2018	2019
Eurozone	0.1	0.2	1.5	1.6	1.7
US	0.1	1.2	2.2	2.2	1.9

Interest rates	current	Mar.18	Jun.18	Sep.18	Dec.18
ECB MRR	0.00	0.00	0.00	0.00	0.00
3M Euribor	-0.33	-0.30	-0.30	-0.30	-0.30
Germany Govt. 10Y	0.58	0.50	0.70	0.90	1.10
Swap 10Y	0.95	0.80	1.00	1.20	1.40

Interest rates	current	Mar.18	Jun.18	Sep.18	Dec.18
Fed Funds Target Rate*	1.42	1.63	1.88	2.13	2.13
3M Libor	1.71	1.90	2.20	2.40	2.40
US Govt. 10Y	2.55	2.60	2.70	2.80	3.00
EURUSD	1.21	1.13	1.11	1.10	1.12

*Mid of target range

Source: Bloomberg, Erste Group Research

[1] By regulations we are obliged to issue the following statement: Forecasts are no reliable indicator for future performance

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