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ECB preview: still dovish despite better data

Pernille Bomholdt Henneberg
Senior Analyst
+45 45 13 20 21/+44 20 7410 8157
perni@danskebank.com

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Investment Research

Important disclosures and certifications are contained from page 13 of this report.

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ECB preview: still dovish despite better data

We do not expect a hawkish stance from the ECB, although the latest economic survey indicators have strengthened further and inflation has risen above 1.0% for the first time in three years. President Mario Draghi will most likely argue that the ECB does not react to a single inflation figure, that the latest inflation gains are due primarily to energy prices and consistent with the ECB's inflation forecast – broadly in line with last week's comments from the hawkish executive board member Yves Mersch.

The higher inflation is good news for the ECB but it seems clear that the underlying price pressure is most important and here there are *'no signs yet of a convincing upward trend'*. ECB executive board member Benoît Cæuré said recently, *'we are still waiting for signs that core inflation is on the rise and will clearly exceed 1%'.* We expect core inflation to stay below 1.0% for most of this year, while the ECB looks for a rise to 1.1% on average. See *Highest Euro Area Inflation in Three Years – But the Underlying Price Pressure Remains Weak*, 4 January.

Although tapering speculation is likely to be boosted in coming months by rising inflation, the ECB has, in our view, sidelined itself until H2 with the latest QE extension. We expect headline inflation to rise temporarily above 1.5% but to come back below 1.3% and stay there in H2 17. Based on this, we expect the ECB to extend its EUR60bn monthly QE purchases into 2018. See *Five Reasons the ECB Will Not Announce QE Tapering in 2017*, 4 January.

ECB preview: still dovish despite better data

It remains an open question how aggressive the ECB's buying of bonds yielding below the deposit rate will be, as it has only said it will be 'to the extent necessary'. We estimate that – in order not to breach the 33% issue limit – 15% of the QE purchases in German government bonds will have to be below the deposit rate in a scenario with unchanged yields on German bonds throughout 2017. If purchases below the deposit rate are postponed as long as possible, the ECB will be forced to buy bonds yielding below the deposit rate in November in the scenario with unchanged yields (note the estimates are very sensitive to assumptions). See *How much will the ECB have to buy below depo in Germany in 2017?*, 11 January.

Yesterday, the ECB published a legal act on the option to buy bonds yielding below the deposit rate, which revealed this was not possible until 13 January 2017 (see *link*). Previous communication from the ECB had suggested it would be possible from 2 January (see *link*).

As we expect the ECB to continue its QE purchases in 2018, buying bonds with a yield below the deposit rate could become more pronounced, as the QE holdings will have hit the issue limit aside from new issuance. However, the ECB could also decide to deviate the purchases more aggressively from the capital key distribution – in the minutes from the December meeting, the ECB said it wants to minimise departures from the capital key, thereby also indicating that this is a possibility (see *link*). Buying a larger share of bonds in periphery countries seems attractive to the ECB when, at some point in time, it will exit the QE programme, as this will avoid material spread widening.

ECB preview: still dovish despite better data

1. The ECB does not react to a single inflation figure

2. The underlying price pressure remains weak

3. To what extent will the ECB buy below the deposit rate?

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Higher inflation is very close to the ECB's projection

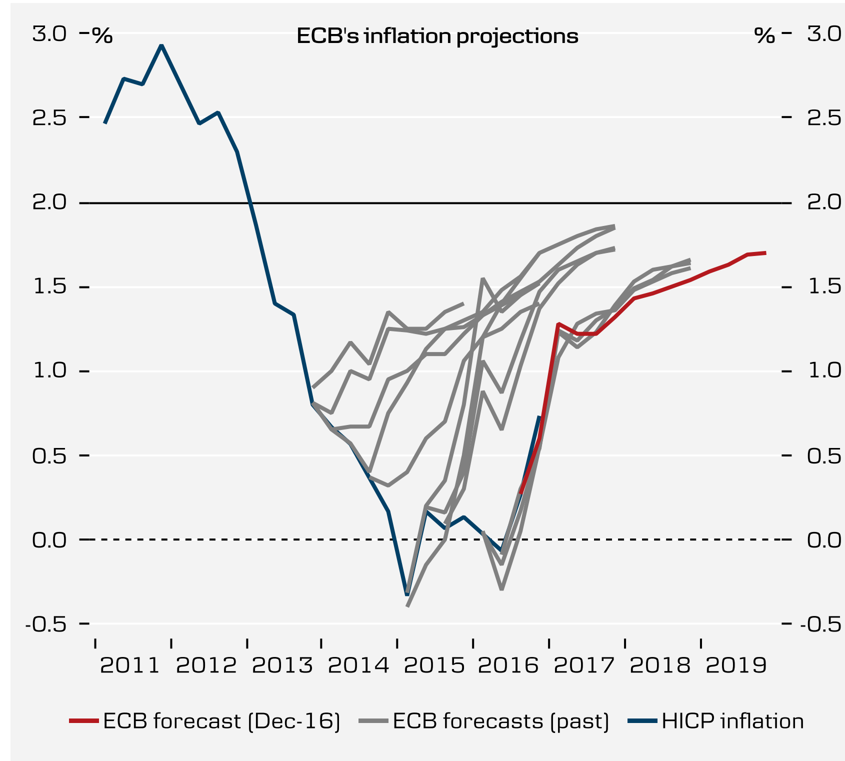
Inflation is broadly as the ECB had expected:

The rise in inflation above 1.0% for the first time since September 2013 was a bit stronger than consensus, but still in line with the ECB's updated inflation projection from December.

Added to this, the higher inflation followed as the drag from the oil price has turned into a tailwind, which the ECB most likely does not consider a 'sustained adjustment in the path of inflation'.

Based on this, we expect the ECB to remain dovish at the meeting in January and maintain this stance as long as the underlying price pressure is not following the upward trend seen in headline inflation.

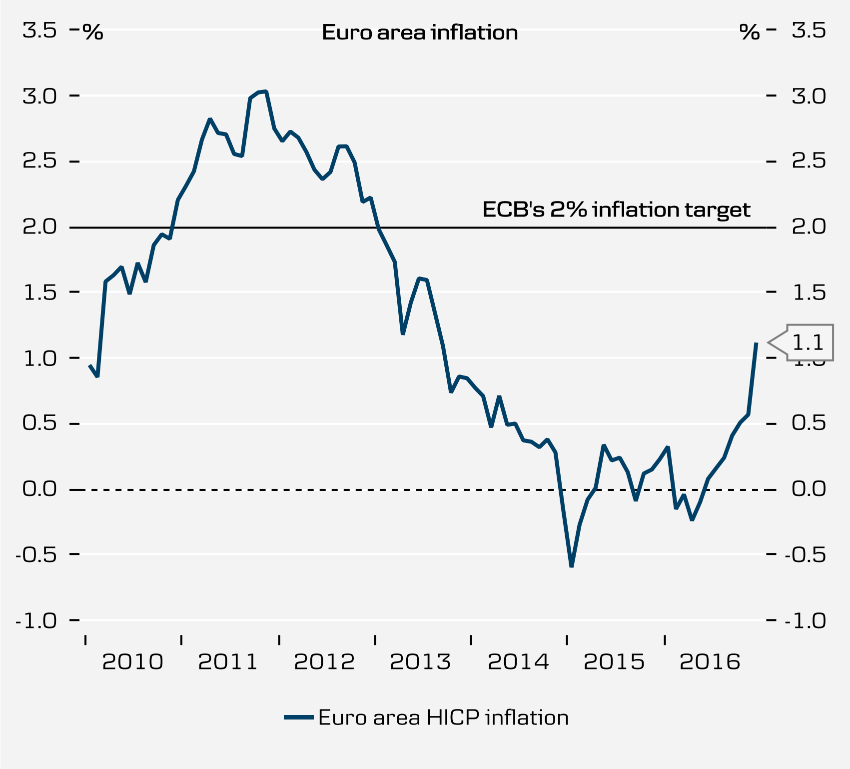
Higher inflation is in line with ECB's forecast



Source: ECB, Eurostat, Danske Bank Markets

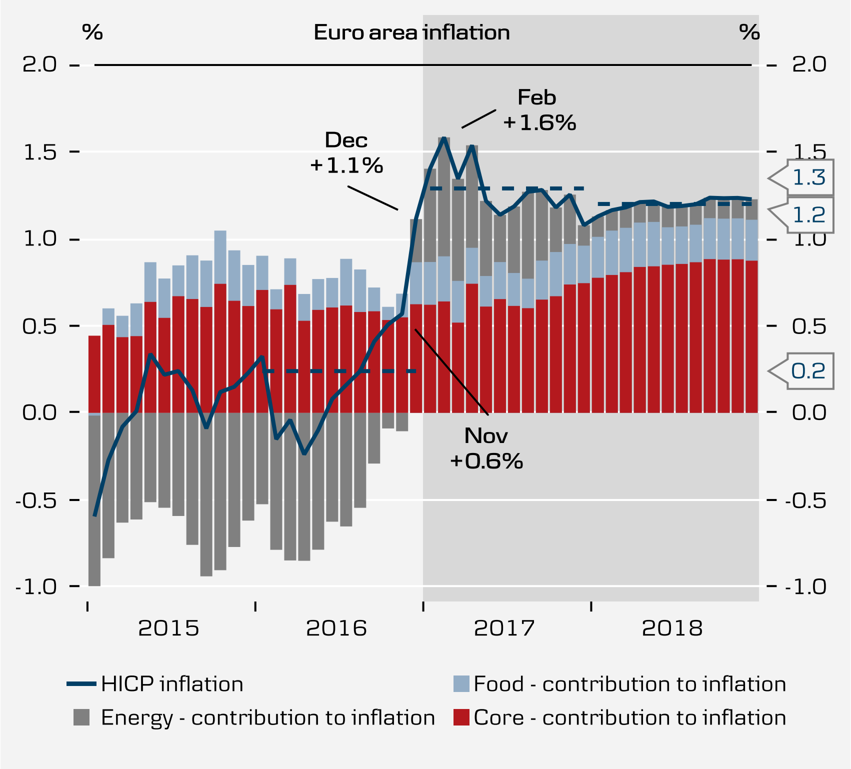
Highest euro area inflation since mid-2013, but driven by energy

Highest euro area inflation since Sep-2013



Source: Eurostat, Danske Bank Markets

Inflation is rising as energy is now a tailwind



Source: Eurostat, Danske Bank Markets

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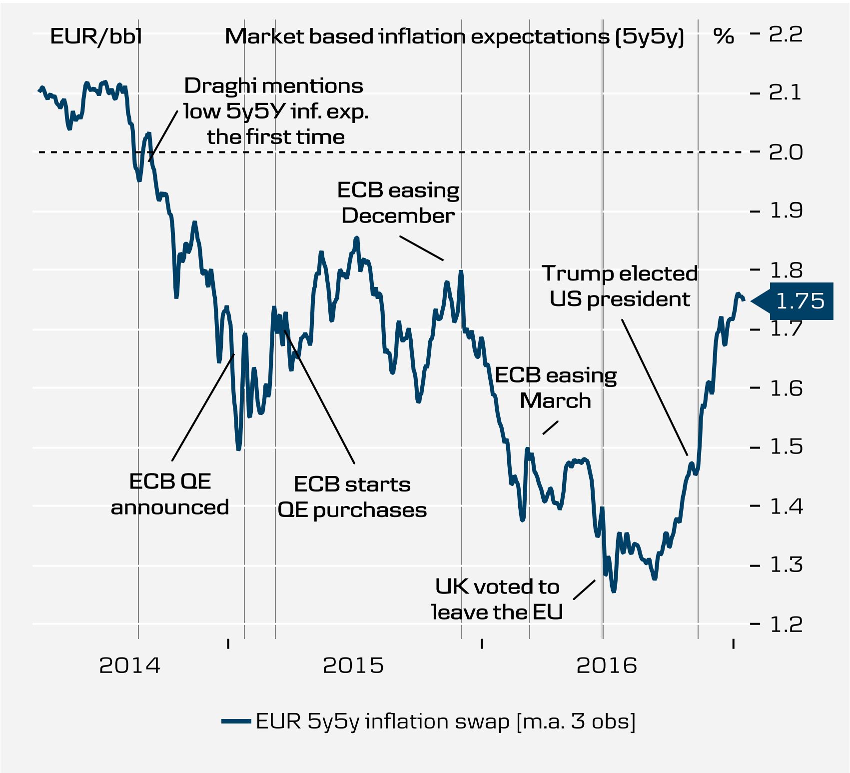
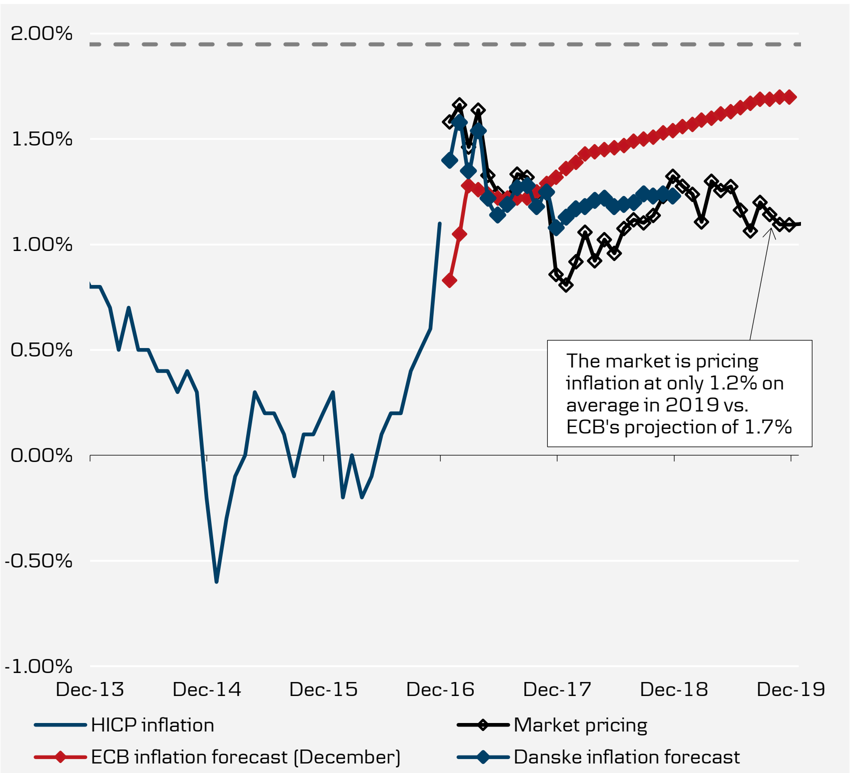
Market pricing in higher inflation but still below ECB's forecast

5Y5Y inflation expectations have gone up



Source: Bloomberg, ECB, Danske Bank Markets

Inflation is priced lower again in 2018



Source: Bloomberg, ECB, Eurostat, Danske Bank Markets

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Core inflation is not set to clearly exceed 1.0% in 2017

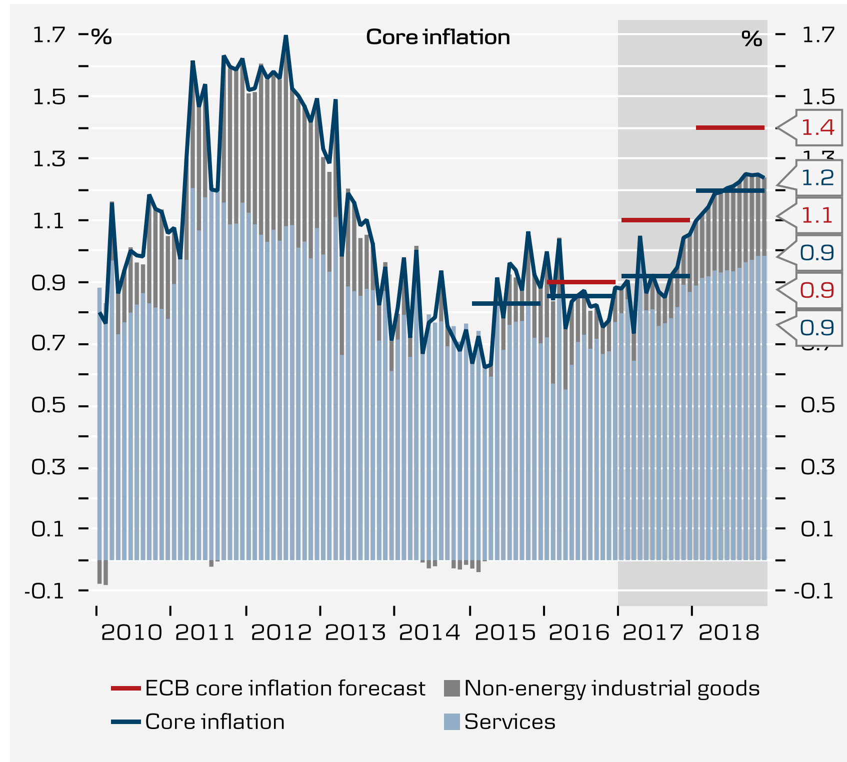
Core inflation is set to stay low this year:

The latest comments from the ECB show clearly that the underlying price pressure is important to the ECB and decisive in deciding when it will start tapering its QE purchases.

It seems that the ECB wants core inflation to rise clearly above 1.0% before starting QE tapering, but we do not expect this to happen before some time in 2018. This is the most important reason why we look for a third QE extension beyond December 2017.

The weak underlying price pressure is also reflected in wage growth, which is still at a historically low level despite the declining unemployment rate.

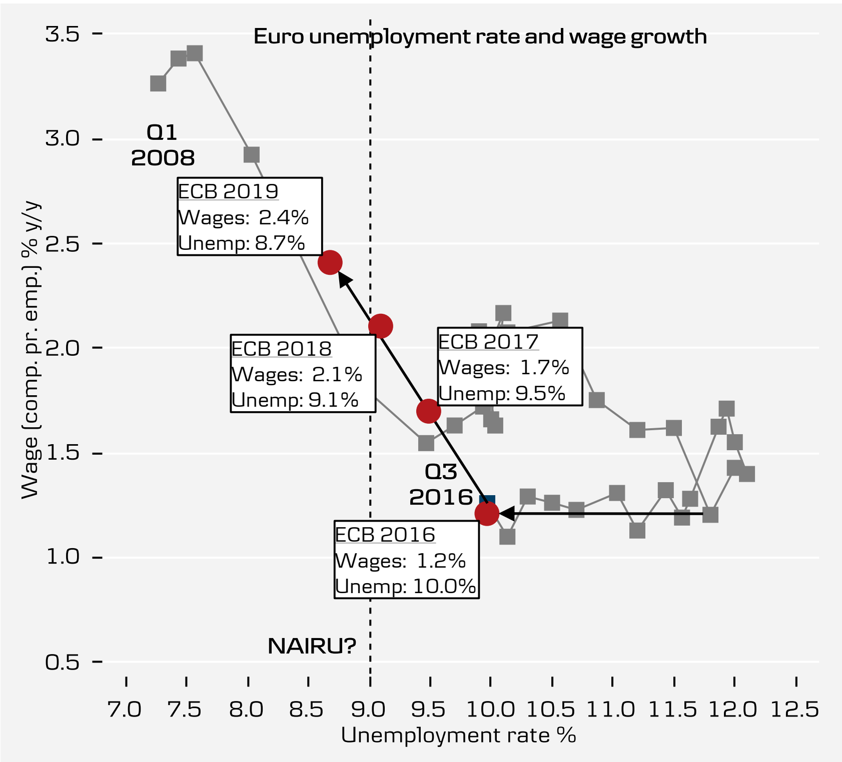
We forecast core inflation at 0.9% in 2017



Source: ECB, Eurostat, Danske Bank Markets

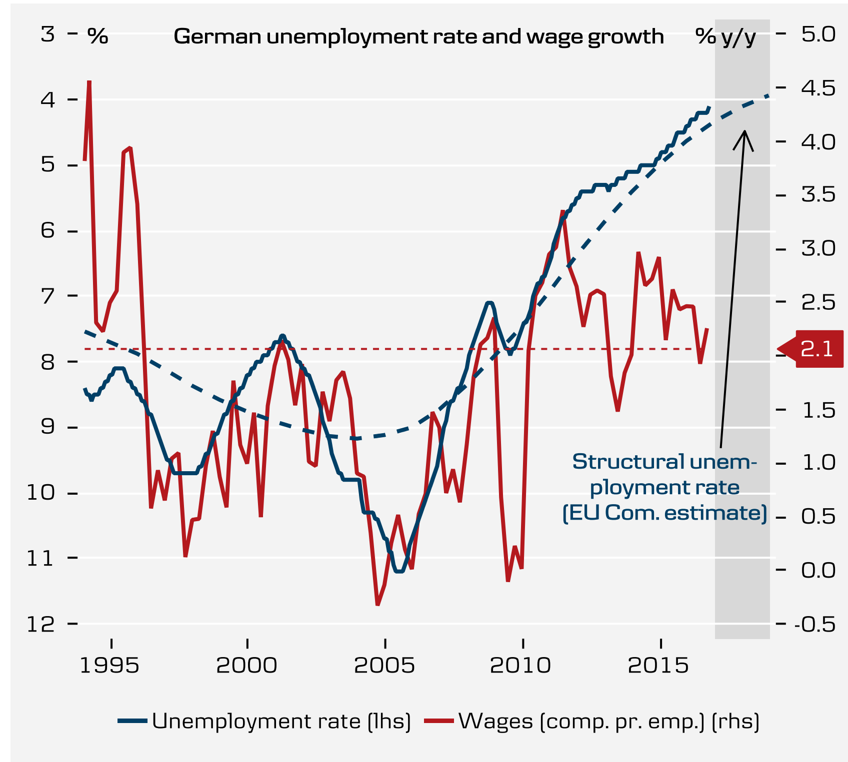
ECB's wage forecast is hopeful – German wage growth still stable

Philips curve: ECB's wage forecast is hopeful



Source: ECB, European Commission, Eurostat, Danske Bank Markets

Not even German wage growth is rising



Source: ECB, European Commission, Eurostat, Danske Bank Markets

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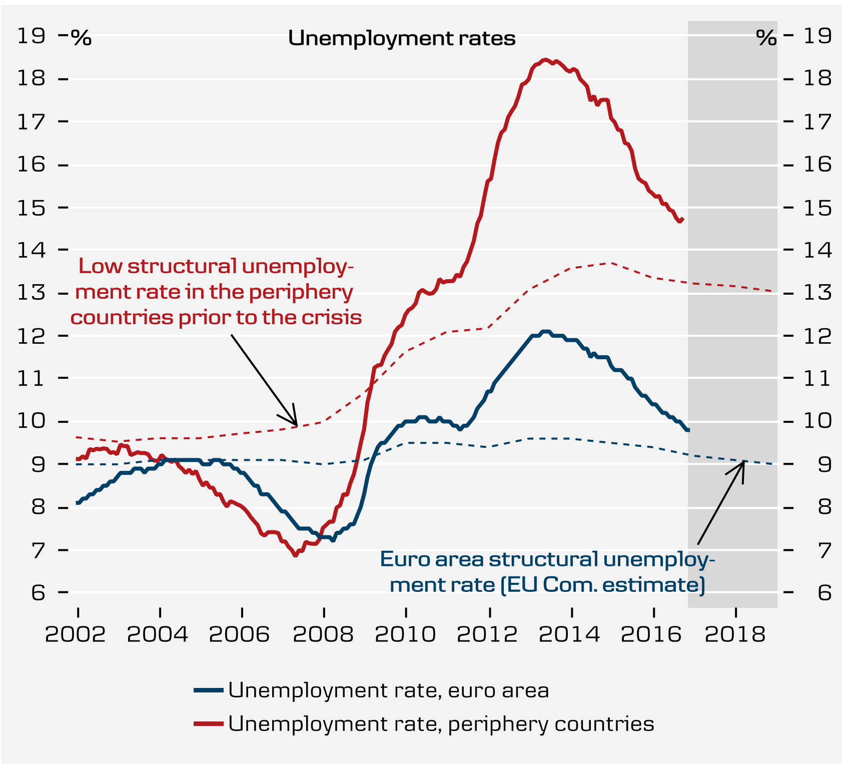
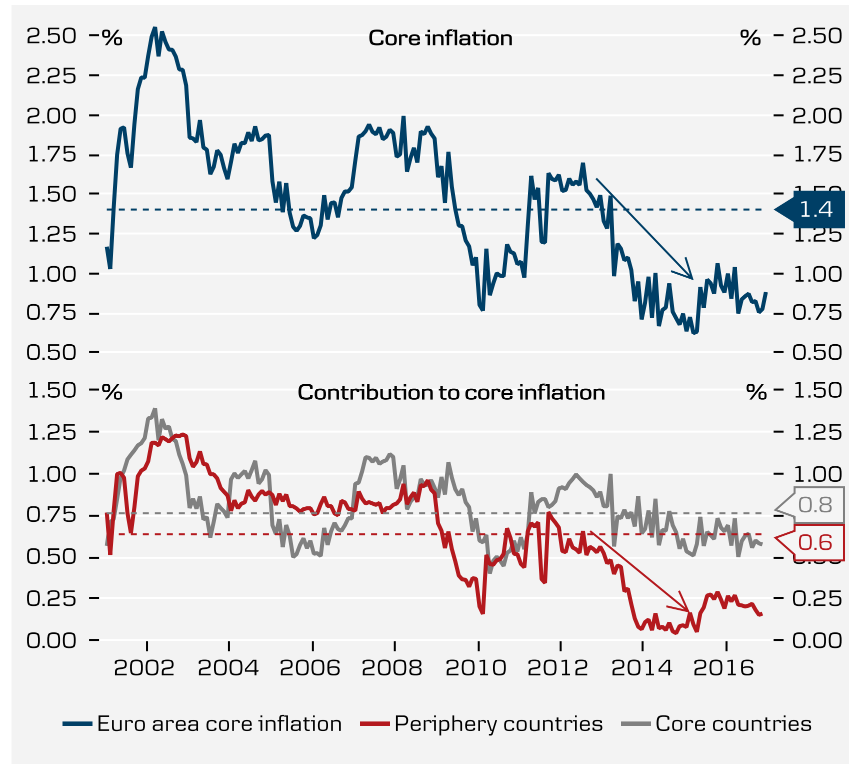
Labour market slack in periphery countries will keep wages low

A lot of labour market slack in the periphery



Source: European Commission, Eurostat, Danske Bank Markets

Very low core inflation in periphery countries



Source: Eurostat, Danske Bank Markets

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Continuing QE into 2018 could imply different purchase pattern

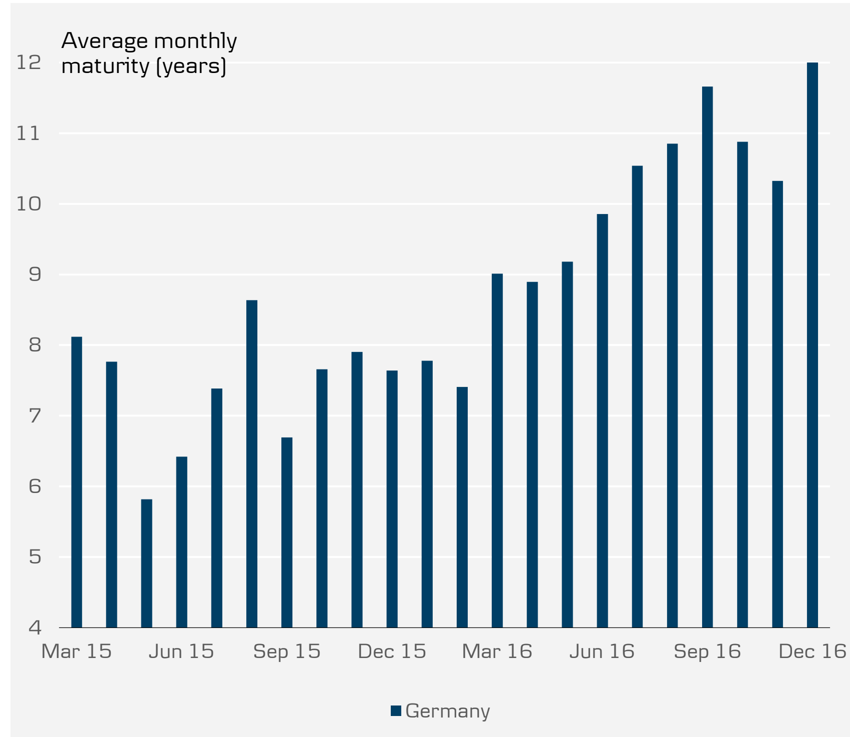
Different purchase pattern could be needed:

Extending QE into 2018, which we expect, could force more pronounced purchases of bonds yielding below the deposit rate, as the QE holdings will have hit the issue limit aside from new issuance.

However, this is not the only way for the ECB to continue QE without breaching the 33% issue limit, as it could also decide to deviate its QE purchases more aggressively from the capital key distribution.

The ECB has said it wants to minimise departures from the capital key but instead of following this distribution, a larger share of bonds in the periphery countries seems attractive to the ECB, when at some point it will exit the QE programme, as this will avoid material spread widening.

Average maturity of German purchases rises



Source: ECB, Danske Bank Markets

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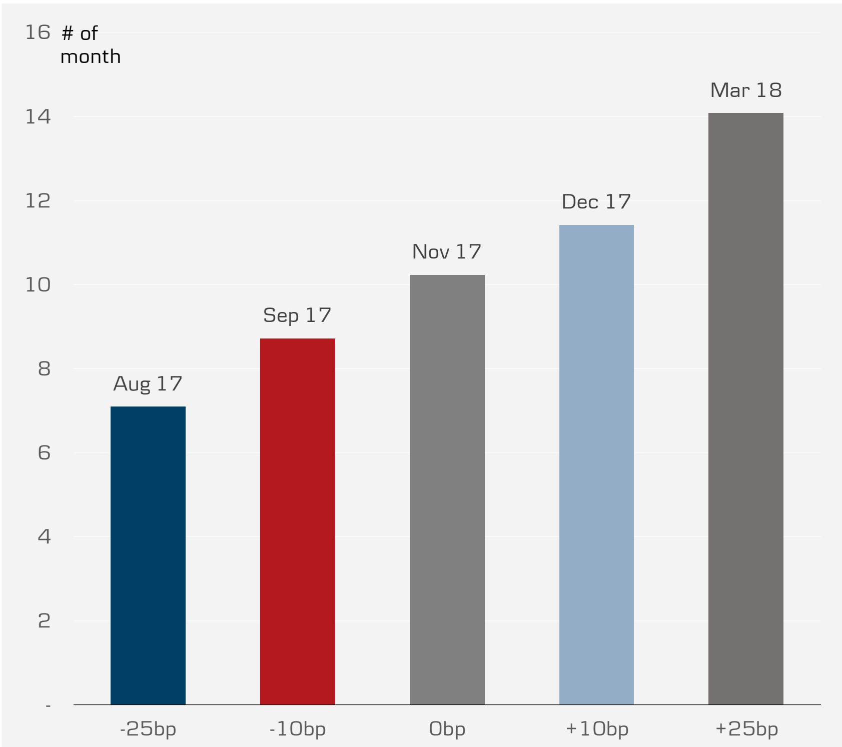
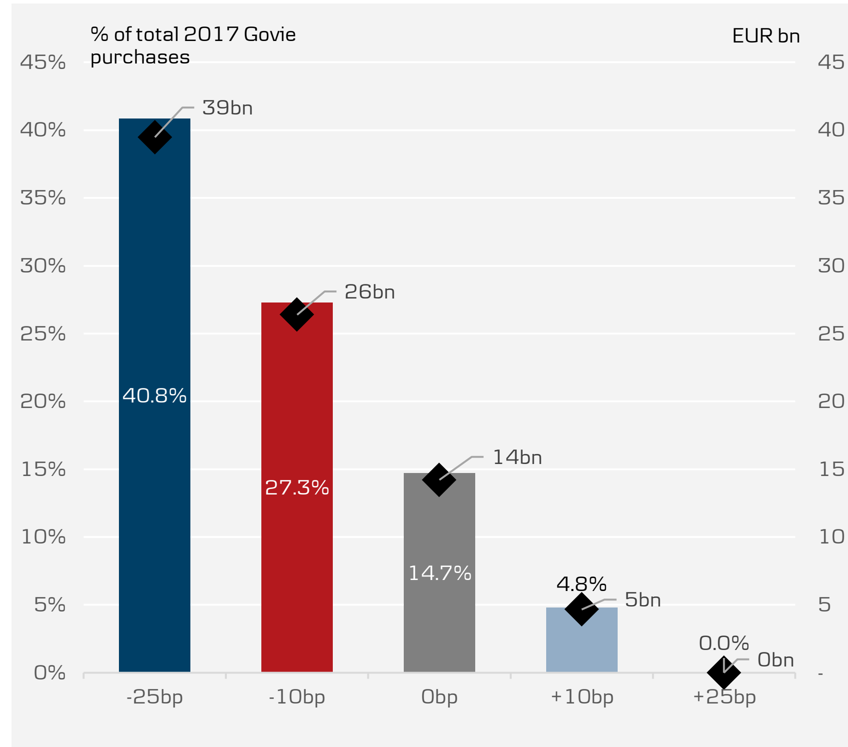
ECB will eventually exercise the option to buy below deposit rate

Month where QE is 'forced' below depo rate



Source: Danske Bank Markets

Fraction of QE buying below depo rate



Source: Danske Bank Markets

Note: Estimates are based on a number of assumptions including (1) purchases are made proportional on the curve when eligible historically (above depo and in eligible mat. segment); (2) purchases in agencies/regionals are assumed to represent the outstanding weight in the PSPP universe – historically and going forward; (3) other Eurosystem holdings of German government bonds besides from PSPP are not included (ECB A.7.2 amounts to EUR320bn or c.5% of EGBs, but are most likely mainly in short maturities); 4) we estimate EUR95bn QE in German government bonds in 2017.

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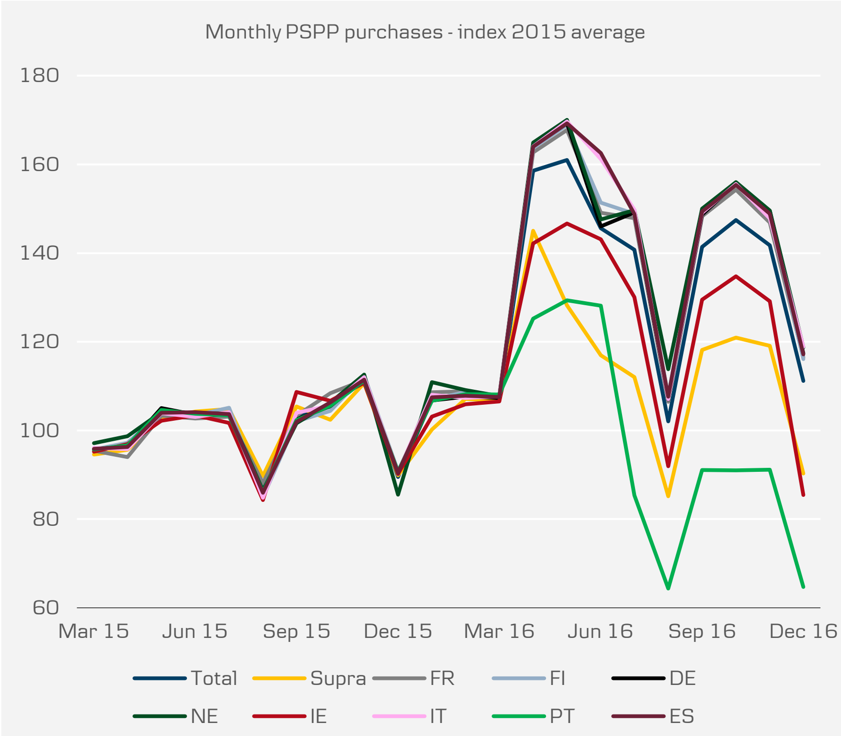
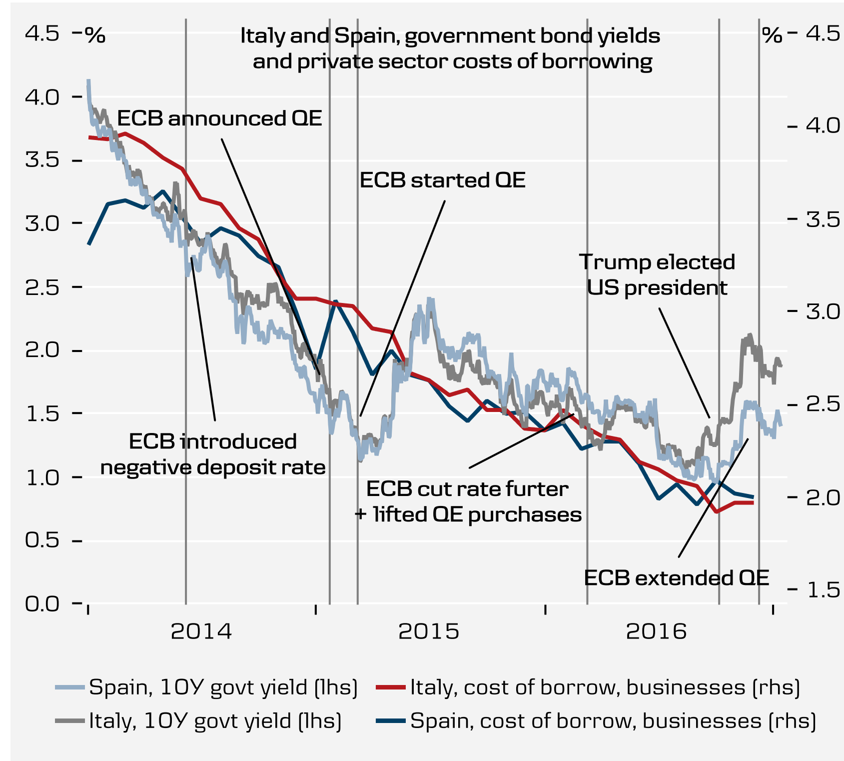
Capital key deviation could help the periphery under QE tapering

ECB has already deviated from capital key



Source: ECB, Danske Bank Markets

Tapering will lift periphery yields and rates



Source: Bloomberg, ECB, Danske Bank Markets

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