Danske Bank
Corporates & Institutions

ECB preview: too early to discuss tapering

Pernille Bomholdt Henneberg
Senior Analyst, Euro area macro Research
+45 45 13 20 21/+44 20 7410 8157
perni@danskebank.com

14 October 2016

Investment Research
www.danskemarketsequities.com

Important disclosures and certifications are contained from page 19 of this report.

ECB preview: too early to discuss tapering

We do not expect any new announcements from the ECB at the meeting next week. President Mario Draghi will, in our view, balance his tone, reflecting the economic resilience to political uncertainty on the one hand but on the other hand, sound dovish, as the ECB is concerned about the subdued underlying price pressure and weakness in the banking sector.

We expect Draghi's main message to be that the ECB's focus is on full QE implementation. Draghi has remained on the sidelines in the recent tapering debate, which started after ECB officials allegedly said that the ECB is considering QE tapering options once the programme ends. In our view, it is too early to discuss tapering but following last week's unconfirmed reports, it will remain a topic going forward.

At the following ECB meeting in December, we expect the ECB to announce an extension of the QE purchases by six months without pre-announcing tapering. The QE extension should follow although inflation is set to rise in coming months but reflect the lack of upward trend on core inflation. In our view, there is a risk the ECB will extend QE again later due to low core inflation.

We do not expect the ECB to adjust its self-imposed QE restrictions ahead of a potential extension of the purchases in December. In our view, the ECB could continue to deviate from the capital key without introducing new buying distribution. Currently, we do not consider it very likely that the ECB allows large-scale buying below the deposit rate.

Too early to discuss tapering – QE could continue for much longer

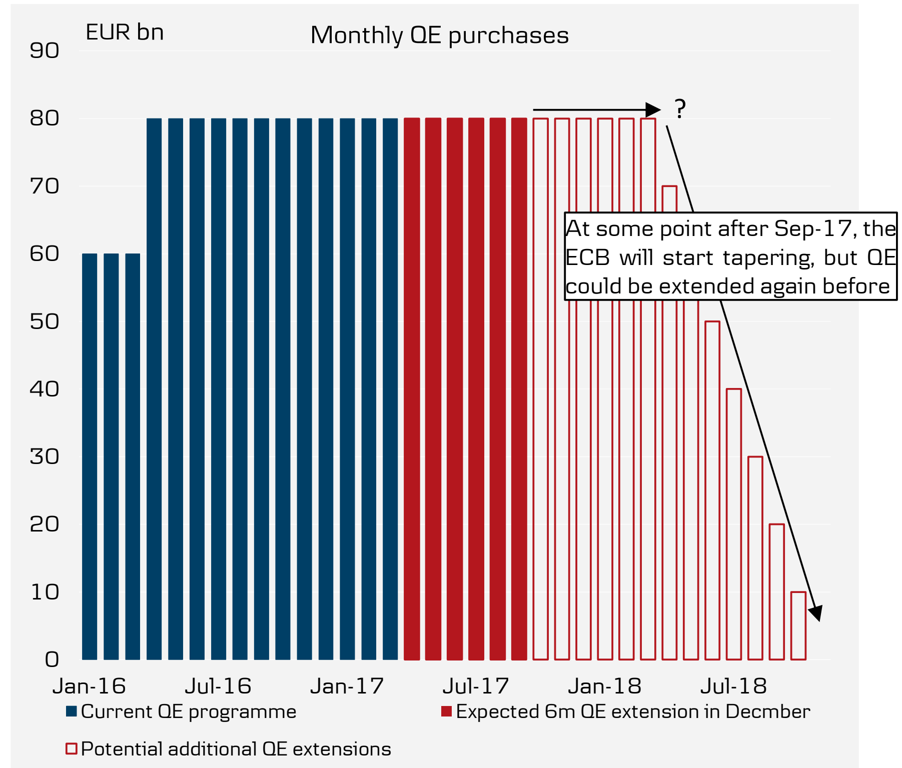
Not yet time for pre-announced QE tapering:

At next week's ECB meeting, the main topic is likely to be QE tapering after unconfirmed reports of ECB officials indicating that the ECB is considering QE tapering options once the programme ends. See [Bloomberg](#).

In our view, the ECB will not pre-announce QE tapering at the meeting. Instead, we expect the programme's end date to remain dependent on the inflation outlook, and we believe the ECB will extend the QE purchases by six months at the meeting in December.

We see some risk that the ECB will scale down its purchases to EUR60bn per month as was the case until April 2016, but our base case is that the current pace of EUR80bn per month will be maintained.

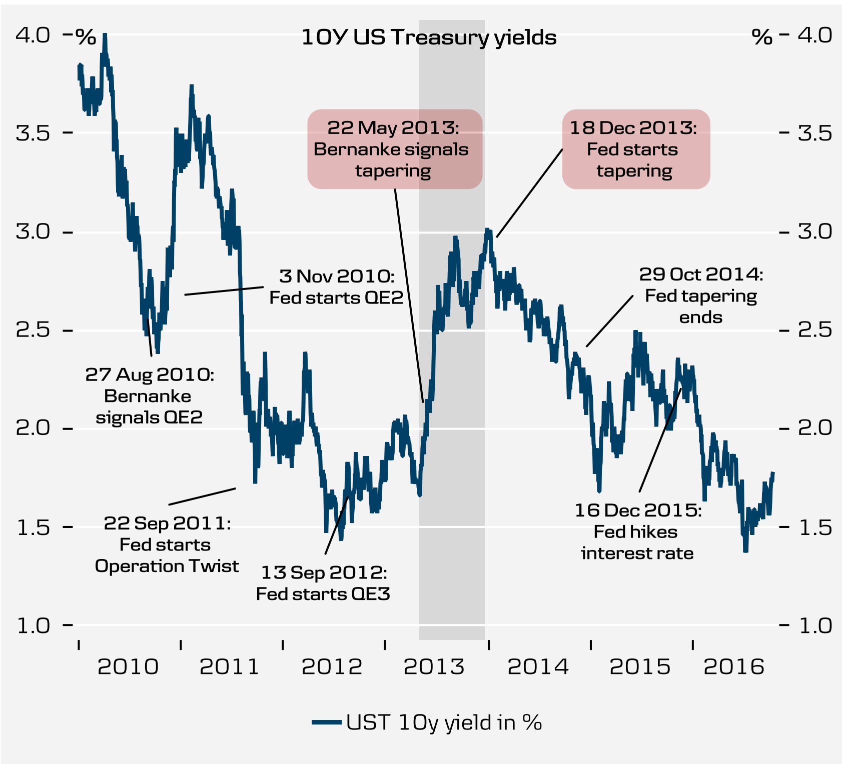
At some point after Sep-17 the ECB will taper



Source: ECB, Danske Bank Markets

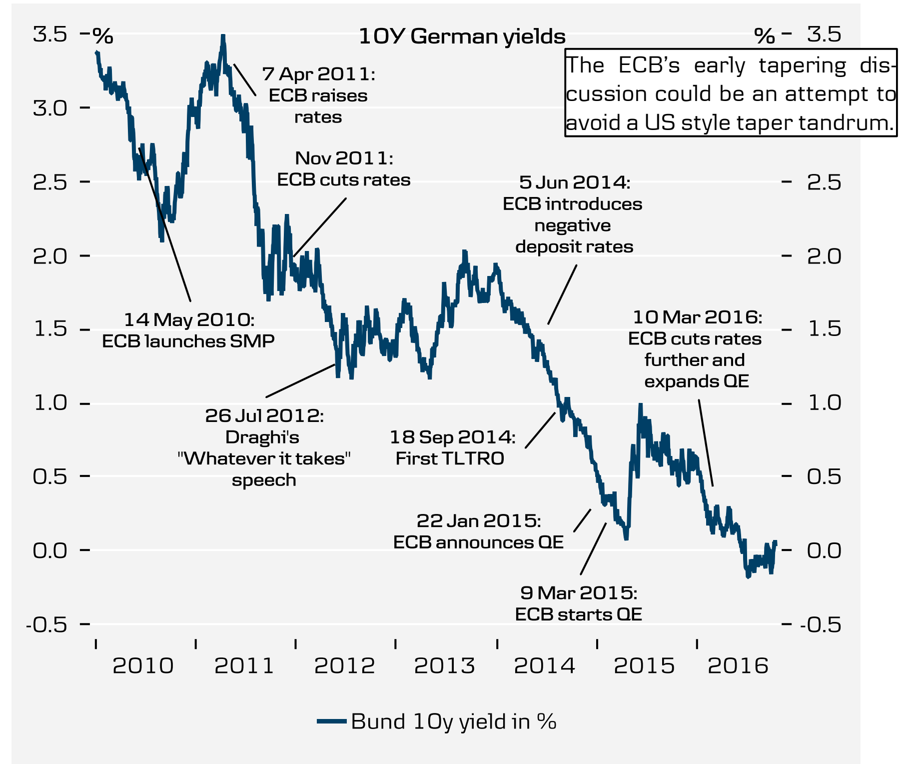
In the US, yields rose on tapering reports, not actual tapering

US yields rose ahead of actual tapering



Source: Macrobond, Danske Bank Markets

10Y German yields are still very close to 0%



Source: Macrobond, Danske Bank Markets

The ECB set to extend QE despite rising inflation in coming months

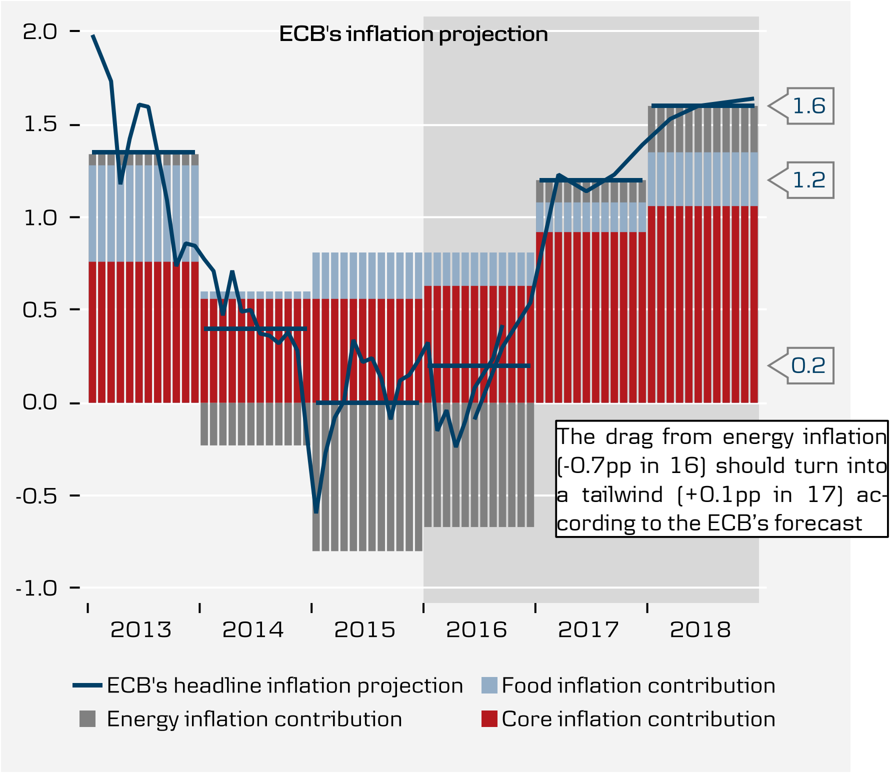
<u>ECB to continue QE despite higher inflation:</u>

The ECB has since the QE announcement in January 2015 argued that the programme will run until the Governing Council sees *'a sustained adjustment in the path of inflation consistent with its inflation aim'*.

In coming months, inflation is set to pick up, but this is due largely to base effects of the past oil price decline. Related to this, prominent ECB members have recently emphasised the lack of a convincing upward trend in underlying price pressures.

Based on this, we do not believe the ECB will end QE purchases, although headline inflation will move closer to the 2% target as the rise in inflation does not reflect higher underlying price pressure.

Higher inflation driven mainly by the oil price

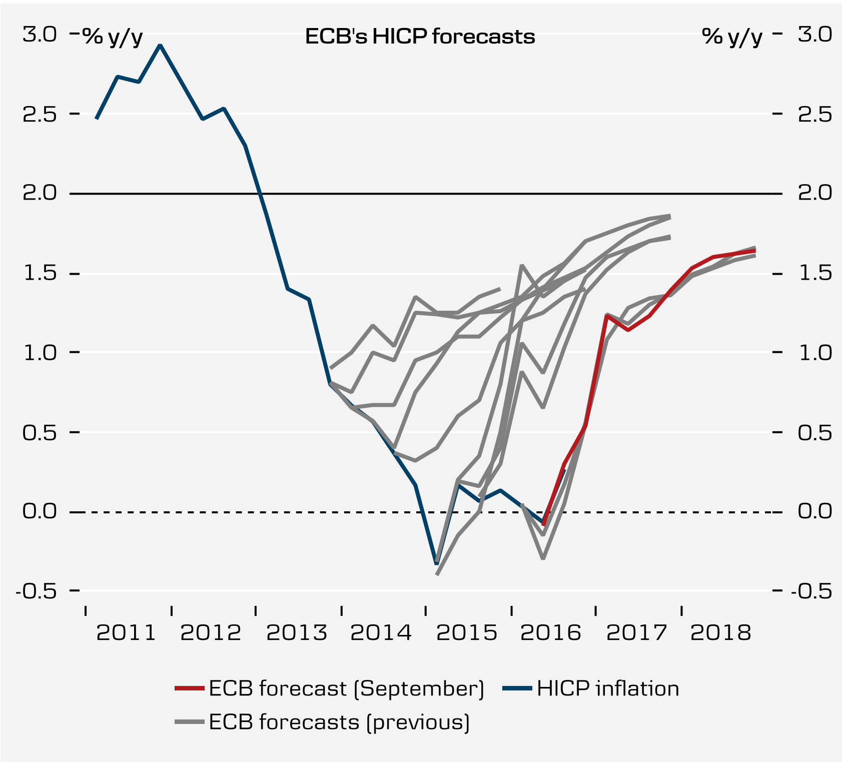


Source: ECB, Eurostat, Danske Bank Markets

Danske Bank
Corporates & Institutions

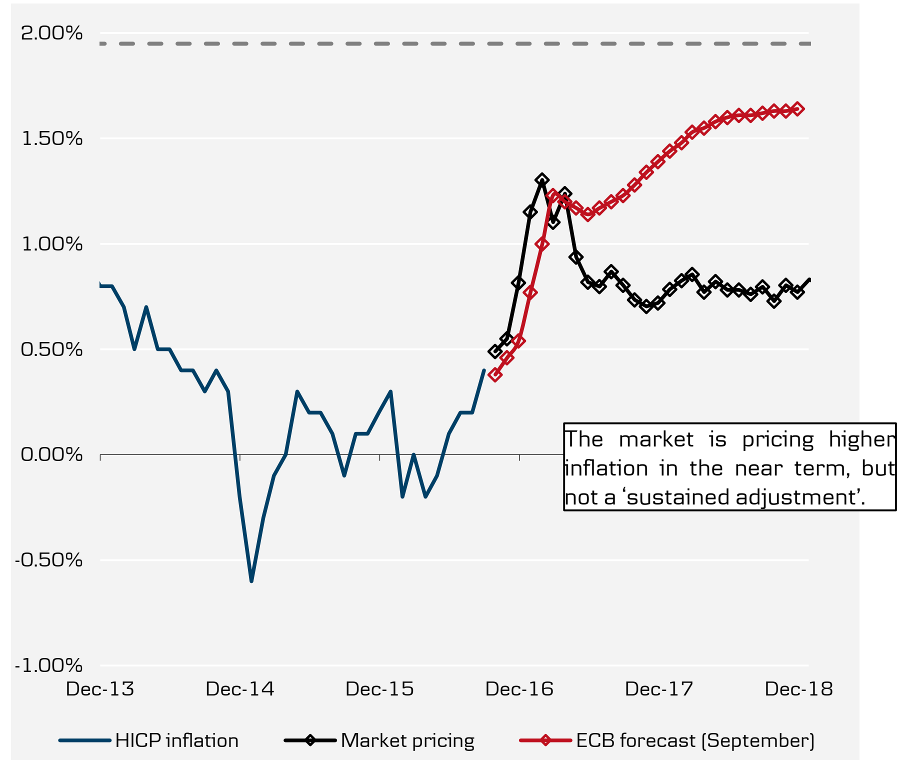
It is not the first time the ECB has expected a pick-up in inflation

The ECB again expects much higher inflation



Source: ECB, Eurostat, Danske Bank Markets

The market does not agree with the ECB

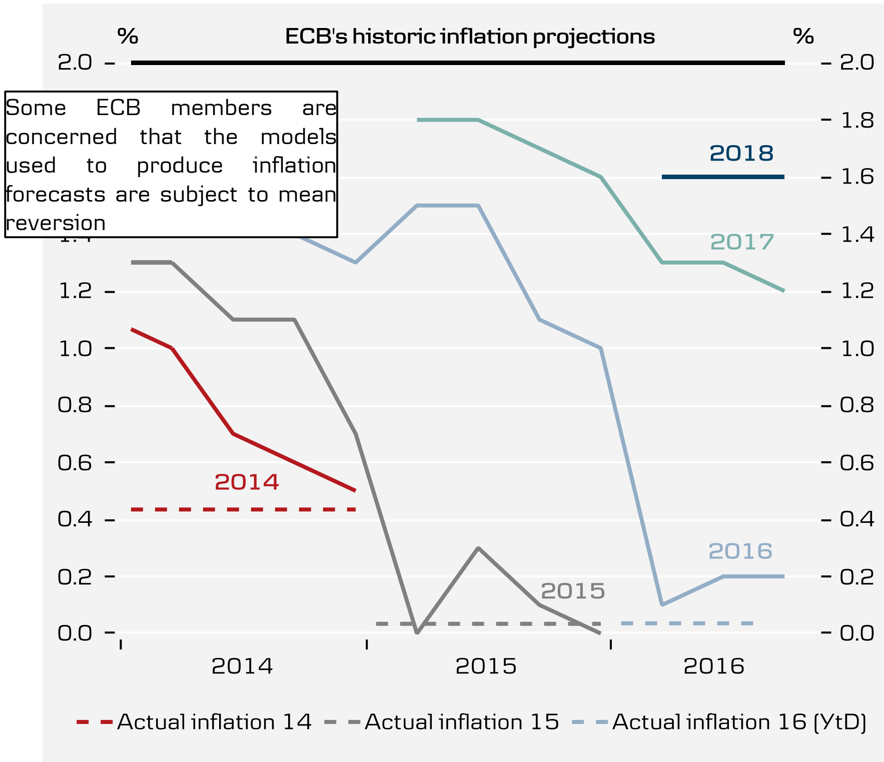


Source: Bloomberg, ECB, Eurostat, Danske Bank Markets

Danske Bank
Corporates & Institutions

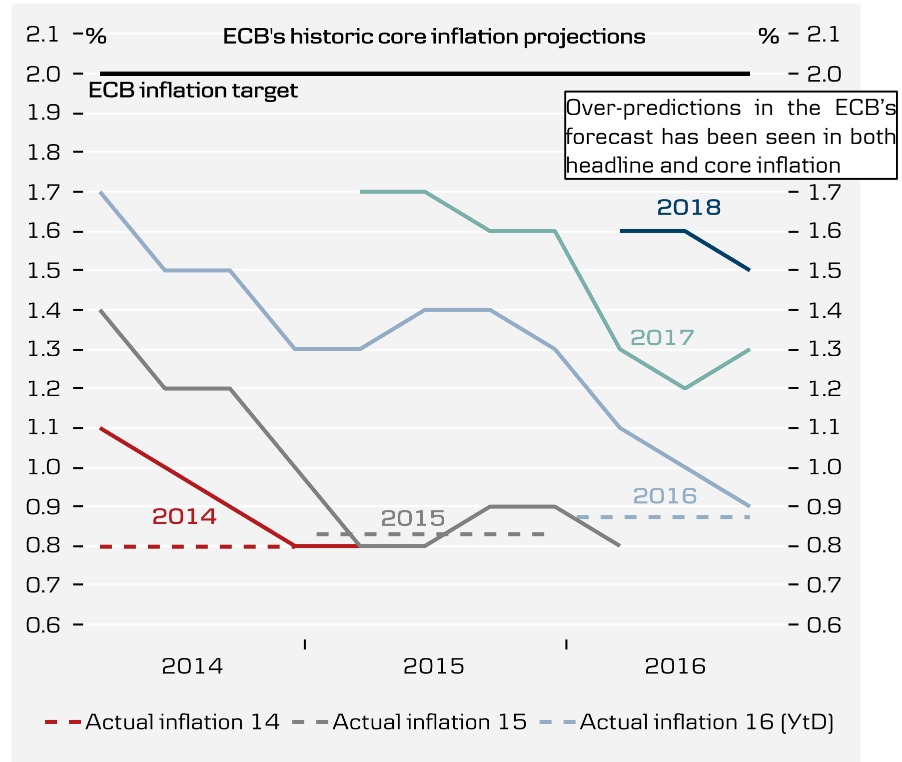
ECB members aware of over-predictions in the ECB's forecasts

ECB has been too optimistic on inflation



Source: ECB, Eurostat, Danske Bank Markets

Also, core inflation has been over predicted



Source: ECB, Eurostat, Danske Bank Markets

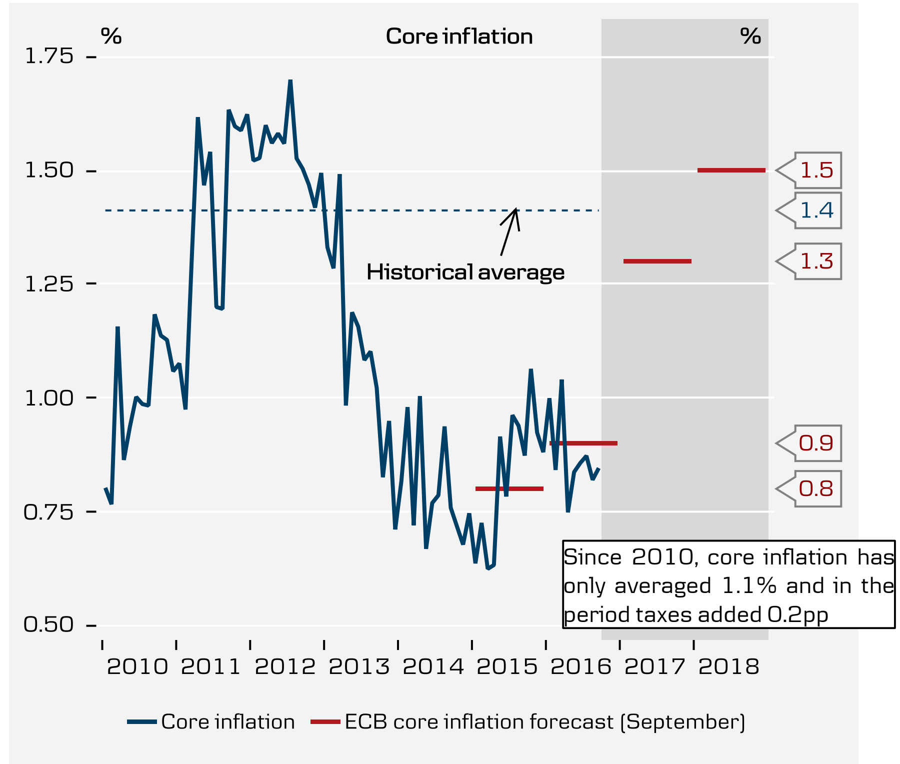
Danske Bank
Corporates & Institutions

ECB is again overly optimistic on the outlook for core inflation

ECB's four factors behind higher core inflation:

1. *'Improvements in labour market conditions, as reflected in a notable decline in the unemployment rate, are expected to bolster a gradual pick-up in wage growth'.*
2. *'With the ongoing economic recovery, continued support to underlying inflation is also expected to materialise via improvements in corporations' price-setting power and the related increase in profit margins.*
3. *'The fading of the dampening indirect effects of energy and non-energy commodity price developments should also contribute to the expected increase in HICP inflation excluding energy and food.*
4. *'Upward effects can also be expected from rising global price pressures more generally.*

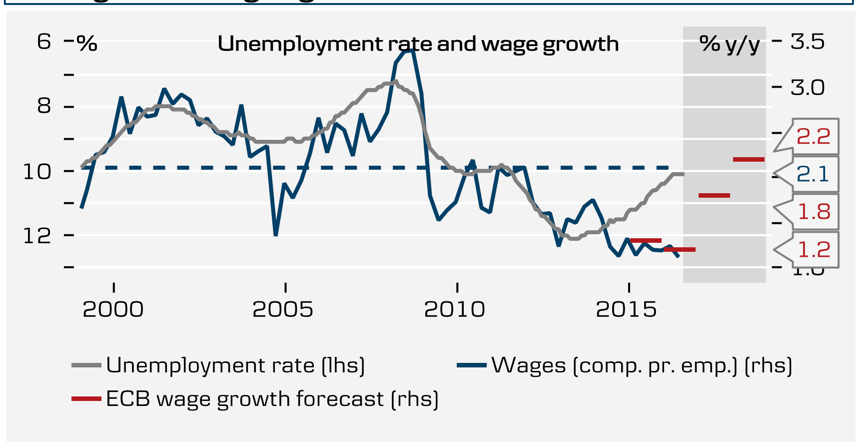
ECB still too optimistic on core inflation



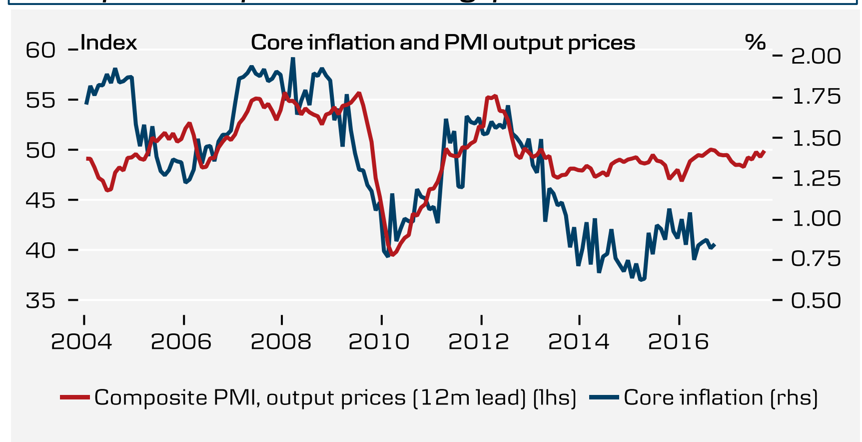
Source: ECB, Eurostat, Danske Bank Markets

ECB's four factors behind higher core inflation will not be enough

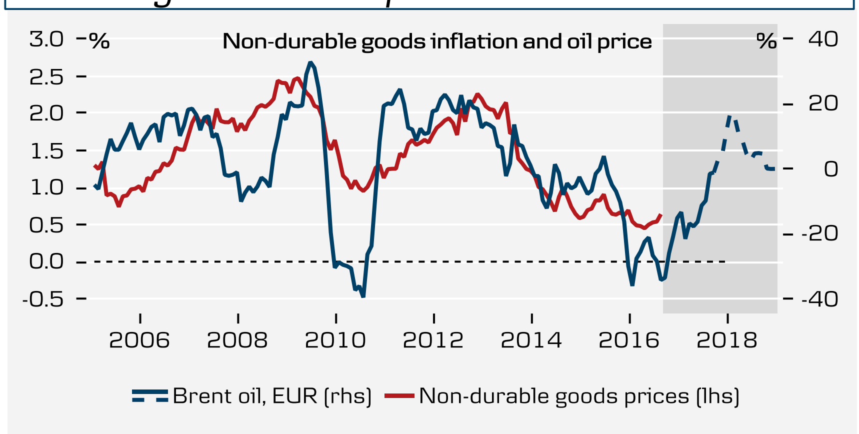
1. Higher wage growth



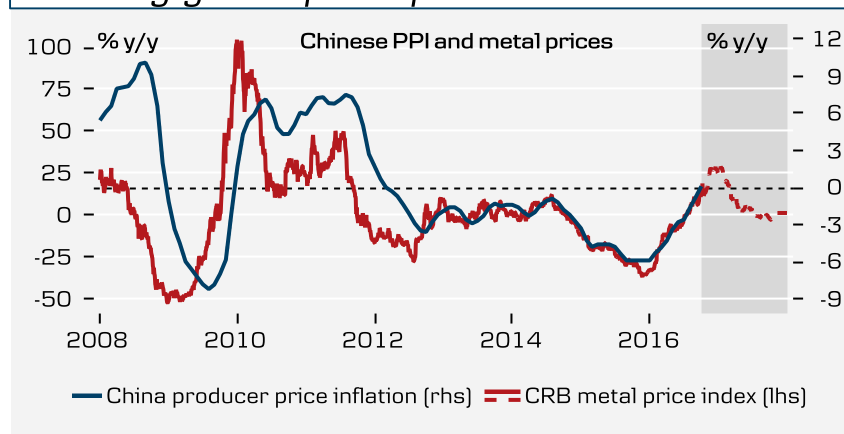
2. Improved price-setting power



3. Fading indirect impact of commodities



4. Rising global price pressures



Source (both charts): Bloomberg, ECB, Eurostat, Danske Bank Markets

Source (both charts): Bloomberg, Eurostat, Macrobond, Markit PMI, Danske Bank Markets

QE could be extended again if wage growth does not pick up

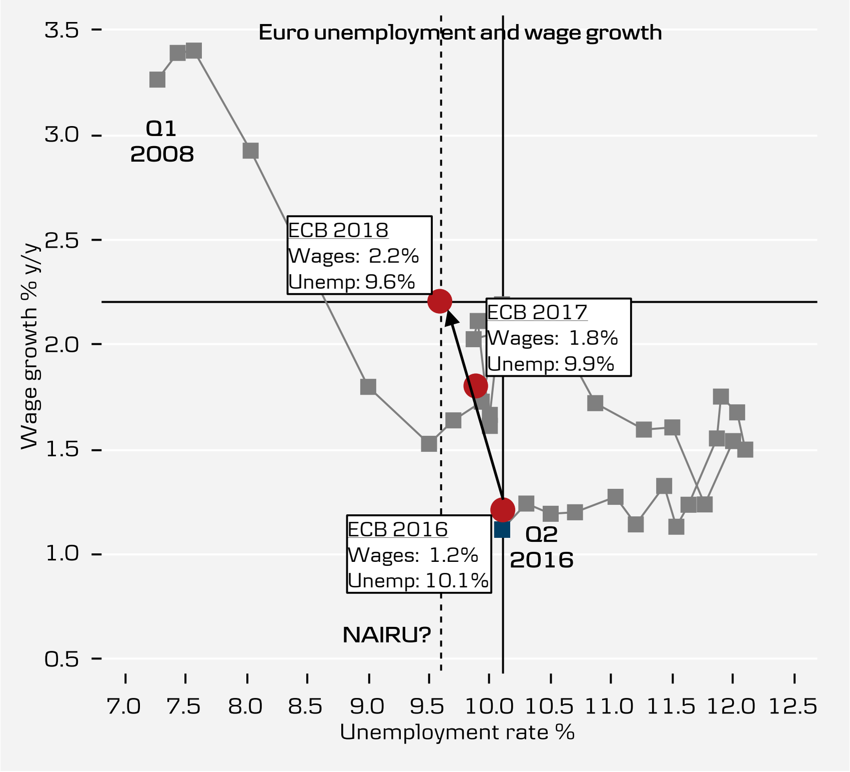
ECB follows developments in wages closely:

The ECB's expectations of higher core inflation are based on higher service price inflation, which is linked to stronger wage growth. Related to this, the ECB considers it *'important to continue to follow developments in wages closely'.*

Some ECB members have noted that analysis of the inflation outlook using a range of Phillips curves suggested that the projections could be considered optimistic.

In our view, wage growth will not pick up as fast as the ECB expects implying core inflation to undershoot the ECB's projection. Based on this, we see a risk that the ECB will end up extending its QE purchases beyond September 2017.

Phillips curve: ECB's wage forecast is hopeful



Source: ECB, Eurostat, Danske Bank Markets

The ECB is closely monitoring the bank lending channel

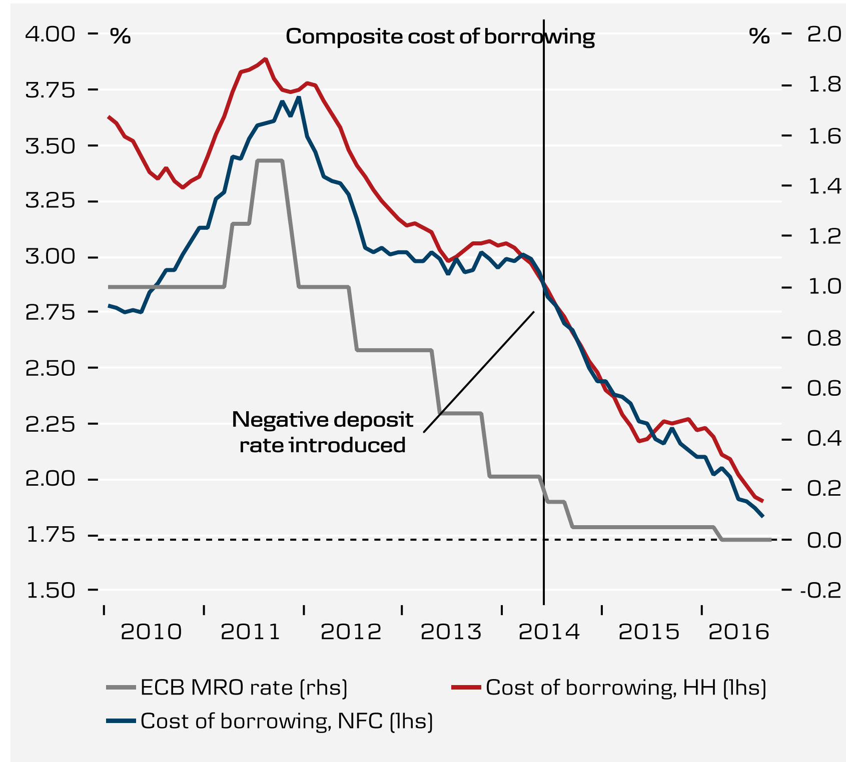
Close monitoring of the bank lending channel:

At the latest ECB meeting, President Mario Draghi said the transmission of the monetary policy had *'never worked better'*, but recently a lot of focus has been on weakness in the banking sector.

The minutes from the latest ECB meeting also revealed some concern about the banks as it was concluded that *'developments in the bank lending channel deserved close monitoring'*.

Additionally, the minutes stated that the continued underperformance of bank equity prices *'might contain a cautionary signal for future loan growth'*.

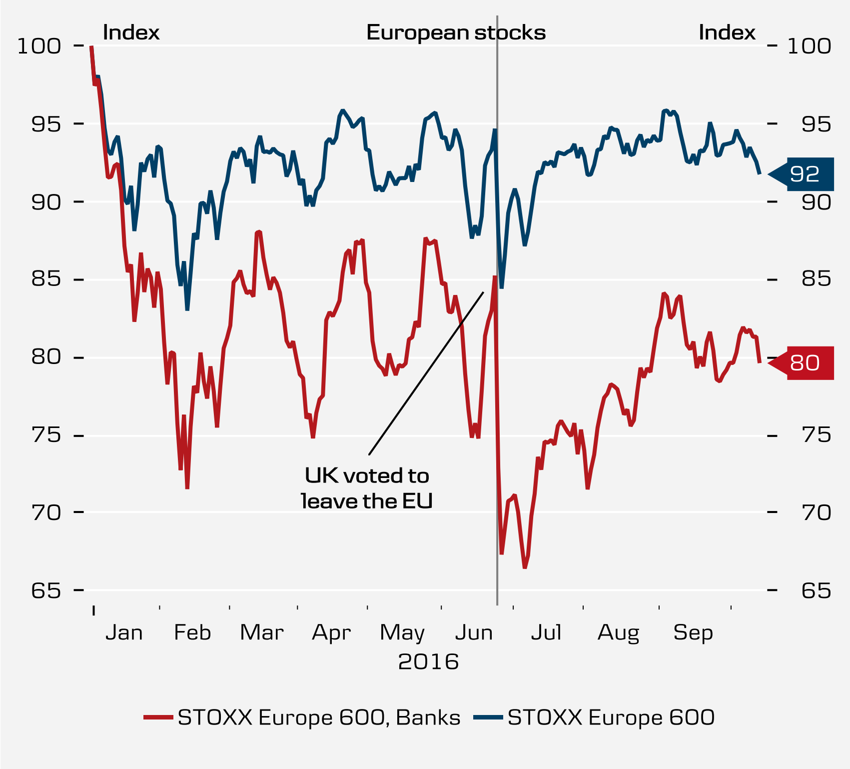
ECB transmission has 'never worked better'



Source: ECB, Danske Bank Markets

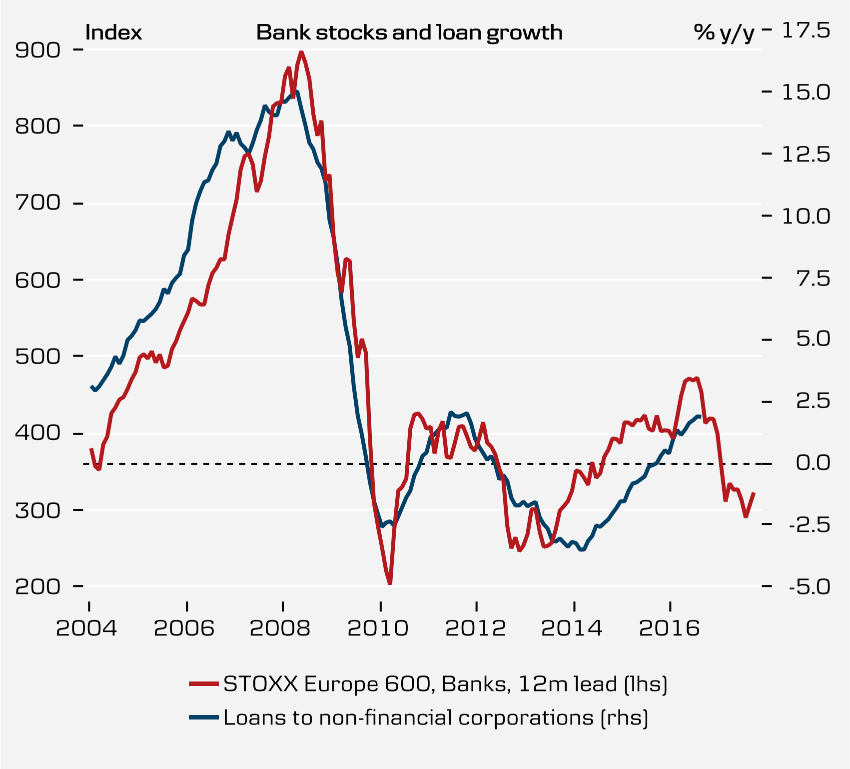
Will weakness in bank stocks affect future bank lending?

Bank stocks lower than at the start of year



Source: Bloomberg, Danske Bank Markets

Bank stocks signal weakness in loan growth



Source: Bloomberg, ECB, Danske Bank Markets

Could the ECB consider hiking earlier due to the costs to banks?

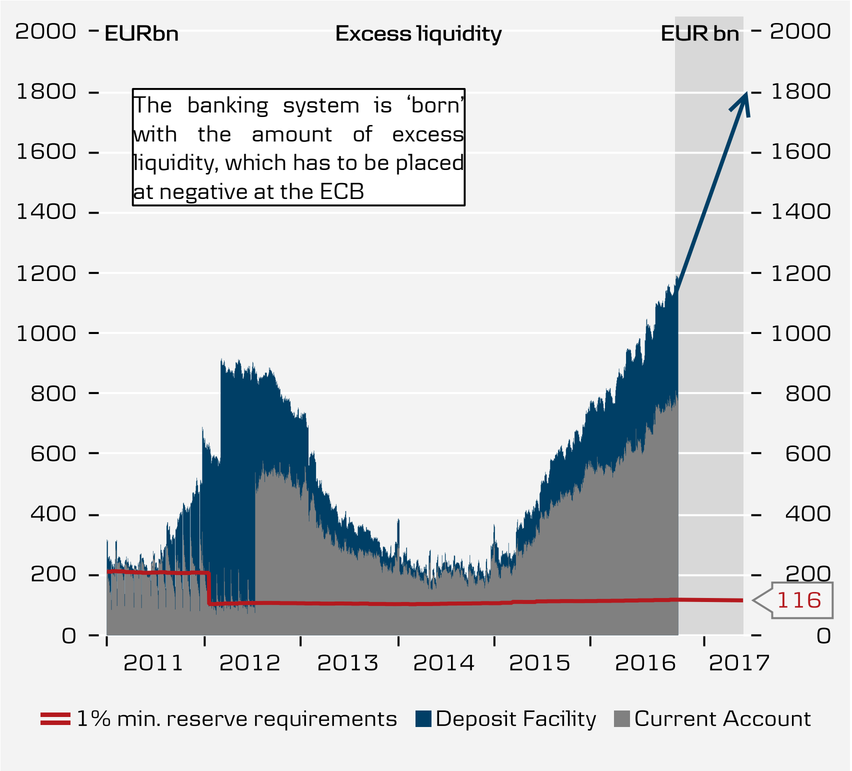
Draghi: negative rates cannot go on forever:

The weakness in the banking sector has been linked to the ECB's negative deposit rate, which leaves banks with an increasing cost as long as excess liquidity continues to rise.

According to Draghi, *'bank business models should be able to withstand periods of low interest rates'*. Nevertheless, he concluded that *'I think the negative interest rate is not something that can go on forever'*.

The ECB might consider reducing the cost to the banking system either by hiking rates early or as in Denmark, introduce a two-tier deposit rate system where some of the excess liquidity is not placed at negative levels. See *ECB and two-tier deposit rate system – the Danish lesson*, 26 November 2015.

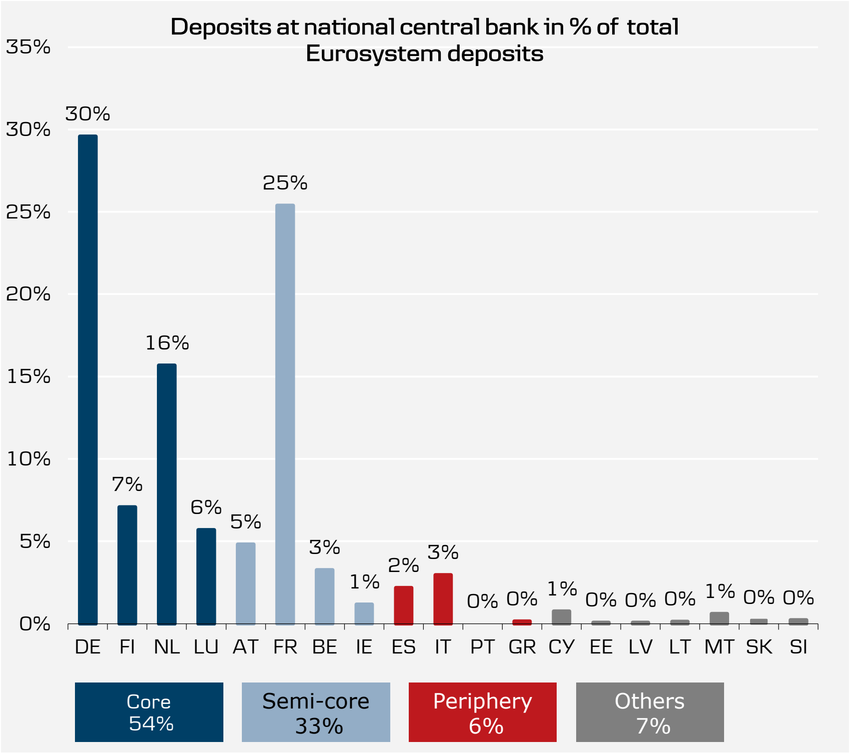
Higher excess liquidity is a cost to banks



Source: ECB, Danske Bank Markets

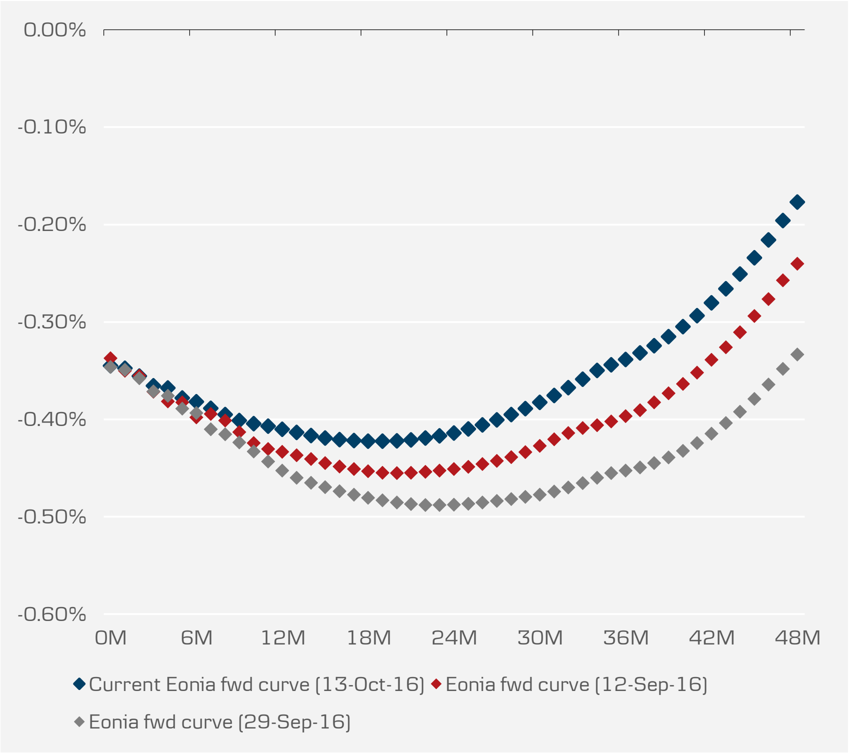
The market is still pricing an additional cut from the ECB

Mainly core banks pay for negative rates



Source: ECB, Danske Bank Markets

Market prices 10bp cut – slow normalisation



Source: Bloomberg, ECB, Danske Bank Markets

Danske Bank
Corporates & Institutions

Changing the QE restrictions not before an extension

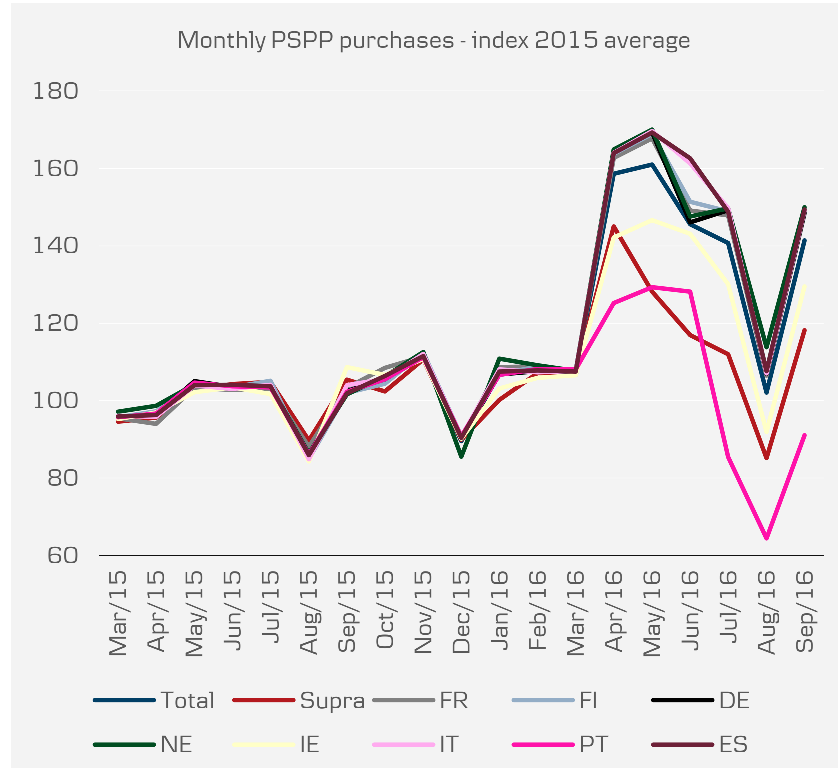
Committees work on smooth implementation:

According to (unconfirmed) ECB sources, the restrictions being discussed are (1) buying below the deposit rate, (2) not following the capital key distribution or (3) lifting the 33% purchase limit.

The final solutions could be a compromise including a temporary or partial change, e.g. instead of following the capital key strictly, the ECB could buy other bonds if low yields imply there are not enough German bonds in a given period. Regarding the deposit rate limit, instead of eliminating the threshold completely, it could be applied to only some bonds.

Such an announcement could, in our view, be a disappointment to those market participants expecting significant changes to the QE restrictions.

ECB is already deviating from the capital key



Source: ECB, Danske Bank Markets

Lifting the 33% issue/issuer limit – problematic for Germany

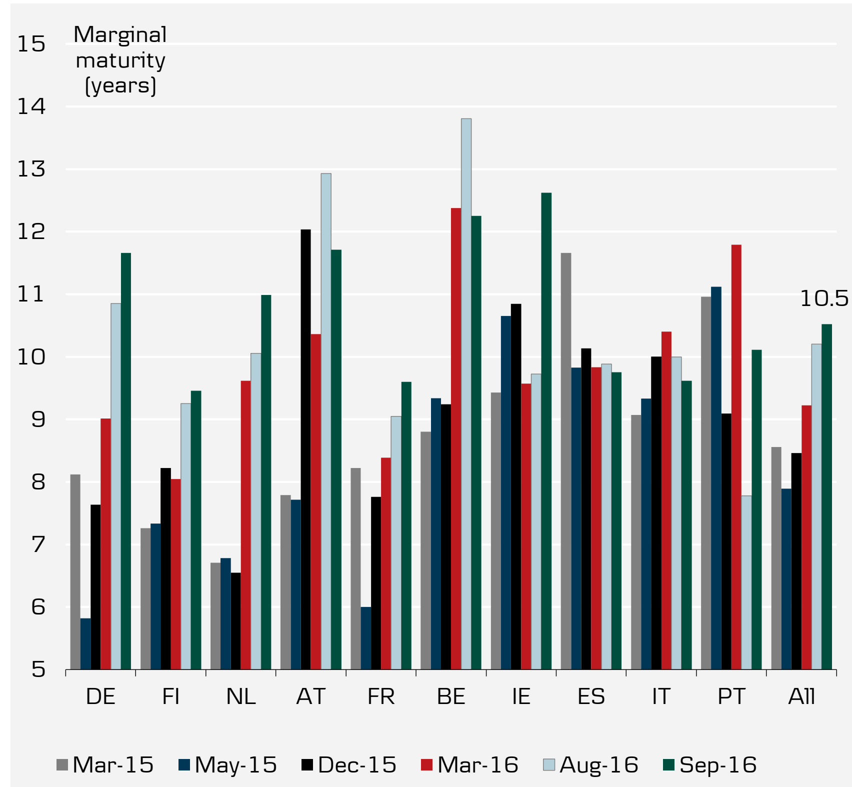
Repo squeeze already an ECB concern:

Lifting the issue/issuer limit above the 33% limit would be more aligned with the approach among other major central banks.

However, lifting the limit to e.g. 50% would imply more long-end purchases in Germany (repo squeeze in German curve is most extreme from 8Ys and out). The ECB is aware of the increased scarcity and in the minutes it said *"borrowing rates for some government bond collateral had deviated from ECB policy rates, highlighting increasing scarcity of some bonds"*

On the other hand, the ECB could be open to buy more Irish and Portuguese bonds where the ECB already has reduced purchases probably due to the 33% issuer limit. This suggests some flexibility on the restriction.

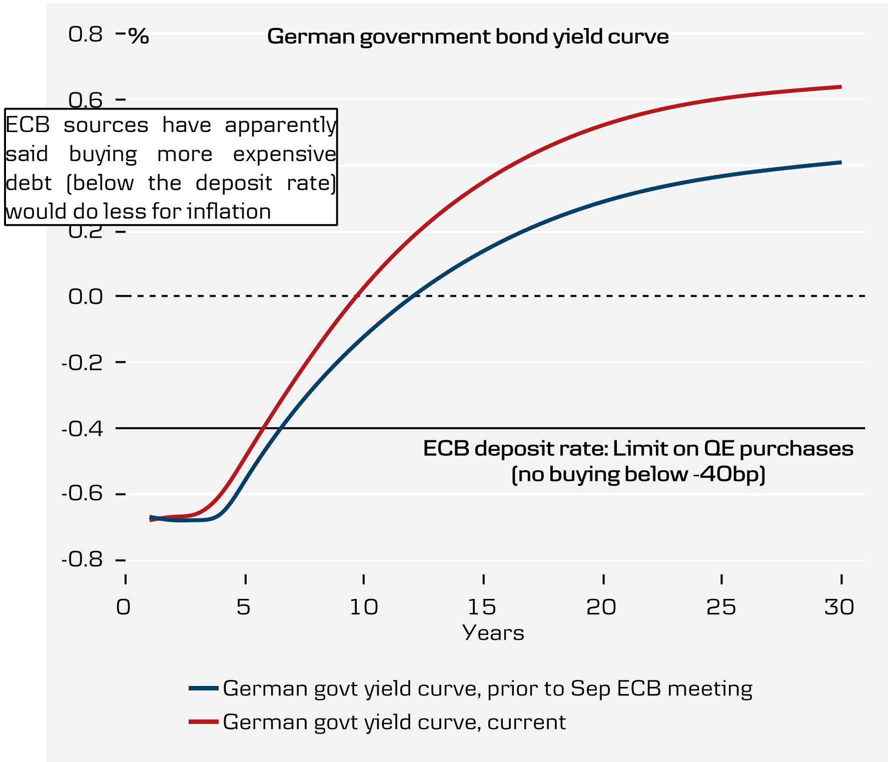
QE push out on the curve in Germany



Source: ECB, Danske Bank Markets

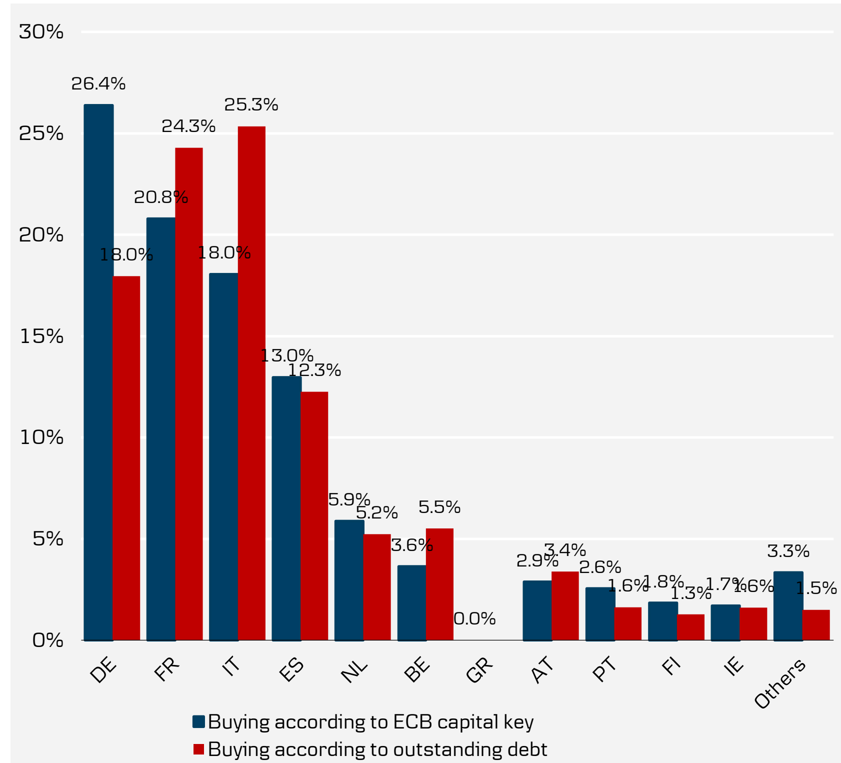
Not large-scale QE buying below the deposit rate

ECB will not allow buying below deposit rate



Source: Bloomberg, Danske Bank Markets

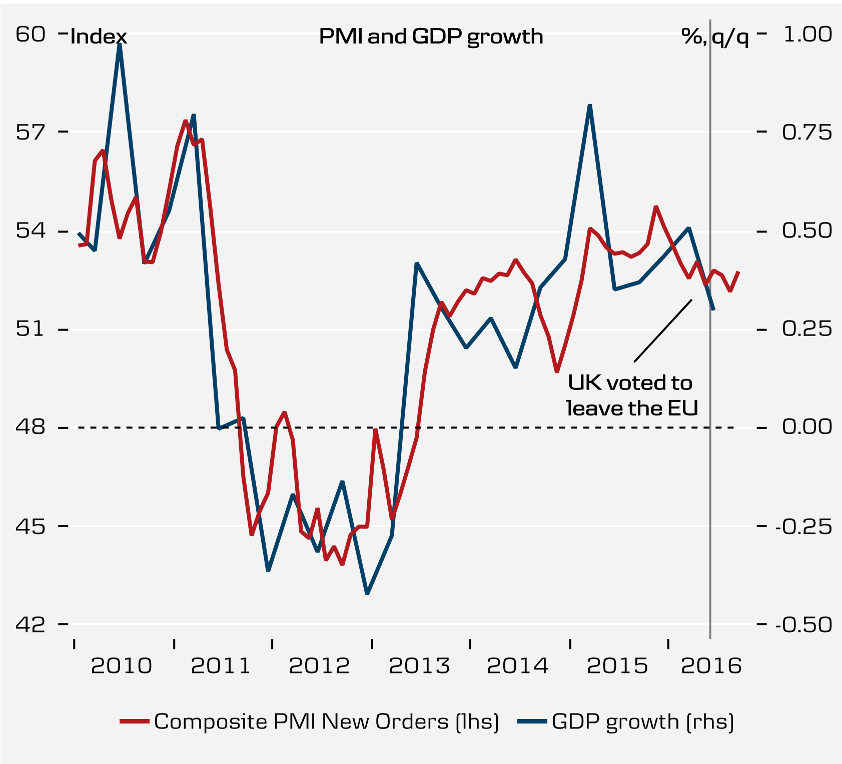
Germans will not accept debt distribution



Source: Bloomberg, ECB, Danske Bank Markets

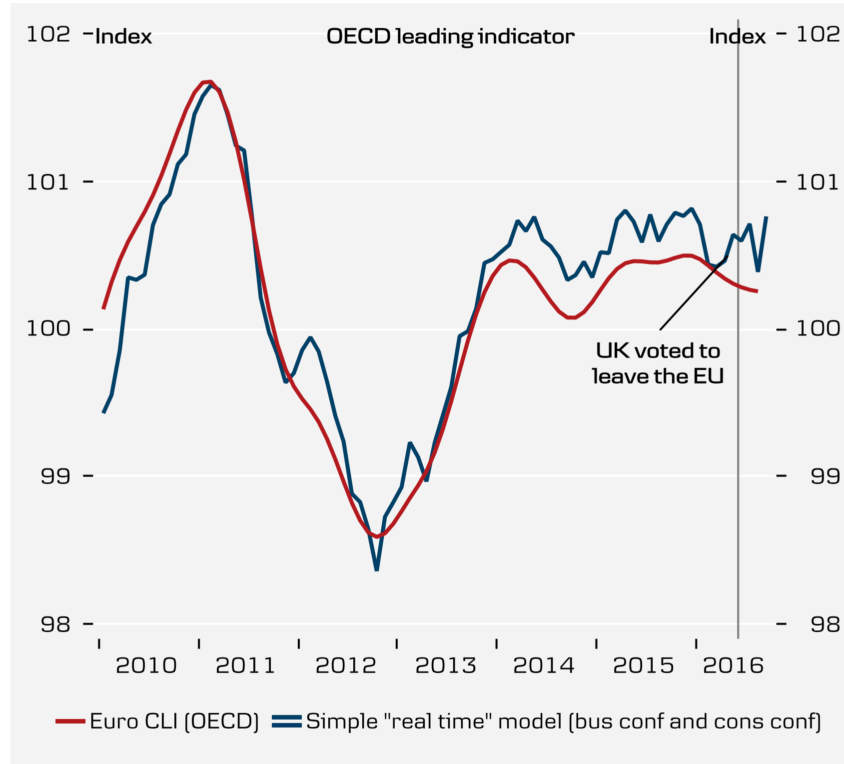
Still no impact from the Brexit vote on economic sentiment

Stable PMIs for six consecutive months



Source: Eurostat, Markit PMI, Danske Bank Markets

Other sentiment indicators also very stable



Source: European Commission, OECD, Danske Bank Markets

Danske Bank
Corporates & Institutions

Several possible changes to QE restrictions and the market impact

QE (PSPP) change	Pros	Cons	Market implications
(1) Removing the 'no buying below the -40bp deposit' limit	Would imply a large amount of bonds could be included in the PSPP. On the German curve, bonds out to 8Y are trading with a yield below -40bp (more than 60% of the German curve). Also, a substantial part of the other core market, supras and agencies is excluded due to this limitation.	This restriction could result in losses for the Eurosystem as the ECB's effective 'funding cost' is the deposit rate at currently -40bp.	Would push yields in the short end of core lower and cause substantial curve steepening as purchases in longer maturities decrease. Similarly, in ASW it would cause Bund and BUXL ASW tightening while 2Y is likely to widen.
(2) Shifting from 'capital key' to an 'outstanding debt key'	Would mean that the QE programme could proceed for longer with current buying restrictions as purchases would be biased towards sovereigns with higher debt levels.	The fact that countries with a higher debt level would be rewarded with higher purchases is likely to be criticised by some Governing Council members.	Would benefit Italy, France, Belgium and Austria at the expense of Germany, the Netherlands, Finland, Ireland and Portugal. Purchases in Spain would be around the current level. In ASW, it is likely to cause Bund ASW tightening - particularly in the 30Y, which has been most squeezed. Core curves are also likely to steepen on this.
(3) Removing the 33% issue/issuer limit	Would allow the QE programme to be extended further without hitting the issue/issuer limits.	These restrictions were put in place to prevent the ECB from actively having to take a stance in the case of a new EGB haircut as was the case with, for instance, the Greek PSI. A 'low' holding would mean that the ECB could be CAC'ed into taking the same losses as other investors in a scenario with an orderly default; thereby not having to freely accept 'monetary financing' of euro area governments.	Purchases in Portugal and to some extent also Ireland have already been reduced due to (most likely) these concerns. Hence, these would be the main beneficiaries. In the core, Germany/Finland could also benefit further from this. Bund and Buxl spreads could also widen further on this and the core curve flatten further in, for instance, the 5-30Y.
(4) Removing maturity restrictions (sub 2Y and plus 31Y)	Would free some but very limited additional liquidity.	The additional market liquidity in +31Y is very limited.	Would cause performance in the ultra long segment across issues and also versus swaps.
(5) Removing the isin limit on non-CAC bonds	Would allow higher purchases in 'off the runs' and thereby increase the eligible basket.	Is likely to create 'kinky' points on EUR sovereign curves.	Off-the run non-CACs would outperform CACs bonds resulting in curves with kinks.

Source: Danske Bank Markets

Disclosures

This research report has been prepared by Danske Research, a division of Danske Bank A/S (‘Danske Bank’). The author of this research report Pernille Bomholdt Henneberg, Senior Analyst.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in this research report accurately reflect the research analyst’s personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

The research reports of Danske Bank are prepared in accordance with the Danish Finance Society’s rules of ethics and the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank’s research policies. Employees within Danske Bank’s Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank’s Research Departments are organised independently from and do not report to other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Danske Bank is a market maker and may hold positions in the financial instruments mentioned in this research report.

Danske Bank, its affiliates and subsidiaries are engaged in commercial banking, securities underwriting, dealing, trading, brokerage, investment management, investment banking, custody and other financial services activities, may be a lender to the companies mentioned in this publication and have whatever rights are available to a creditor under applicable law and the applicable loan and credit agreements. At any time, Danske Bank, its affiliates and subsidiaries may have credit or other information regarding the companies mentioned in this publication that is not available to or may not be used by the personnel responsible for the preparation of this report, which might affect the analysis and opinions expressed in this research report.

See *www-2.danskebank.com/Link/researchdisclaimer* for further disclosures and information.

General disclaimer

This research has been prepared by Danske Bank Markets (a division of Danske Bank A/S). It is provided for informational purposes only. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change, and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.