14 December 2017

ECB review

Christmas mood leaves QE exit decisions for 2018

- **Despite a stronger growth and inflation outlook, the ECB delivered a fairly balanced policy message, without further hints about a shift towards a more 'holistic' view on inflation and the economy. We expect discussions about QE exit and policy normalisation to gain prominence in the spring of 2018.**
- **ECB sees euro zone heading in 'the right direction' – we see EUR/USD headed firmly into 1.20s in 2018.**

In line with our expectation, the ECB left its policy measures and forward guidance unchanged, keeping the QE programme open-ended (see also *Preview*). The ECB reiterated that policy rates would remain at current levels for an extended period and well past the horizon of asset purchases. The Q&A also brought little news as Draghi confirmed that both the new QE composition and a possible decoupling of the QE forward guidance from the inflation outlook were not discussed at the meeting.

Although Draghi stressed that the Governing Council is growing more confident in its ability to meet the inflation target eventually, not least because of the stronger growth outlook, today's meeting confirmed that the ECB is in a wait-and-see mode for now and any further discussions about QE exit and policy normalisation would probably only gain prominence in the spring of 2018. Related to this, we think it is important to watch out for growing support within the Governing Council for the idea of decoupling the forward guidance on QE from the requirement for a sustained rise in inflation and instead linking it to the overall monetary policy stance, as this would enable the ECB to end QE even if inflation continues to undershoot the target. Such a change in the forward guidance might come for example in the April or June meetings next year.

ECB forecasts foresee strong growth in 2018, but core inflation again revised down

ECB projections December 2017	2017		2018		2019		2020
HICP inflation	1.5% (1.5%)	→	1.4% (1.2%)	↗	1.5% (1.5%)	→	1.7%
Core inflation	1.0% (1.1%)	↘	1.1% (1.3%)	↘	1.5% (1.5%)	→	1.8%
GDP growth	2.4% (2.2%)	↗	2.3% (1.8%)	↗	1.9% (1.7%)	↗	1.7%
Unemployment rate	9.1% (9.1%)	→	8.4% (8.6%)	↘	7.8% (8.1%)	↘	7.3%
Wage growth	1.7% (1.5%)	↗	2.1% (2.0%)	↗	1.9% (2.3%)	↘	2.7%

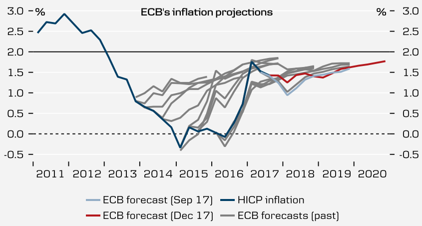
Parenthesis are the old ECB projections (from September 2017)

Source: ECB, Danske Bank

Euro area research

- *Euro Area Research: ECB inflation gap persists in 2019*, 4 December
- *The Big Picture: Global economy still on a roll* , 4 December
- *ECB Preview – On autopilot for now*, 8 December

Upward revision in HICP inflation due to higher oil and food prices



Source: ECB, Eurostat, Macrobond Financial, Danske Bank

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We still believe the ECB will end the QE programme in 2018 and taper purchases to zero in Q4 18, due to a combination of binding technical restrictions, the growing size and importance of QE reinvestments, fading deflationary risks with core inflation staying above 1.0% and a growing consensus within the Governing Council that the October QE extension was the last one. Given gradually rising underlying inflation pressures, we expect the ECB to deliver its first 10bp deposit rate hike in Q2 19, supported by a growing urge in the Governing Council to move ahead with monetary policy normalisation in order to regain room to manoeuvre for future crises and avoid falling behind the curve (see *Special Report: The Euro-Scandi exit and what it implies for markets*).

ECB projects core inflation at 1.8% in 2020

The ECB also released new economic forecasts at the meeting, which, as expected, painted a rosier picture for the eurozone growth and inflation outlook.

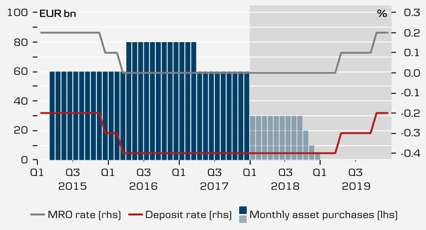
1. The ***'significant improvement in the growth outlook'*** gives the ECB greater confidence that inflation will converge to its aim. The GDP growth forecast for 2018 was lifted to 2.3% from 1.8%, reflecting the strong cyclical momentum, and which is even above our forecast of 2.0%. The projection for 2019 was also raised, by 0.2pp to 1.9%, while the ECB sees growth moderating to 1.7% in 2020. Risks to the growth outlook were judged to be broadly balanced.
2. **The inflation outlook** was revised up, mainly reflecting higher oil and food prices, as we anticipated in *Euro Area Research: ECB inflation gap persists in 2019*. It was still judged that an ample degree of monetary accommodation was needed for underlying inflation pressures to continue to build up and Draghi stressed that the inflation outlook remains (too) dependent on the accommodative monetary policy stance. The ECB kept its 2017 and 2019 HICP inflation forecasts unchanged, but raised the 2018 forecast by 0.2pp to 1.4%. Interestingly, at the same time, the ECB lowered its core inflation forecast for 2018 by 0.2pp to 1.1%, which is now in line with our forecast. The new 2020 forecast projects core inflation close to the target at 1.8%, in line with the ECB's belief in increasing underlying inflation pressures in light of the continued strong economic momentum and an expected strong pick-up in wage growth to 2.7% in 2020.

FX: ECB sees euro zone headed in 'the right direction' – we see EUR/USD headed firmly into 1.20s

A fairly muted reaction in EUR/USD to the 'October replay message' from the ECB insofar as its stance on QE and forward guidance on rates were concerned. First, the sense Draghi tried to convey in terms of upward economic revisions, namely that things are moving in the right direction in the euro zone, helped to send EUR/USD higher at the start of the press conference. However, the fact that decoupling the inflation outlook from the QE decision had not been discussed helped to send the cross lower again (even as the inflation forecasts were lifted). We also note that the strong US retail sales figures, which came out this afternoon, and the ongoing tightening in USD liquidity (as evident in a still-wider basis) likely helped to send the cross back down again.

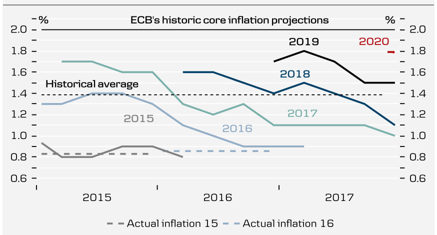
While there were no clear hints from Draghi today that the 'holistic' approach to the economic outlook and to the overall policy stance is gaining further traction yet, this is something for the FX market to watch out for when the minutes are published in a few weeks' time. Notably, Draghi did remind us of what we have dubbed the 'Sintra accord', i.e. the (seemingly coordinated) move by a range of central bankers back in late June to urge for policy 'normalisation' on the grounds that deflationary risks had evaporated. This suggests to us that the FX market should be able to keep the faith that the

ECB to taper QE purchases to zero in Q4 18



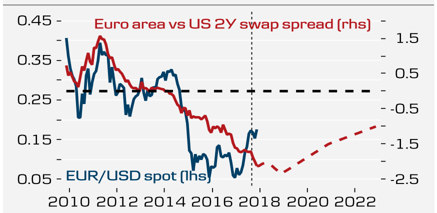
Source: ECB, Macrobond Financial, Danske Bank

ECB again lowers 2018 core inflation forecast



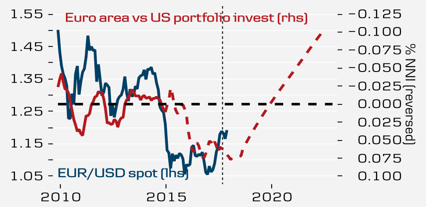
Source: ECB, Danske Bank

Relative rates might weigh near term but set to become a key support...



Source: Bloomberg, Macrobond, Danske Bank

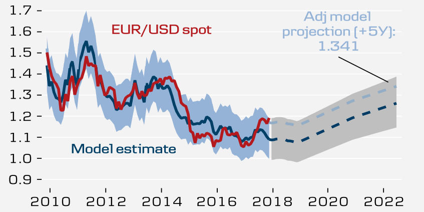
... as would relative portfolio flows as the ECB 'normalises' policy



Source: Bloomberg, Macrobond, Danske Bank next level of ECB 'normalisation' is just around the corner. We think this will be a key theme in Q2 next year.

As we have stressed repeatedly - and notably in our recent *Special Report* - we see risks in EUR/USD tilted to the upside for 2018 as a whole. While relative rates could possibly weigh a bit in the near term, what the FX market would increasingly be focused on is the potential not least for debt flows to support the single currency in the ECB's 'exit' process that is only just getting started. We are long EUR/USD on a 12M horizon via options in our *FX Top Trades 2018*.

EUR/USD headed above 1.30 on 'normalisation' in EUR rates and flows



Source: Bloomberg, Macrobond, Danske Bank

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Expected updates

None.

Date of first publication

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