7 September 2017

ECB review

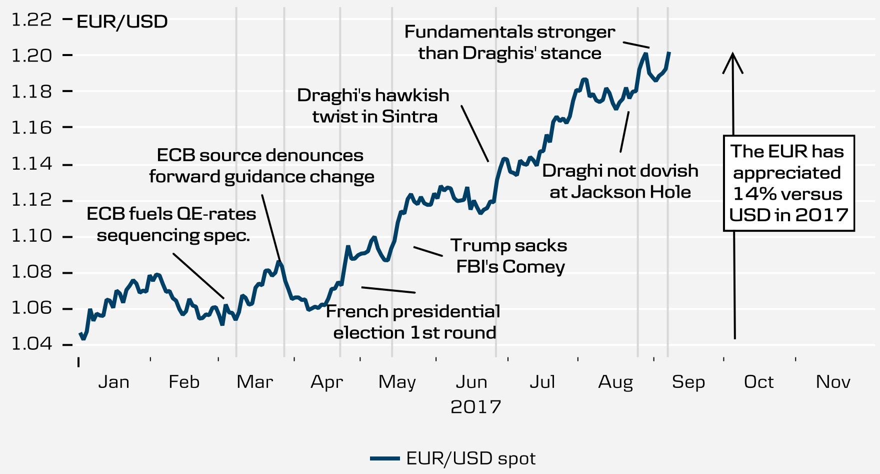
Warming up to QE extension in October

The ECB left its policy measures unchanged and President Mario Draghi confirmed that the bulk of decisions regarding the QE purchases beyond 2017 will most likely be taken in October. There was a lot of focus on the exchange rate development and during the introductory statement Draghi mentioned the euro appreciation three times, saying that *'the recent volatility in the exchange rate represents a source of uncertainty that requires monitoring'*. Notably, the FX market did not perceive Draghi as dovish enough to counteract the strong underlying momentum and EUR/USD ended higher. In fixed income markets, the periphery was the big winner, reflecting it is now deemed more likely that the QE programme will continue in 2018.

The discussion about how to continue the QE programme beyond 2017 has started and Draghi gave some insights. First of all, the sequencing in the exit strategy was not discussed, hence it was confirmed that policy rates will remain at their present levels after the QE programme has ended. Secondly, the ECB did not consider lifting the 33% issue/issuer limits. Related to this, the ECB did not discuss scarcity issues but Draghi argued that the ECB has repeatedly shown its ability to deal with this. Instead, focus was on the length and size of the programme including pros and cons of different scenarios for the future purchases. In addition, Draghi opened up for higher purchases in France, Italy and Spain and lower ones in Germany and the Netherlands where the holdings are approaching the 33% limit, as he said there has always been and will always be deviation from the capital key distribution.

We still believe the ECB will announce a reduction in its QE purchases to EUR40bn per month in H1 18 at the next meeting in October. The programme should be continued without lifting the 33% limits, but instead be based on continued capital key deviations. We also consider it likely that the ECB will buy a higher share of corporate bonds. These purchases will have a more direct economic impact and the ECB's holdings are not close to the 70% ISIN limit.

Chart 1. Underlying euro momentum dominated the dovish stance from Draghi



Source: Bloomberg data, ECB, Danske Bank

Key points

- Draghi confirmed the bulk of QE decisions is likely in October – the 33% limits will not be lifted, hence capital key deviations continue
- The inflation outlook was revised lower reflecting the stronger euro – a substantial degree of monetary accommodation is still needed
- The underlying euro momentum remains strong and any dips in EUR/USD should be shallow and short-lived
- Focus on the euro and the smaller concern about an abrupt end to QE resulted in a strong performance for the periphery bond markets

Euro area research

- *ECB preview: Dovish stance due to strong euro*, 1 September 2017
- *Stronger EUR keeping inflation far from the ECB's target*, 27 July 2017

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Downward revision to the inflation forecast due to stronger euro

The Governing Council discussed three topics at today's meeting and Draghi's conclusion was the following.

1. **The strong growth momentum** boosts confidence that inflation will pick up eventually. Related to this, the ECB lifted its GDP growth forecast for 2017 to 2.2% from 1.9% reflecting the recent strong data. The projections for 2018 and 2019 were kept unchanged at 1.8% and 1.7%, respectively. The ECB added that there are downside risks to the growth outlook related to developments in foreign exchange markets.
2. **The inflation outlook** was revised down a bit, mainly reflecting the euro appreciation. It was still judged that a substantial degree of monetary accommodation was needed for underlying prices to pick up. The ECB kept its 2017 inflation forecast unchanged at 1.5% but lowered the 2018 and 2019 forecast by 0.1pp to 1.2% and 1.5%, respectively. Interestingly, the ECB lowered its core inflation forecast for 2019 by 0.2pp to 1.5%.
3. **The exchange rate** was once again described as not being a policy target, but Draghi said it is very important for growth and inflation and to such an extent that the medium-term outlook for inflation was revised down. Due to this and according to Draghi, the ECB must take exchange rate developments into account in its decisions as also reflected in the comment in the introductory statement about the exchange rate's possible implications for the medium-term outlook for price stability.

FX: underlying EUR momentum remains strong

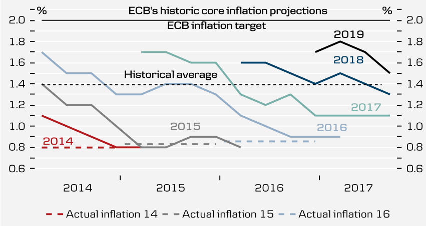
The FX market bought the pair on ECB's more positive assessment of economic growth this year and the signals that an announcement on monetary policy awaits in October. However, at the press conference Draghi made an effort to cap a further rise in EUR/USD by stressing the negative impact on the medium-term outlook for inflation from the stronger euro. Hence, **while the price action today underscores our view that underlying euro momentum remains strong, the market will keep in mind that the ECB is unlikely to tolerate a further strong euro appreciation in the short term, which should put a soft cap on the pair ahead of the October meeting.** We maintain our view that any dip should be shallow and short-lived.

Fixed income: support to the carry-friendly environment

The fixed income market and particularly the periphery reacted positively to the message from Draghi that a decision will be taken at the October meeting and not least that the euro is being monitored closely. The more the euro appreciates the more likely it becomes that the ECB will extend its QE programme and postpone rate hikes. Hence, the key variable for the fixed income market at the moment is the euro. We have seen 10Y German yields a few basis points lower and the curve steepened slightly as 2Y bond yields fell a bit less after the press briefing.

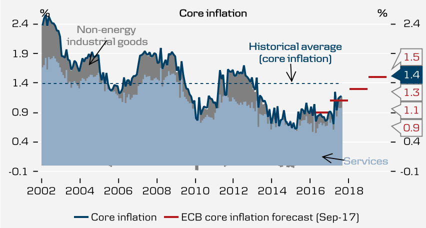
The focus on the euro and the smaller concern about an abrupt end to QE pushed investors towards periphery bond markets that performed strongly after the press briefing. 10Y Spanish and Italian yields outperformed Germany by some 4bp this afternoon. We agree with the positive reaction in periphery and core FI markets. In our view Draghi today supported the carry-friendly environment we have seen over the summer. We are long 5Y Spain and 5Y Italy versus swaps in our Government Bond Weekly trading portfolio and we are very comfortable with these trades in light of the message from Draghi today.

Chart 2. The ECB lowered its core inflation forecast, especially for 2019



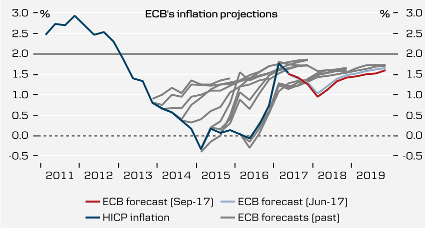
Source: ECB, Eurostat, Danske Bank

Chart 3. However, the ECB still expects core inflation to rise above its average



Source: ECB, Eurostat, Danske Bank

Chart 4. Small downward revision to headline inflation in light of euro move



Source: ECB, Eurostat Danske Bank

Chart 5. Lower headline and core inflation forecast due to stronger euro

ECB projections (September 2017)	2016		2017		2018		2019	
HICP inflation	0.2% (0.2%)	→	1.5% (1.5%)	→	1.2% (1.3%)	↘	1.5% (1.6%)	↘
Core inflation	0.9% (0.9%)	→	1.1% (1.1%)	→	1.3% (1.4%)	↘	1.5% (1.7%)	↘
GDP growth	1.8% (1.7%)	↗	2.2% (1.9%)	↗	1.8% (1.8%)	→	1.7% (1.7%)	→
Unemployment rate	10.0% (10.0%)	→	9.1% (9.4%)	↘	8.6% (8.8%)	↘	8.1% (8.3%)	↘
Wage growth	1.2% (1.3%)	↘	1.5% (1.7%)	↘	2.0% (2.1%)	↘	2.3% (2.4%)	↘

Parenthesis are the old ECB projections (from June 2017)

Source: ECB, Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Pernille Bomholdt Henneberg, Chief Analyst.

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None.

Date of first publication

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