Flash

Monday, 21 January 2019

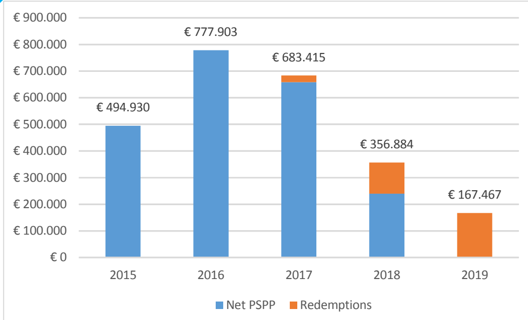
No NY's resolutions from ECB

Reinvestment policy and forward guidance interest rates to remain unaltered

No downgrade of risks to eco outlook (yet)

Muted market reaction expected, but sensitivity to comments on TLTRO's?

This week, the ECB holds its first policy meeting after ending net monthly purchases under its Asset Purchase Programme (APP). **The two remaining pillars, its interest rate policy and its APP reinvestment strategy, are expected to stay firmly in place.** Guidance on interest rates given consistently since last June suggests no action at least through the Summer with markets increasingly emphasizing the 'at least' element of this phrase and pushing expectations of the timing of the ECB's initial rate increase into 2020.



ECB remains active in sovereign bond market via its reinvestment policy of maturing bonds

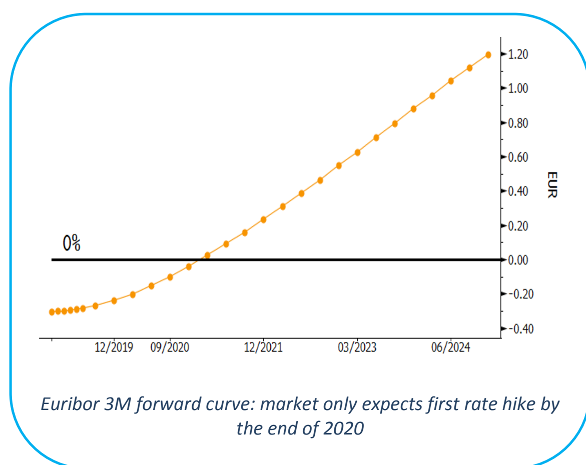
The ECB remains active on bond markets (and consequently exerts a dampening effect on yields) by reinvesting the proceeds of this year's €214bn redemptions from its APP-portfolio. The lion share (€168bn) will flow to the government bond market. These amounts are expected to grow next year given the magnitude of the central bank's total portfolio (€2570 bn of which €2102bn government bonds) which leaks duration.

Recent EMU economic activity data extended their soft trend. To an extent this is consistent with the ECB's slight downgrade to its growth forecasts at the December meeting and the accompanying guidance that the balance of risks was moving to the downside. In the interim, the EMU composite PMI in December recorded its fourth consecutive decline, from 52.7 to 51.1, equaling (Nov 2014) the lowest reading since the aftermath of the EMU sovereign debt crisis. Industrial production readings also suggest that the EMU economy didn't recover from the Q3 (0.2% Q/Q) slowdown. The German economy barely grew in Q4 according to national data, while French growth forecasts were significantly lowered because of the yellow-vests protests. ECB President Draghi acknowledged that recent economic developments have been weaker than expected in December and that **uncertainties, notably related to global factors, remain prominent. However, some more hawkish members of the governing council have downplayed the extent of this devaiation from the ECB's previous baseline scenario.**

We don't expect the ECB to alter risks to the economic which it labels "broadly balanced, but moving to the downside" yet. Given volatility in monthly data and the range of uncertainties in the current environment, **the central bank will probably take a wait-and-see approach until the March 7 policy meeting** when new growth and inflation forecasts are available.

The softening trend in activity indicators of late was accompanied by data showing the persistence of subdued price pressures. EMU core inflation remains stubbornly low at 1% Y/Y, while the headline reading suffered an energy price-related setback to 1.6% Y/Y in December. ECB president Draghi for now holds the narrative that upward wage pressure, the ECB's stimulative policy and a narrowing output gap **will eventually deliver higher core EMU inflation, warranting the start of an interest rate hike cycle. Significantly, the ECB continues to distinguish between largely external downside risks and the persistence of** a strong domestic economy and improving labour markets which should help overcome the current economic dip. They will be comforted in this regard by the drop in the EMU unemployment rate to 7.9% in November, the lowest level in slightly over a decade.

It is important to emphasise that (Rate) markets currently don't buy the ECB's forward guidance. The market implied probability of a first rate hike at this year's December meeting amounts only 25%. The 3M forward Euribor strip curve only crosses the 0% mark for the March 2021 contract! **We think that this positioning is too soft and do believe that Draghi's successor could pull the trigger for a tightening cycle at the final meeting of 2019.** We think the ECB could follow the playbook adopted by the Federal reserve when it began the US tightening cycle at the end of 2015 and implement a non-aggressive increase in policy rates that doesn't sharply tighten financial conditions. However, markets aren't considering such a possibility at present.



Euribor 3M forward curve: market only expects first rate hike by the end of 2020

Another consideration is that by the end of the year, we'll be dealing with a completely different governing council. Chief economist Praet leaves the board at the end of May. His successor is expected to be known by February 11, with Irish central bank governor Lane the clear frontrunner. ECB President Draghi's term ends at the end of October and French governing councel member Coeuré's tenure spans until the end of the year. On balance, the changed composition of the ECB is likely to make it slightly less dovish.

One special topic likely to command increasing market attention in coming months will be the prospect of developments in regard to the ECB's liquidity providing policy. The ECB's 4 remaining outstanding Targeted longer-term refinancing operations mature between June 2020 (€379.85bn) and March 2021 (€233.2bn). The September 2020 (€44.31bn) and December 2020 (€61.48bn) maturities are smaller. Over the past months, rumours repeatedly suggested the ECB might announce an extension of these TLTRO loans by mid-2019. The TLTRO-loans are included in commercial banks' long-term liquidity ratio's (NSFR). These will face a negative impact when the residual maturity drops below 12 months (50% haircut) and below 6 months (100% haircut). Cash-strapped banks will have to rely on market funding to replace these TLTRO's which might come at a heavy cost and effectively amount to a monetary policy tightening. We don't think that the ECB wants to send such signal. Indeed, the account of the December policy meeting suggest the matter had been raised by some governors.Therefore, ECB President Draghi might this week or in March **ask an ECB task force to exploit the options to replace TLTRO's.**

Markets will be sensitive to hints about new longer term liquidity operations. They could pull yields and the single currency lower, though we don't expect any lasting impact. As we approach the June deadline, markets will probably start behaving asymmetric. With the "adverse" impact being larger in absence of communication compared to the constructive reaction in case of an extension. Soft warnings on the economy are given current market positioning probably by and large discounted. **So all in all, we expect a muted market reaction to the ECB and, in the near term, it may be the equity markets fluctuating attitude to risk that possibly determines the faith of other markets.**

Mathias Van der Jeugt, KBC Brussels
Austin Hughes, KBC Dublin

Contacts

Brussels Research (KBC)		Global Sales Force	
Mathias Van der Jeugt	+32 2 417 51 94	Corporate Desk(Brussels)	+32 2 417 45 82
Peter Wuyts	+32 2 417 32 35	Institutional Desk(Brussels)	+32 2 417 46 25
Mathias Janssens	+32 2 417 51 95	CBC Desk (Brussels)	+32 2 547 19 19
Dieter Lapeire	+32 2 417 25 47	France	+32 2 417 32 65
Dublin Research		London	+44 207 256 4848
Austin Hughes	+353 1 664 6889	Singapore	+65 533 34 10
Shawn Britton	+353 1 664 6892		
Prague Research (CSOB)		**Prague**	+420 2 6135 3535
Jan Cermak	+420 2 6135 3578		
Jan Bures	+420 2 6135 3574		
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8809	**Bratislava**	+421 2 5966 8820
Budapest Research			
David Nemeth	+36 1 328 9989	**Budapest**	+36 1 328 99 85

ALL OUR REPORTS ARE AVAILABLE VIA OUR KBC RESEARCH APP (iPhone, iPad, Android)

This non-exhaustive information is based on short-term forecasts for expected developments on the financial markets. KBC Bank cannot guarantee that these forecasts will materialize and cannot be held liable in any way for direct or consequential loss arising from any use of this document or its content. The document is not intended as personalized investment advice and does not constitute a recommendation to buy, sell or hold investments described herein. Although information has been obtained from and is based upon sources KBC believes to be reliable, KBC does not guarantee the accuracy of this information, which may be incomplete or condensed. All opinions and estimates constitute a KBC judgment as of the data of the report and are subject to change without notice.