6 September 2019

ECB Research

Enough talking, now is the time for action

- We expect the long-awaited ECB meeting on 12 September to set the scene for months and potentially quarters to come. The question is not *if* the ECB will announce new initiatives but *how much* it will deliver.
- We expect the ECB to announce (1) a 20bp cut in the deposit rate (other key rates unchanged) and that the extended forward guidance ('at present or lower…well past the horizon of net asset purchases') will remain; (2) a 12-month QE restart of EUR45-60bn per month, albeit also acknowledging the downside risks given the recent hawkish communications from a few Governing Council members; and (3) a tiering system.
- The package is not likely to be a silver bullet for markets. The FX market is set to keep its focus on the rate cut, while the fixed income markets focus on the size of QE.

ECB has to come big to preserve credibility

After a decline in inflation expectations since the start of the year, which intensified in the second quarter, we believe the ECB will now be forced to act. While key ECB Governing Council members (GC) have recently voiced concerns about additional stimulus via bond purchases, we still expect a bold ECB package as the ECB's credibility is on the line. If the ECB fails to deliver a substantial package, we believe inflation expectations will not creep higher from the alarmingly low levels (compared with its inflation mandate). Furthermore, if the ECB fails to deliver, the financial market community would have been thrown off the trail by the numerous dovish comments, including the major shift from Mario Draghi in Sintra, which would be a dent to its credibility and transparency. We keep our call for next week's ECB meeting as we outlined after Draghi's Sintra speech to include a *rate cut and restart of QE* (18 June 2019). We argue for a restart of QE for EUR45-60bn for 12 months, a rate cut of 20bp, a *tiering system* and extended forward guidance.

Failure to deliver would force the ECB to act at a later stage

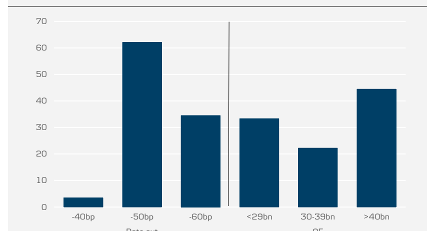
The recent hawkish comments from Dutch GC member Klaas Knot, ECB board member Sabine Lautenschläger and German GC member Jens Weidmann, who all see no reason to restart QE at the current juncture and would be in favour of a rate cut if any stimuli, pose a risk to our dovish QE call. However, we also believe that if the ECB does not deliver a sizeable package (we believe a QE restart is more important than a rate cut), we see it as unavoidable that the ECB will have to step up its easing measures at a later stage, while still waiting for fiscal support. A compromise of QE could be of less volume and of longer duration but, ultimately, in our view, the package needs to be bold as the absence of action in the current environment poses a risk to the ECB's determination.

This morning, Bloomberg's survey of analysts indicates that our call is for a bolder package than consensus. The survey shows that 62% of analysts expect a 10bp rate cut, while 34% expect a 20bp rate cut. Should ECB only deliver a 10bp rate cut, money market rates (EONIA pricing) would see a stark reaction, as there is currently 16bp priced in for a rate cut. ECB is seen to cut rates to -60bp in December (and no further cuts). The median expectations for the QE programme is 30bn for 12 months. 82% expect mitigating measures alongside a rate cut.

12 September (CEST)

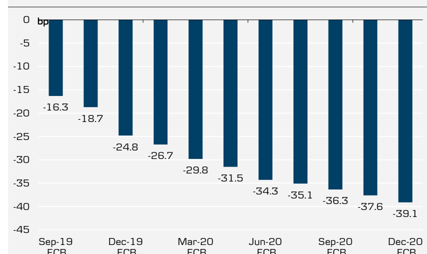
- 13:45 Decision
- 14:30 Press conference
- 15:30 Technical document (expected)

Analysts' expectations



82% expect a QE programme. 29 respondents
Source: Bloomberg, Danske Bank

September ECB pricing is fair in our view; aggressive in 2020



Source: Bloomberg, Danske Bank

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Does more of the same work?

We could debate at length about the transmission from additional monetary policy easing measures to inflation. We believe the important part here is that an absence of action would put credibility in danger given the current levels of inflation, which Draghi also acknowledged at the July meeting, when he said ‘we don’t like what we see’.

An *ECB paper from March* 2019 showed that the effect of monetary policy transmission has been decreasing from *all* non-standard monetary policy instruments to inflation and growth. A rough calculation suggests that assuming the ECB wants to close the medium-term gap from the staff projection in 2021 (our expectation for the ECB projection) of 0.5%, then the package should be at around EUR684bn (EUR2.6trn/1.9% inflation × 0.5% inflation gap). The ECB has so far bought EUR2.6trn in its asset purchase programmes. That said, the impact also includes other non-standard monetary policy instruments, such as negative interest rate policies and targeted longer term refinancing operations, which would speak in favour of a smaller package. However, as the impact of additional non-standard measures is likely to be declining, it would speak in favour of a higher package, so on balance we see a package of around EUR700bn as needed. Our expectation for the initial package totals between EUR540bn and EUR720bn (depending on the purchase rate for the first 12 months). Our package also includes a lift of ISIN limits, as under the current ISIN limits there are only around five months left in the German space for additional purchases (assuming a EUR45bn per month purchase rate). We expect ISIN limits to be lifted to 50%, which would bring another EUR1.8trm of bonds to the availability list.

Further, we note that at the onset of the QE programme in 2015, ECB emphasised the importance of the flow effect of new purchases. However, as the number of free floating government bonds has decreased markedly (below 10% in Germany), the stock effect has become the dominant factor (price sensitivity increases for the additional bond purchased).

Growth and inflation outlook set to take a beating

The September meeting also brings an update to the ECB’s staff projections, which we need to see in the context of the policy package unveiled. As we look for a comprehensive easing package including QE restart, we think the new forecasts will underpin the narrative with a clear downward revision in both the growth and inflation outlooks.

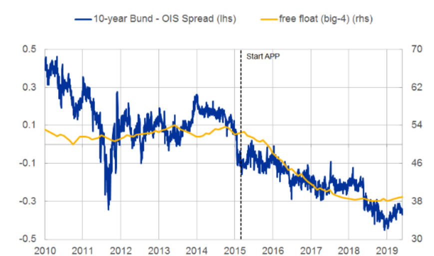
Since the last projections in June, the euro area growth outlook has weakened further (see *Global Economic Update – Stuck in the mud but no hard landing yet*, 22 August). Uncertainty on the global stage has risen and the many downside risks listed by the ECB have largely materialised. GDP growth slowed to 0.2% q/q in Q2 and we think it will be difficult for ECB staff to envision a growth scenario where the economic momentum gains speed in the near term. Hence, a downward revision in the 2020 growth forecast by 0.3pp to 1.1% seems warranted to us. Similarly, clouds have gathered on the inflation horizon. Core inflation continues to move sideways around the 1% level, as a strong pass-through from wages to service price inflation remains to be seen and goods price inflation remains stuck below 0.5%. With a more subdued growth outlook, paired with a lower oil price forward curve and a slight appreciation of the effective exchange rate, we think the stage is set for a downward revision in the core inflation profile by 0.2pp in 2020 and 0.1pp in 2021 (see table). However, even then, we think the ECB’s inflation outlook remains on the optimistic side as we expect core inflation to average only 1.1% in 2020.

Impact of non-standard policy measures on euro area inflation and growth

	Inflation %	Growth %
2016	0.85	0.79
2017	0.49	0.48
2018	0.22	0.31
2019	0.21	0.2
2020	0.16	0.08
Cumulative (16-20)	1.9	1.9

Source: ECB

Stock effects have been built up gradually



Note: Past performance is not a reliable indicator of current or future results
Source: ECB

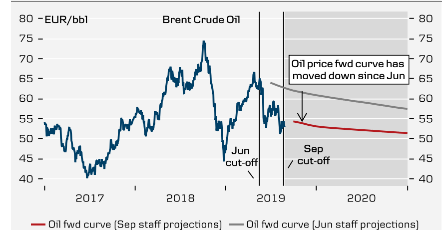
Growth and inflation outlook set to take a beating

ECB projections September 2019	2019		2020		2021	
GDP growth	1.1 (1.2%)	↘	1.1% (1.4%)	↘	1.3% (1.4%)	↘
HICP inflation	1.2% (1.3%)	↘	1.3% (1.4%)	↘	1.5% (1.6%)	↘
Core inflation	1.1% (1.1%)	→	1.2% (1.4%)	↘	1.4% (1.6%)	↘
Wage growth	2.1% (2.1%)	→	2.4% (2.5%)	↘	2.4% (2.5%)	↘

Parenthesis are the old ECB projections (from June 2019)

Source: ECB, Danske Bank

Stronger exchange rate and lower oil prices set to weigh on inflation outlook



Note: Past performance is not a reliable indicator of current or future results
Source: ECB, Macrobond Financial, Danske Bank

How will the fixed income markets react?

In our view, this will be perhaps the most complex policy package the ECB has presented at a time of a weaker global economic environment, which makes predicting market reactions extraordinarily difficult.

Main scenario (60%)

If we are correct that the ECB will deliver a dovish package including a 20bp rate cut, extended forward guidance and a sizeable new QE programme, it should be positive for fixed income markets. Funding rates would be lower and the ECB would be back as the major buyer in the bond market. In our view, the fixed income sell-off this week is partly a reflection of lower QE expectations after the recent QE pushback from hawkish ECB members. Lower geopolitical risks are admittedly also a factor. Hence, in our main scenario, we look for lower yields and flatter curves. This said, we do not rule out a kind of 'buy the rumour, sell the fact' or 'everything is priced in' reaction from a restart of QE. When the ECB started the first QE programme in Q1 15, bond markets sold off as optimism returned to the market and inflation expectations recovered.

ECB disappoints in respect of QE (40%)

Admittedly, risk is skewed towards the ECB delivering a smaller QE programme than we predict. In this scenario, the outcome is also unclear. It is likely the instant reaction would be an extension of the recent fixed income sell-off (higher yields and steeper curves). However, in this scenario, we argue that any sell-off would be relatively short-lived. The market will soon start to discuss whether the ECB is 'behind the curve', or even whether it is about to run out of options. The result is well known: Inflation expectations are set to dip further, while risk appetite would suffer and demand for fixed income would strengthen once again.

This will be no silver-bullet

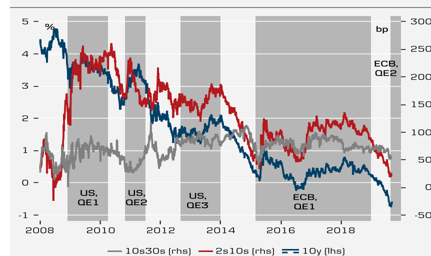
What we do argue is that the package next week, whether small or big, will be no silver-bullet for the ECB and the outlook for inflation and growth for the euro area. Hence, in both scenarios we have a hard time seeing the ECB meeting being a prelude for a more significant bond sell-off as we witnessed in Q1 15. We stick to our view that 10Y bund yields will trade close to -0.70% over the next one to three months. We remain reluctant to steepen positions given the negative roll in the curve.

Sizeable rate cut set to weigh temporarily on EUR/USD

We expect the ECB to deliver a sizeable package, which could weigh on EUR/USD on the day. As we wrote in *FX Edge – The EUR and ECB – rate cuts are all that matter*, 12 July, we believe how much the ECB cuts rates will be more important for FX markets and EUR/USD. A 20bp rate cut, depending on the mitigating measures, may just be enough to do the trick.

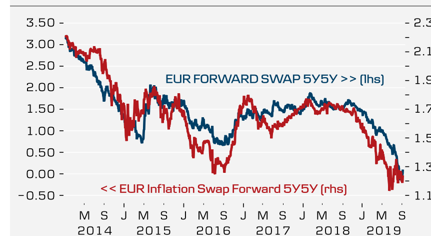
Volatility in EUR/USD during ECB meetings has overall been low over the past couple of years. The median high-low for EUR/USD over the past 15 ECB meetings is 67 pips (measured between 13:44 and 16:00 CET/CEST). However, they have also been relatively uneventful meetings. It is likely this will not be the case on Thursday. If we look at the nine meetings under Mario Draghi where interest rates were cut, the median high-low is 151 pips. In the big picture, the ECB needs a weaker EUR to get closer to achieving its inflation mandate and we do not expect the ECB to trigger a more persistent downward trend in EUR/USD on Thursday. In this regard, the big uncertainty is whether the ECB has any tools that would significantly weaken the EUR and revive inflation expectations and if it does, whether it would be willing to employ these. We forecast EUR/USD at 1.10 in 3M, before rising to 1.13 in 6M and 1.15 in 12M.

'Buy the rumour, sell the fact' sell-off?



Note: Past performance is not a reliable indicator of current or future results
Source: Macrobond, Danske Bank

Keep an eye on inflation expectations, especially if the ECB 'disappoints'



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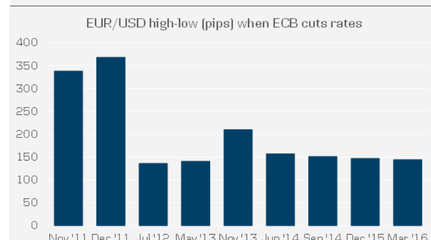
Source: Macrobond Financial, Bloomberg. Danske Bank

EUR/USD high low when ECB cut rates



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Source: Bloomberg. Danske Bank

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