20 March 2018

ECB Research

10bp, 20bp or ...? ECB in uncharted waters

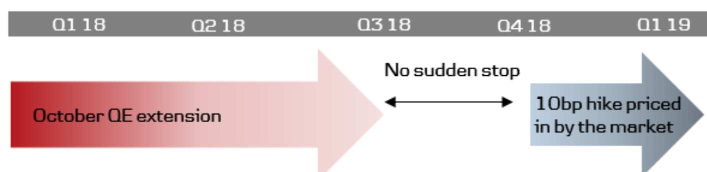
- **We continue to expect the ECB to raise the deposit rate by 10bp in Q2 19, also after weighing the arguments for the size of the hike in this note.**
- **The degree of subjectivity regarding the first hike is high. We doubt even the ECB's GC members have formed a view, yet.**
- **For market pricing, we argue that it is neither the size nor the timing that is crucial to markets, but how the first hike is communicated and its subsequent rate path.**
- **We believe that the risk/reward for the ECB coming earlier with the hike rather than later is not balanced. We recommend receiving 2Y2Y EUR swap outright.**

Recently, market speculation about the first rate hike from the ECB has resurfaced, not only on the timing but also on the size of the first hike. Most recently, *Reuters* reported a Q&A with the ECB's Chief Economist Peter Praet on Friday touching on this topic as well as yesterday when 'ECB sources' suggested that the focus in the Governing Council could be turning towards the interest-rate path.

That the size of the first hike is uncertain is new to modern monetary policy and the fact that the size is unknown complicates the discussion on the market's usual questions; 'what is priced in?' and 'is the market pricing fair'?

In the following note, we reflect on elements that we expect to play an integral part in the Governing Council's (GC) decision to hike rates. **As the size is uncertain the degree of subjectivity regarding the first hike is high.** Ultimately, we argue that on balance we expect the ECB to hike by 10bp in Q2 19. The size and timing needs to be seen in the light of our view of the ECB communicating a slow and gradual normalisation as well as testing waters towards higher rates. Controversially, **we conclude that it is neither the size nor the timing of the first hike that is crucial to market pricing; it is the communication that accompanies the hike that will drive the markets.**

Taking profit. In *Fixed Income Strategy: Rec Dec-18 to Mar-19 EONIA swap on too aggressive ECB pricing*, 11 January 2018, we sent out a trade recommendation to receive Dec-18 to Mar-19 EONIA swap. Our main argument for this trade was the stretched pricing from a sequencing perspective at a time when markets already had a first 10bp hike in Q1 19. **The trade has reach the target and is therefore closed with a profit of 5.2bp.**



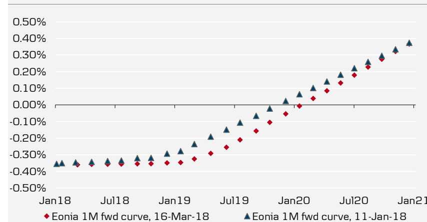
Recent research

- *ECB Review - 'Hawkish' action - softish language,* 8 March
- *Eurozone Inflation - Upside risks from oil prices and rising wage pressures,* 27 February

Chart 1: Months to next 10bp hike

Source: ECB, Danske Bank

Chart 2: Market has adapted to ECB sequencing since January



Source: Danske Bank

Senior ECB / Euro Area Analyst
Piet P.H. Christiansen
+45 4513 2021
phai@danskebank.dk

Analyst, Fixed Income Research
Mathias Rønn Mogensen
+45 4513 7179
mmog@danskebank.dk

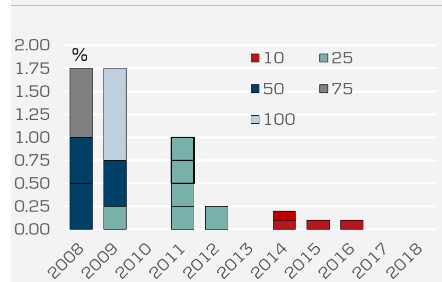
Recent market developments

In the period leading up to the March GC meeting, we saw the front of the curve flattening sub Q2 19. That move was intensified after the March meeting, where Bunds have also gained. The markets continue to price the first 10bp hike in 12-16 months time (Chart 1, page 1). Hence, the current pricing is now more in line with our interpretation of the 'well past' communication and we see little premium left at the front of the curve sub Q2 19 (see Chart 2, page 1).

Why is the size unknown?

Since the start of the crisis, the ECB has cut the deposit rate 15 times and the main refinancing rate 17 times. As Chart 3 shows, the recent cuts in the deposit rate have been of 10bp, after the usual 25bp (or multiple thereof). Complicating this is the MRO rate which has been cut in increments of 5bp, 10bp, 20bp or multiples of 25bp, and with no clear guidance from the ECB on the size, the market has to do its own guesstimate (Chart 4). That means that the ECB is not bound by any prior sizes when deciding on a size.

Chart 3: Different size of deposit rate changes complicates the assessment



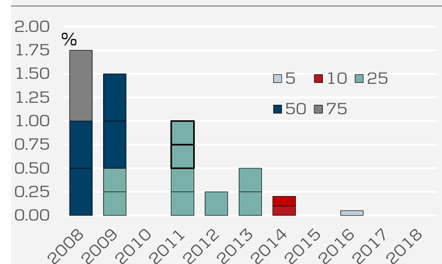
Source: ECB, Danske Bank

Do even the GC members know?

We doubt that the GC members have set their mind to a specific size of the first hike, as this is beyond the current forward guidance on sequencing. Further, we do not believe that they have a blueprint ready on how to conduct the rate hiking cycle. Ultimately, this is the main factor complicating the assessment of market pricing.

Only a few GC members have commented on the prospect of the first hike recently, as the focus in the GC is not on the policy rate hike (though that may be shifting), but on the winding down/ending of QE. Most prominent has been Bundesbank president Jens Weidmann (hawk) and board member Praet. Weidmann was asked about analysts' expectations of a hike in mid-2019, to which he replied that he found the expectations 'realistic'. Praet was reluctant to talk about the size of the first hike in his comments on Friday (see Reuters link on p1).

Chart 4: Different size of MRO rate changes complicates the assessment



Source: ECB, Danske Bank

Only the deposit rate or the entire corridor?

Without doubt the most important policy rate for the ECB today is the deposit rate. The record-high excess liquidity of EUR1.9trn, which is only expected to peak this year, has caused the EONIA fixing to be 4-5bp above the deposit rate (recall EONIA is the first step for transmitting policy rates from the ECB to the real economy).

Consequently, the MRO and the lending rate are of lesser importance and we could see the possibility of ECB hiking only the deposit rate which is currently -40bp, leaving the other rates unchanged, initially at least. This would speak in favour of a 15bp hike to the deposit rate to have the corridor symmetric (MRO and lending rate are 0% and 0.25%, respectively). Going forward, the entire corridor would move in tandem, as the ECB has had a tendency to prefer to have a symmetric corridor.

Removal of the 'technical adjustment' cut

We find the argument of only hiking the deposit rate to zero or into positive territory communicated as removal of the 'technical adjustment' from 2014 (and in 2015-2016) as the main risk to the ECB hiking early. The technical adjustments reference that the ECB used to lower the rates is hampering banks' profitability. While the ECB in the short run should not worry about banks' profitability, (they rightfully did not sound worried in 2014) the fact that the negative deposit rate is challenging for banks may be a driver for the ECB to hike rates.

Our concern with a 'one-and-done' approach is the communication on a one-off rate hike. We expect the market to embark on a fully-fledged hiking cycle, which would lead to an unwanted tightening of financial conditions.

Currently, the market pricing also reflects an expectation of a gradual hiking-cycle with the EONIA forward curve being slightly negative convex in the 1Y-4Y segment. That said, although not our baseline, from a market perspective we acknowledge the probability/risk of an intensified focus on a 'one-and-done' approach – especially as time passes and we approach the theoretical end-point of the current forward guidance on sequencing. If so, we could see a move towards a more S-shaped EONIA forward curve around the focal point of 0% deposit level (see Chart 2).

What is 'well past'?

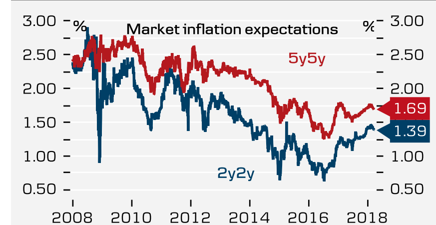
'Well past' is often quoted on financial media, but what does that mean? 'Well past' is data-dependent as Draghi would say, but to market participants, this does not add much value. 'Well past' is of course important as it clearly suggests the sequencing, i.e. the first rate hike will only come 'well past' the end of net asset purchases, **but 'well past' will be removed from the statement this year**. Once 'well past' is removed, as QE comes to an end, we expect the ECB to put the conditionality of rates on the inflation dynamics, i.e. 'rates will remain at present levels for an extended period of time and in any case until…' Therefore, the key variable to follow is inflation dynamics – but that should not come as a surprise to anyone.

In our view, **we should not be too focused on spot headline inflation but it is the core inflation rate right now**. We argue that in order for inflation to be self-sustained as the ECB wants, we have to focus on the medium-term core inflation when assessing the prospects of the first rate hike.

Amongst the market variables to follow, we put emphasis on the 2y2y and the 5y5y inflation swap, which currently trade around 1.4% and 1.7%, respectively (see Chart 5). While the 5y5y inflation swap is the blockbuster for financial markets we also pay close attention to the 2y2y as well. We believe that 5y5y should rather be used as a credibility measure of the ECB as it concerns the 5y to 10y inflation, far beyond what normal monetary policy can impact. Therefore, we rather focus on 2y2y for gauging medium-term inflation. The 2y2y inflation swap is expected to trade higher closer to 2% ahead of the first rate (if not deemed removal of a technical cut), which is far from the current 1.4% level.

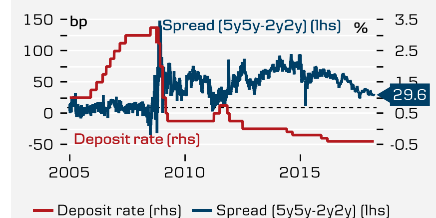
Further, we also note that the 5y5y and 2y2y inflation swap spread has historically traded around 10bp at the time of the hike (Chart 6). We explain the bearish spread compression as a pre-requisite for the ECB to acknowledge anchored inflation expectations all throughout the curve.

Chart 5: 2y2y inflation swap as a proxy for medium-term inflation expectations



Source: Bloomberg, Danske Bank

Chart 6: Spread around 10bp at time of time hike



Source: Bloomberg, Danske Bank

Inflation dynamics, growth outlook and staff projections

Evidently, inflation dynamics and the pace of the expansion is important for the reaction function of the ECB. That said we have already argued that we should not be too focused on spot headline inflation but look at the medium-term horizon. With the March ECB staff projections featuring a more narrow path towards the inflation objectives, albeit with the end point for the central projection slightly lowered, we view the ECB as more confident that inflation will eventually return to target, but we view them as more cautious on the timing (Chart 7).

Complicating this discussion is Draghi's concern about the estimates of the output gap, the nairu etc at the March ECB meeting, to which at the same time we highlight the risks of putting too great emphasis on the staff projections at the current juncture.

Therefore, staff projections could gain increasing importance again in 2019 when arguing for a rate hike. At that time, the 'unknown' component to an already tested system, i.e. the QE impact on growth and inflation, will also fall out of the staff projections (reinvestments still in place though). Also Praet said on Friday that 'we should not put too much weight on the projections'.

Market reaction – market to central bank feedback loop

The ECB's recent communication also shows that the interaction between the ECB and markets is critical when changing forward guidance. During the ECB watchers' conference last week, *Praet* put significant effort into illustrating the ECB's success in guiding markets. This was also reiterated in his comments on Friday. Chart 8, which is taken from Praet's speech, shows a high correlation between the inflation deviation from its aim (note: ECB uses 1.9% as its aim) and the deviation between the timing of the 10bp market pricing of the first hike and the Bloomberg survey on the timing of the first hike. Ultimately, market pricing at the short end of the curve is a great focus for the ECB.

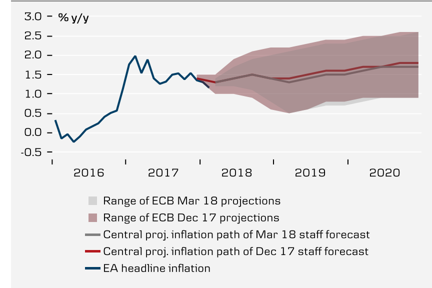
Timing of hike

We find increasing arguments for the ECB to come relatively 'late' to markets with a first rate hike. The ECB will be reactive and not proactive to any changes. Also, we believe that the risk/reward for the ECB to come earlier with the hike rather than later is not balanced, and consequently see that ECB will likely run the 'risk' of running the economy hot for a number of months, rather than moving earlier. Ultimately, the timing of the first hike is probably also dependent on the size of the hike. An earlier hike would warrant a smaller rate hike, and vice versa.

The Board when the ECB hikes

It is well known to markets that the ECB board will see significant changes in composition by next year. What is not communicated in this regard is that the confidence we put in Draghi, Constancio, Praet and Coeuré to be reactive, slow and gradual may be too high, given they may not even be on the board at the time of the first hike (Chart 9). Constancio, who will be replaced by another dove in May this year (incoming de Guindos is less dovish than Constancio though), will surely not be on the board at the time of the first hike. In May 2019, Draghi's first in line soldier, Praet will be replaced, and it is uncertain who will follow. Ultimately with Draghi's term ending a few months later in October 2019 and Coeuré in December 2019, we may see a shift in the board that could risk changing the ECB's board in either direction, albeit most likely with a less dovish twist than currently.

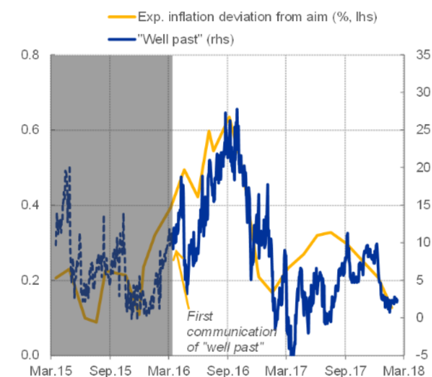
Chart 7: Stronger growth outlook has narrowed convergence path in inflation



Source: ECB, Eurostat, Macrobond Financial, Danske Bank

Chart 8: ECB communication well understood by markets.

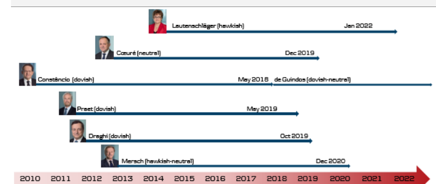
Panel B: "Well past" horizon implied by expected APP end and forward curve (months)



Source: Bloomberg, ECB calculations.[14]

The 'well past' horizon is derived as the difference between the date at which the forward curve prices in a full 10 basis point hike and the median expected APP end-date based on Bloomberg surveys.
Inflation expectation deviations from the aim are derived as the difference between 1.9% and the 5-year-in-5-year inflation expectations implied by inflation-linked swap rates
Source: Bloomberg, ECB

Chart 9: Four of six ECB board members to be replaced by end 2019



Source: ECB, Danske Bank

What's next? – FI thoughts

In *EUR Fixed Income – Misaligned rates and inflation markets*, 1 March 2018, we recommended selling a 1Y5Y ATMF EUR payer swaption as the re-pricing of the 'belly' of the EUR curve on the back of the December ECB minutes and the January ECB meeting seemed too aggressive, in our view – especially given the subdued market-based inflation expectations (Chart 12).

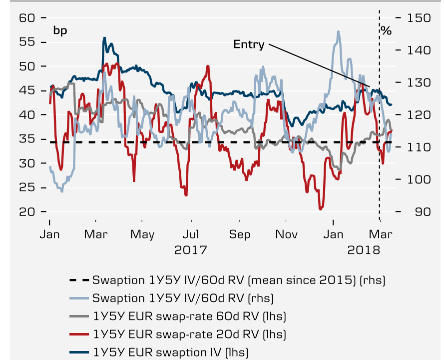
Since entry of the strategy, implied 1Y5Y EUR rates volatility has edged lower, leaving implied volatility relative to 60 days' realised volatility around 115% from above 1.25% at entry, i.e. slightly above the mean since 2015 of 111% (Chart 10).

Despite the recent move lower in EUR rates on the back of the March ECB meeting, we still see limited room for a repricing of the curve sub 5Y, near term. Although we think the balance of risk to our euro-area inflation forecast lies on the upside, *Eurozone Inflation – Upside risk from rising oil price and wage pressure*, 27 February 2018, this is already priced into the EUR rates market, in our view. Besides, we still expect euro-area inflation to remain subdued in both 2018 and 2019 (Chart 11). Recently, at the March ECB meeting, the ECB staff projection of euro inflation was revised down in Q4 20 from 1.8% to 1.7% (Chart 11). However, the ECB still expects core inflation to accelerate significantly in 2020 to 1.8%, supported by a strong pick-up in wage growth to 2.7% in 2020. We still see that as optimistic.

As such, we still like the delta in the 1Y5Y EUR payer swaption position, but think the current risk/reward in the volatility component is less attractive than at inception. **Hence, currently, we prefer to express our view in outright terms instead and book a 23.9bp profit on the strategy, with around 7.7bp assigned to the optionality component and the remainder to the delta. The sold payer swaption has lost more than 25% of its initial forward value. Instead, we recommend to receive 2Y2Y EUR swap outright at 61.7bp (indicative mid-price), with a 1Y roll-down of 45.5bp. Target/stop-loss: 30bp/80bp.**

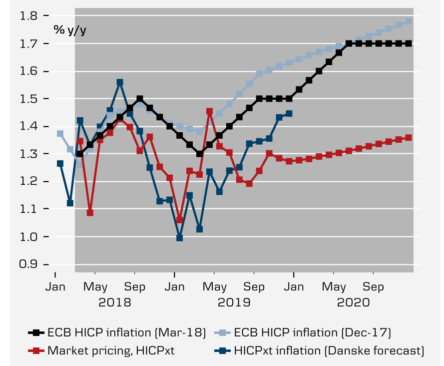
Amid a solid roll-down and subdued market-based inflation expectations in the 2Y2Y-segment, receiving EUR rates in this part of the curve should theoretically also be less resilient to a one-off rate hike from the ECB moving the deposit rate to 0%, as the current EONIA forward curve is positive from 2Y and onwards. That said, we emphasise that a 'one-and-done' approach is not our base case expectation, in part, as a consequence of our concern with the communication of a one-off rate hike. We would expect the market to embark on a fully-fledged hiking cycle, leading to a steepening of the front-end, also in the 2Y2Y segment. Hence, although we acknowledge that more probability/risk could be assigned to a one-off hike, we do not put too much weight on this in our current strategic market based risk/reward considerations at the front end of the EUR curve.

Chart 10: Implied 1Y5Y EUR vol has edged lower since primo March-18



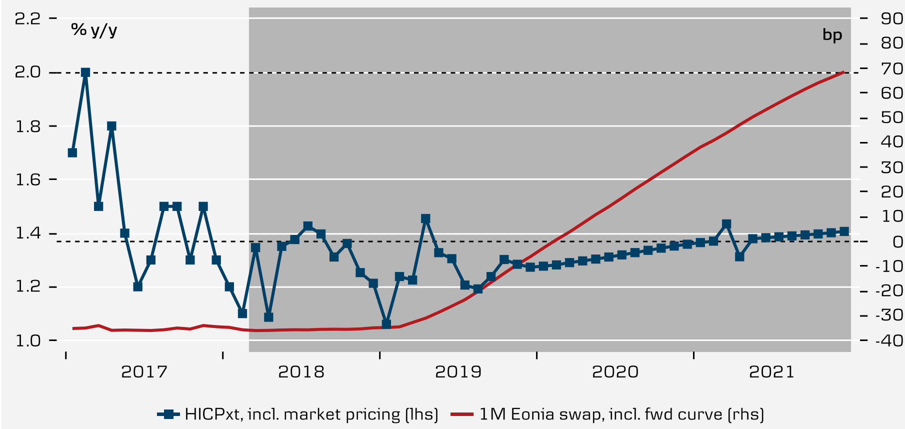
*Note: *IV = Implied volatility, **RV = Realised volatility, and *** Realised volatility computed as x-days' average of squared daily changes in underlying swap, reported as bp/year.*
Source: Macrobond Financial, Danske Bank

Chart 11: ECB inflation projection revised down in March, but it is still too optimistic, in our view



Note: Euro HICPxt is HICP excluding tobacco
Source: Eurostat, Macrobond Financial, Danske Bank

Chart 12: ECB set to enter a hiking-cycle with inflation well below 2% – short-end EUR real rates should fall



Note: Euro HICPxt is HICP excluding tobacco

Source: Bloomberg, Macrobond Financial, Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Piet P.H. Christiansen, Senior ECB / Euro Area Analyst, and Mathias Rønn Mogensen Analyst, Fixed Income Research.

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