06 March 2020

ECB Preview

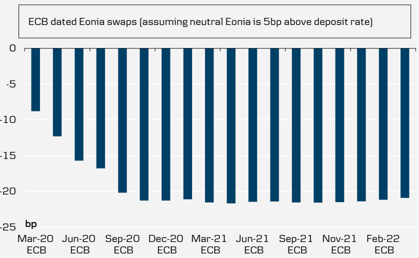
A cut is not the cure for COVID-19

- We plan to monitor closely next week's ECB meeting following the outbreak of the COVID-19 virus and with the policy response space less than for other central banks. In our view, the ECB will have to be innovative to address this special situation. Contrary to market pricing, we do not expect the ECB to cut rates but rather to focus on liquidity facilities targeting small and medium-sized enterprises (SMEs), a tweak to the QE programme and potentially reintroducing its date-based forward guidance. However, it is important to stress that we see a significant risk of a 10bp cut at next week's meeting.
- We expect the ECB to stand ready to ease monetary policy via rate cuts should the economic outlook deteriorate sharply in the near future. As such, we see the possibility of a rate cut in Q2, perhaps as early as the 30 April meeting.
- We expect the new ECB staff projections to lead to lower GDP growth and broadly unchanged inflation projections. However, with the limited amount of data released taking into account the COVID-19 effect, we believe markets will focus on the narrative rather than the projections.
- From a risk-reward perspective, we recommend paying the EONIA 2Y1Y for a positioning into Q2 and paying Mar20 EONIA heading into the ECB meeting next week.

12 March 2020 (CET)

- 13:45 Decision
- 14:30 Press conference
- 15:30 Staff projection (potential technical document on SME LTRO)

Markets are fully pricing in a rate cut for next week



Source: Bloomberg, Danske Bank

ECB comments does not suggest an imminent and forceful response – just yet

Over the past week, particular focus has turned to ECB Governing Council (GC) members' views of the impact of COVID-19 on the economy. At the January meeting, the ECB said that the balance of growth risks was on the downside but had become 'less pronounced' and while we have seen another downside risk from a sharp slowdown, we do not expect the ECB to launch a large easing package – at least not yet. In Christine Lagarde's first real test as ECB President, we believe she will seek the consensus of the GC by allowing tasked committees to examine the impact of the virus on the inflation outlook and, as such, design policy responses should they be needed. In the meantime, we expect liquidity facilities and a call for co-ordinated fiscal stimulus to be the clear message.

The list of GC members' comments in recent days (see *Appendix*) shows that they view the monetary policy as being already very accommodative and that governments should act prior to central banks. Therefore, with the exception of Philip R. Lane's comment on 27 February, we do not see any appetite to take hasty decisions. **Lagarde's statement on Monday night also suggested no hasty decisions, as it stated that the ECB stands ready to take 'appropriate and targeted measures' in response to the impact on the economy and medium-term inflation expectations**. As the data have yet to be released to gauge the economic and inflationary impact of COVID-19, we expect the ECB to adopt monitoring, not forcefully reacting, and focus on targeted liquidity measures and QE tweaks rather than changing the overall monetary policy stance. In summary, we expect the ECB to sound ready to ease monetary policies (beyond liquidity injections) without a clear guidance of how. We see a risk of markets being disappointed next week on the lack of clear easing guidance.

Chief Strategist, ECB & Fixed income
Piet P. H. Christiansen
+45 45 13 20 21
phai@danskebank.com

Senior Analyst, Euro area
Aila Mihr
+45 45 12 85 35
amih@danskebank.com

Senior Strategist, FX
Lars Sparresø Merklin
+45 45 12 85 18
lsm@danskebank.dk

Difference between the Fed and ECB statements – different actions?

We also find it important to highlight and compare the statements from the Fed last Friday versus the statement from Lagarde on Monday. Scrutinising the Fed's statement, which later led to this week's 50bp rate cut, compared with Lagarde's statement shows an important difference: The ECB statement explicitly highlighted the need to take 'targeted' measures and more focus on medium-term inflation, which was not mentioned in the Fed statement (see below).

Fed and ECB statements

ECB on 2 March 2020	Federal Reserve on 28 February 2020
The ECB is closely monitoring developments and their implications for the economy, **medium-term inflation** and the transmission of our monetary policy. **We stand ready to take appropriate and targeted measures, as necessary and commensurate with the underlying risks.**	The Federal Reserve is closely monitoring developments and their implications for the economic outlook. **We will use our tools and act as appropriate to support the economy.**

Source: ECB and Fed websites, bold emphasis Danske Bank

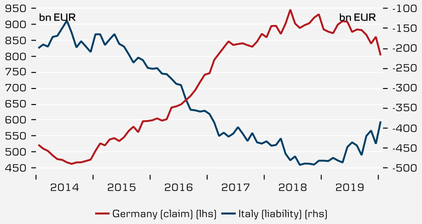
While we read the Fed statements as warranting full availability of the toolbox, importantly a (sizable) rate cut, Lagarde's emphasis on 'targeted' measures suggests to us a more limited approach, using liquidity measures instead of a full-fledged rate cut. If the full ECB toolbox were to be opened next week, we would expect a use in the press release of the usual language from the introductory statement that 'the Governing Council continues to stand ready to adjust all of its instruments, as appropriate, to ensure that inflation moves towards its aim in a sustained manner'.

Liquidity rather than cut

First and foremost, it is important to highlight that we believe that if the ECB policy rate level would have been comparable to the US and that banks would ultimately pass on a potential rate cut to the real economy, we would have been calling for a rate cut. However, with the deposit rate at -0.50%, it remains uncertain whether the ECB is willing to go deeper into the negative given the potential negative impact on the European banking sector and the discussion about the 'reversal rate', with ECB board member Isabel Schnabel saying last week that no one knows where it is currently.

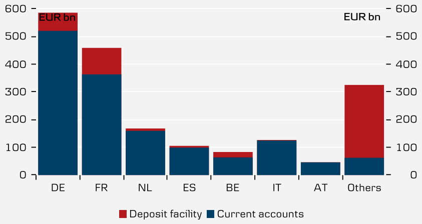
The table below shows the main arguments for and against an ECB rate cut. There are solid arguments for both, which makes the call difficult. However, Monday's statement from Lagarde with the emphasis on targeted does not suggest a general easing of monetary policy, which a rate cut or scale up of QE would bring. As a result, we judge the reluctance to ease generally, particularly via rates due to the discussion on the reversal rate and too hasty conclusions, prevails. Therefore, we do not expect the general ECB communication to warrant an overall easing of monetary policies, until it has a clear indication about the implications for medium-term inflation. Markets are pricing in a full 10bp for the meeting (see chart on front page).

Target2 balances show funds are primarily located in Germany



Source: ECB, Bloomberg, Macrobond and Danske Bank

Current account and deposit facility holdings per country



Source: ECB, Macrobond and Danske Bank

While we are certain the ECB will deliver some kind of liquidity facility, there are uncertainties about the form. The issue at hand is to ensure that euro area companies have sufficient liquidity to address any potential squeeze they may have on the back of COVID-19 consequences. The liquidity squeeze is likely to occur in specific sectors, such as tourism, restaurants and transportation, but as these sectors are relatively difficult to target and may be located in specific regions of the euro area most hit by the virus, the central bank would have a hard time supporting this (as this is a task for fiscal authorities or banking regulations). We have already seen initiatives from commercial banks such as *UniCredit*, which has subsidised emergency loans and credit line extensions for up to 6M suspension of monthly mortgage payments for companies in the regions affected. As such, we believe the ECB will deliver a temporary liquidity facility in the form of a 6M ‘bridge operation’ targeted at SME clients but as a normal liquidity operation. What should also be noted is that money in the euro area is already located primarily in the core countries, such as Germany (see the Target2 balance and deposit and current account charts). We do not expect the excess liquidity in the euro area to increase significantly on the back of new liquidity facilities. =

As part of the liquidity easing, we do not rule out changes to the TLTRO3 terms as well, to make the terms more favourable. Such changes could entail a lifting of the 30% eligibility pool rule to 40%, which would allow Spanish and Italian bank, in particular, to take addition funds, or easing the rate, for example to MRO-25bp to deposit rate.

The liquidity facilities from the ECB would get the most help from policymakers at an EU level if it was also to happen jointly with regulatory forbearance on the most hit sectors’ debt service to banks. This may be something that the euro group may decide on in two weeks when it meets again. Importantly, the euro group has already communicated possible flexibility with the stability and growth pact rules.

Arguments for and against a rate cut next week

Main arguments for no cut (Our baseline)	Main arguments for rate cut (not our baseline)
- 10bp will have a meagre effect near term - Reversal rate discussions - Not to overreact with no economic data to gauge the effect of COVID-19 on medium term inflation expectations - Signal readiness to cut - A coordinated G7 easing package could have been announced this week - Lagarde's statement on Monday	- "sympathy cut" with other major CBs and a sign of willingness to do something - as markets have pushed them into a corner and as such ECB may be afraid of a sell-off on the back of a no-cut policy. - a rate cut / hike, i.e. 10bp rate cut with tiering multiplier increased to 10x (now 6x), would mean the marginal rate could be -60bp, but the average deposit rate would increase from -27bp to -14bp.

Source: Danske Bank

QE – tweak to the programme

The ECB reactivated its APP net purchases in November 2019 and has so far focused around 60% of its purchases in the PSPP programme. While companies may face liquidity (and potential credit constraints), we expect the ECB to tweak its parameters to focus on the private programmes (CSPP and CBPP3) for coming months, while still keeping its EUR20bn purchase rate. This may help the credit component for the larger corporates that have access to the capital markets. Another possibility may be to keep the PSPP purchases unchanged and increase allocation specifically, e.g. EUR5-10bn per month to the CSPP programme. However, we expect the overall volume to remain unchanged at EUR20bn. We expect the tweak towards CSPP to last until summer.

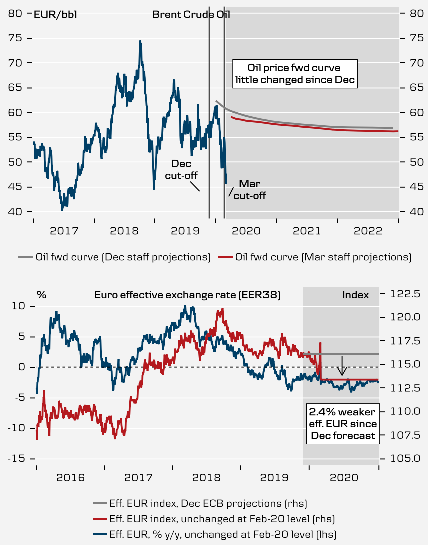
Growth outlook set to take a beating

ECB projections March 2020	2020		2021		2022	
GDP growth	0.7% (1.1%)	↘	1.3% (1.4%)	↘	1.4%	→
HICP inflation	1.1% (1.1%)	→	1.4% (1.4%)	→	1.6%	→
Core inflation	1.2% (1.3%)	↘	1.4% (1.4%)	→	1.6%	→

Parenthesis are the old ECB projections (from December 2019)

Source: ECB, Danske Bank

Weaker EUR provides tailwind for ECB's inflation forecast



Source: ECB, Macrobond Financial, Danske Bank

Economy is steering into uncharted waters

With the arrival of COVID-19 on Europe's shores the coronavirus crisis has morphed from a mainly supply-side hit to a demand shock and we now expect annual euro area GDP to be a mere 0.5% in 2020 (see *The Coronavirus Crisis – U-shaped rather than L-shaped global recovery*, 4 March) In light of the recent developments, we expect the ECB's updated projections to show a marked downward revision of GDP growth in 2020. The services sector has been the main driver of European growth since 2018 and – even more importantly – an important contributor to the gradual rise in core inflation lately observed. Hence, we believe the ECB will keep a close eye on the upcoming HICP prints this spring for any signs that the adverse effects of flagging demand on services inflation outweigh the upside pressure on good prices on the back of global supply-chain disruptions.

However, while the length of the coronavirus crisis is unknown, we expect ECB policymakers to stress that it constitutes not only a short-term hit to the economy but also uncertainties about their baseline. However, we do not expect it to evolve into a protracted 'fully fledged' employment recession. Continued upward trajectories in the medium-term growth and inflation outlook are important arguments for staying put on policy rates.

FI – pay March 20 EONIA and/or EONIA 2Y1Y

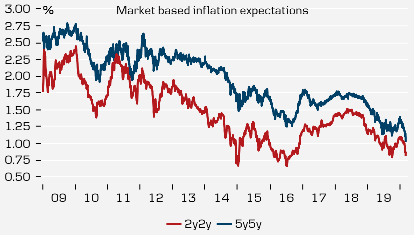
As the situation evolves rapidly on a day-to-day basis, it is difficult to see how the market will trade the ECB meeting. At the current juncture, we do not see the ECB being the circuit breaker for the recent rally, as it remains reluctant to act. As such, we even expect yields to fall further from here. In a nutshell, we expect rates to be low and even lower from here but also to trade fairly 'choppy' heading into next week's meeting. We expect some stabilisation of the spread between core and periphery as well as core and semi-core generally.

Pricing at the short end of the curve to some degree mirrors the very aggressive pricing we saw last summer. Heading into the meeting, we recommend paying the March 20 EONIA at -55bp on our no rate cut call (compared with EONIA spot at -45.5bp), which to some degree is a binary outcome on Thursday (we do not believe the ECB will cut between meetings). We see the risk/reward as attractive, as we see almost zero probability of the ECB cutting more than 10bp next week. Should it cut 10bp, we would expect to see a very limited loss (close to zero), while no cut would see a profit of around 10bp.

However, if you share the market pricing expectations of a rate cut next week by 10bp, we also see very good value and recommend paying the 2Y1Y EONIA at -70bp, as we see a risk of further downside heading into the meeting (currently -65.2bp). The trade has almost no roll (-1.5bp per year), as we see very little chance of the ECB cutting by more than 10bp in the near future (and as such the ECB is done cutting) and as such we find the risk/reward attractive. We target -55bp and have a stop loss for the 2Y1Y EONIA at -80bp (which would be an all-time low).

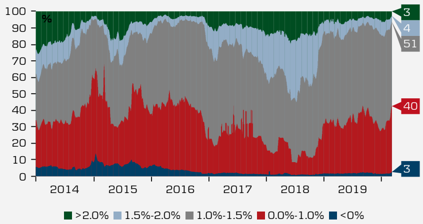
Market-based inflation expectations have touched new all-time lows, most notably the 5Y5Y inflation swap. However, this has seen a high correlation with the nominals. If this were due to deflation hedging, we would be concerned but we do not see this yet. Markets-based probabilities still point to only around a 3% chance of deflation in five years.

5Y5Y inflation swap declines sets new all-time lows



Sources: Bloomberg, Macrobond Financial, Danske Bank

Deflation risks still 'only' at 2% in 5 years



Sources: Bloomberg, Macrobond Financial, Danske Bank

FX – ECB set to support EUR/USD upside

EUR/USD continues to be inversely related to market sentiment across credit, equities and commodities and, on the rates sides, driven mainly by Fed expectations and the unwinding of short EUR/USD positions. With the ECB likely to underwhelm market expectations, this spells upside risk in the cross, notably for Thursday, if we are right in seeing no rate cut and – depending on the spot level heading into the meeting – there is a likelihood we could see a test of the January 2019 highs (slightly above 1.15).

That said, looking further ahead, positive developments in Asia in terms of coronavirus numbers, the prospects for ongoing global policy intervention from (other) central banks, and still-good macro data have the potential to slow down appreciation pressure in EUR/USD further out (see *FX Strategy – EUR/USD upside risks are fading yet again* , 5 March 2020) – notably in light of our baseline of a U-shaped recovery when virus woes should eventually abate. Indeed, looking 6-12M out, there is still plenty of scope for us to end up with a weaker EUR/USD yet again. We still target 1.07 over this horizon, even though it is still too early to position for such.

Appendix: Selected governing council member views in past week

Date	Person	Text
03-Mar	Villeroy	Our current monetary policy is already very expansive and acts as an economic stabilizer That is why governments with fiscal space should use it We make policies based on our own analysis. If necessary, we would stand ready to take appropriate and targeted measures, taking into account the liquidity needs of banks and businesses. Moreover, governments with fiscal space should use it
03-Mar	Holzmann	MONETARY ACTIONS ARE SECONDARY TO FISCAL SUPPORT SEE NO URGENCY TO MOVE ON TLTROS TLTROS WILL BE UNDER CONSIDERATION NEXT WEEK ECB MUST STAY VIGILANT, BUT NOT OVERREACT would currently not support an interest rate cut to help curb the coronavirus effects on the economy.
03-Mar	Kazimir	#G7 coordination, aimed to shield the global economy, is much appreciated Important for ECB to remain alert, monitor situation. There's no imminent need to act, but we're ready to step in when and where necessary Panic & overreaction could cost us a lot. 3/3
03-Mar (very late)	Lagarde	The ECB is closely monitoring developments and their implications for the economy, medium-term inflation and the transmission of our monetary policy. We stand ready to take appropriate and targeted measures, as necessary and commensurate with the underlying risks.
03-Mar (16:08)	De Guindos	"It has to do with the additional space we have in terms of accommodation. If you make a mistake because you overreact, afterwards the correction is not easy" "We an accept that markets overshoot," but an overreaction from a central bank "has consequences in the medium term" It's something you should keep in mind: we are not going to overreact. We will be calm, prudent. When we do react, it will be in line with our mandate"
02-Mar	De Guindos	The coronavirus added a new layer of uncertainty to global and euro-area growth prospects We remain vigilant and will closely monitor all incoming data. Our forward guidance steers the orientation of our monetary policy. In any case, the Governing Council stands ready to adjust all its instruments, as appropriate, to ensure that inflation moves toward its aim in a sustained manner
02-Mar	Villeroy	We are vigilant, we are mobilized, but we remain calm and proportional in the responses we need to have It is very important to have a rational analysis of the phenomenon of economic transmission Any response to virus needs to be "calm and proportionate" If we needed to do more and we had the belief it is effective, we could do it, we could do it but we are not there yet,
01-Mar	Weidmann	slightly revise down our forecast. Most likely assumption is a V-shaped effect. Normalisation will then happen quite quickly Carefully assess the situation... we are confronted with a combination of a supply shock and a demand shock. Our Target is price stability. A negative supply shock could even lead to hike in prices. Question is also how effective our instruments to counter any possible demand effect
28-Feb	Weidmann	ECB ALREADY PROVIDED SOME POLICY INSURANCE... EFFECT OF VIRUS ON PRICES 'IS FAR FROM CLEAR'... MONETARY POLICY IS ALREADY QUITE ACCOMMODATIVE... CURRENTLY DON'T SEE NEED TO TAKE ANY POLICY ACTION EXPECT V-SHAPE REACTION OF ECONOMIC ACTIVITY
27-Feb	Schnabel	Reversal rate is not one number, it's "actually moving," and nobody knows where it currently is CONCEPT OF REVERSAL RATE IS VERY USEFUL
27-Feb	Lane	In order to avoid a long-term de-anchoring of inflation expectations -- easing measures must be sufficiently pre-emptive to guard against a further downward drift in inflation dynamics While above-target inflation can be countered by "sharp monetary tightening," lower bound limits mean that easing "must take the form of less-sharp adjustments that are maintained over an extended horizon"
27-Feb	Lagarde	"very carefully" but said it was not yet at the stage where it would have a lasting impact on inflation and, therefore, require a monetary policy response. "It is a fast-developing phenomenon which requires that we monitor very carefully," said Ms Lagarde. "It is clearly not an area where a central bank has actually an opinion. It is really for the health service and health experts to give us their take . . . on the evolution and particularly importantly on containment."

Source: Bloomberg, Twitter

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Expected updates

None.

Date of first publication

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