Danske Bank

ECB Preview – End of QE approaching but no formal announcement just yet

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QE coming to an end – not officially announced yet

ECB meeting on 14 June 2018. Rate decision at 13:45 CEST, followed by a press conference at 14:30 CEST.

- **Overall/forward guidance.** At the governing council (GC) meeting next week, we do not expect explicit new forward guidance, but may see some hawkish bits, in particular in wage growth discussions along the lines of ECB's chief economist Peter Praet's comments on Wednesday, which were surprisingly hawkish.
- **Tasked committees.** Draghi will face numerous questions on an (upcoming) change in forward guidance. Just as Draghi referred to **tasked committees** when lowering the APP purchase rate from EUR80bn to EUR60bn and EUR60bn to EUR30bn, **we could envisage him using a similar reference while waiting for the July meeting**.
- **Timing**. While **we expect forward guidance to be changed in July**, we cannot rule out the possibility of it coming already next week given the recent comments from Praet. In our view, we have not received any data that should warrant the ECB moving already now. The ECB's actions, which were confirmed in March, have been **reactive when removing stimuli and not proactive**. In our view, **a change to the forward guidance next week would also question the mantra of ECB being reactive**. Should APP guidance change next week, we expect the ECB to step up its rhetoric on rates, reinforcing the depo rate guidance.
- **New staff projections.** We expect **growth to be revised down by 0.2pp** and **inflation to be revised up by 0.2pp in 2018**. We do not look for big changes in the core inflation forecast.
- **Italy.** Focus on Italy during the Q&A. We do not expect the ECB's QE tapering discussions to be changed due to the Italian turmoil. Should the turmoil lead to a sustained deterioration in confidence (in turn leading to a slowdown in the fragile Italian economy) we expect the ECB to get more worried. Further, we expect Draghi to acknowledge the new government and to say that he expects all EU (EA) countries to live up to the rules and that any ECB response is laid out in the rule book (ESM).
- **Buzzword bingo.** You will find our updated buzzword bingo at the end of this preview.
- **Fixed income.** We expect little impact on the EGB term-premium from the June meeting and the impact on the long end should be small. If - contrary to our expectations – we see a more hawkish signal from the ECB, the 5Y point on the EUR curve could be especially exposed. We continue to be positioned for **a tightening of periphery (excluding Italy) spreads versus Germany/swaps.**
- **FX**. EUR/USD in lower range for longer. **Hawkish hints at the press conference should still keep up the sense of the ECB slowly but surely continuing policy 'normalisation'**. While the USD is set to stay supported from a rates point of view, the ECB keeping up its exit process should ensure that EUR/USD is kept afloat further out. We look for broadly the 1.15-1.21 range to be sustained on a 6M horizon.

Changing the forward guidance in 2018

We expect the **next change in forward guidance to come in July and not next week.**

January: No change

March: QE flexibility in increasing the APP in size and duration is removed

April: No change

June: No change

July: (3) and (4) QE tapering for Q4 announced, with fixed end date.

(2) policy rate linked to inflation condition (4)

September: (2) 'well past' removed as QE set to end

Breaking down the ECB's monetary policy decision

(1) Level of policy rates
The ECB expects key ECB interest rates to 'remain at present levels...'

(2) Policy rates horizon
'...for an extended period of time and well past the horizon of our net asset purchases'.

(3) QE magnitude
'Net asset purchases are intended to continue at a monthly pace of EUR30bn until the end of September 2018, or beyond, if necessary...'

(4) QE tapering condition
'...and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim'.

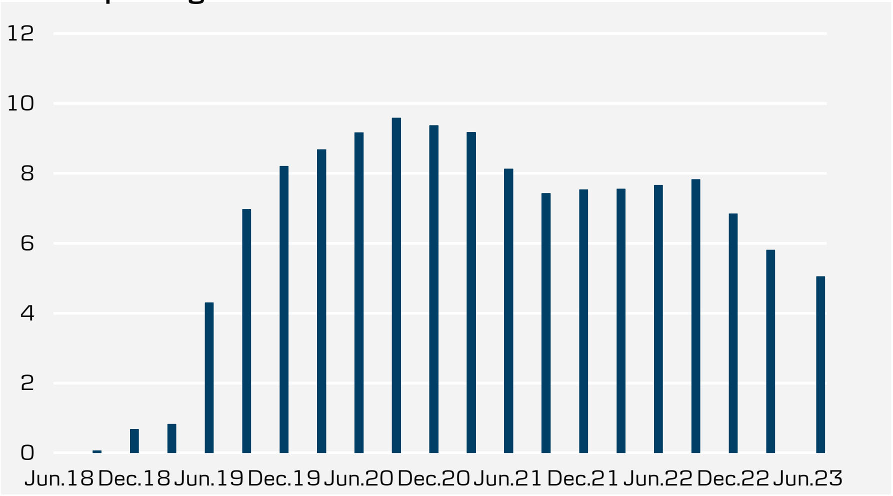
Markets point to 10bp hike in July 2019 and 20bp in December 2019

- EONIA forwards are currently **pointing to a 10bp rate hike priced in July 2019 and 20bp in December 2019**.
- We find the **current pricing to be balanced, which does not warrant entering new positions in the part of the curve as an ECB hike position.**
- **Only 10bp between IMM dates is priced in.**

Month to next 10bp hike in the deposit rate

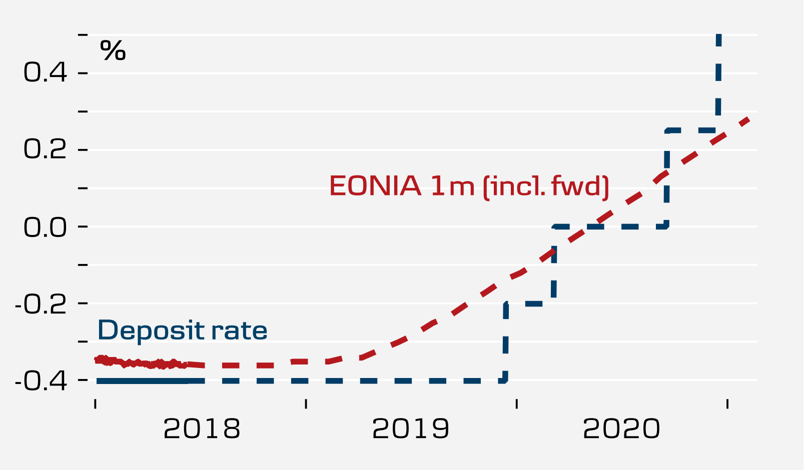
Source: Macrobond Financial, Danske Bank

EONIA pricing between IMM dates



Source: Danske Bank

Deposit rate path and EONIA forwards



Source: Macrobond Financial, Danske Bank

10bp, 20bp or a different size of hike?

- The size and timing of the first hike have been highly debated in financial markets recently, despite the still accommodative monetary policy environment. On Wednesday this week, the most hawkish members in the GC, Weidmann, Knot and Hansson, all advocated a hike in mid-2019.
- Yet, as we have argued before, we should treat those comments as the most hawkish views. Hence, a 'corner solution' to the market pricing distribution (see next slide), not the baseline.
- ECB is very focused on the market impact of its communication, which was visible in April when an ECB spokesperson stressed that Nowotny's comments are '*not the view of the GC*'.
- Further, we continue to **doubt that the GC members themselves have a firm view on the size of the hike, but it is likely to be in the range of 10-25bp.**
- We expect the ECB to stay put as long as Draghi is still President (until October 2019) and believe the new ECB GC taking a slight hawkish twist would prefer to end the NIRP relatively quickly on the back of an improving inflation outlook.
- Further to the argument of a delayed hike, we consider the 'risk/reward' of the ECB acting too early compared with waiting (running the economy 'hot') is not balanced; hence, our rather dovish view on the timing.
- We stress that it is **not the size of the first hike but the communicated rate path that is crucial for market pricing.**

Source: Danske Bank

Tapering in Q4 – reinvestments to become increasingly important

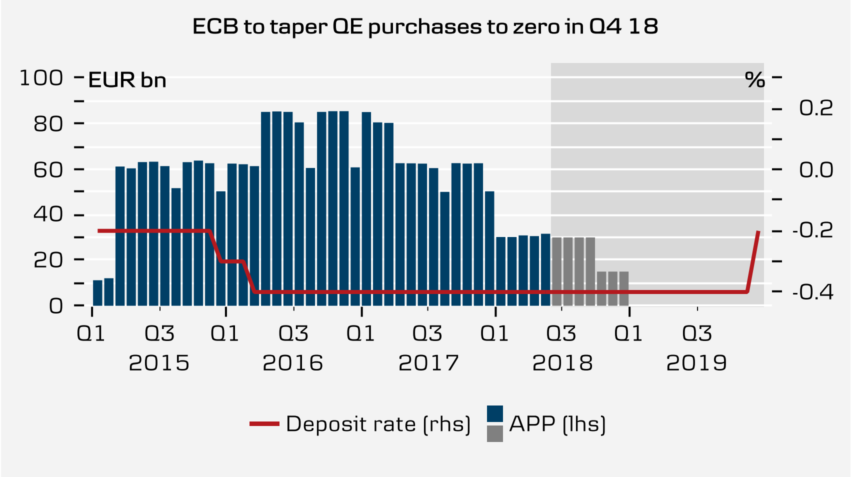
Sequencing is set in stone – no hike prior to ending of net asset purchases.

After a Q4 APP purchase rate of EUR15bn per month, we expect the ECB to end the QE programme in 2018.

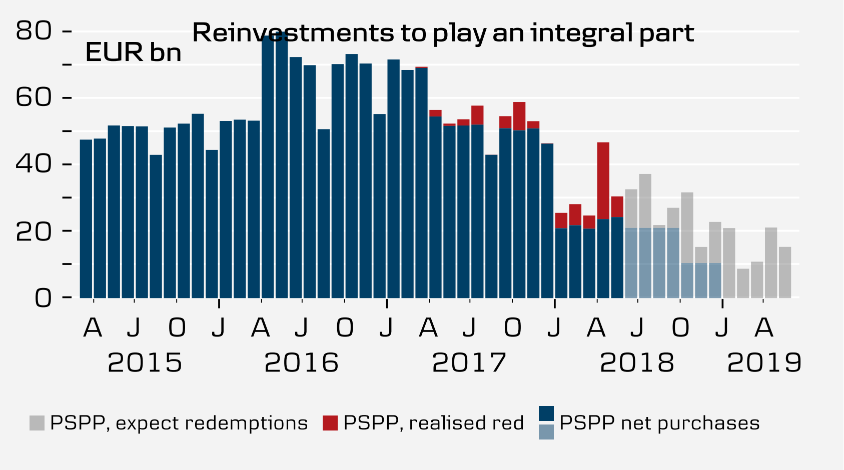
Inflation is expected to pick up somewhat in mid to late 2019, so we expect the ECB to deliver its first 20bp hike in December 2019.

Reinvestments set to become increasingly important and to contribute to an accommodative monetary policy stance.

Reinvestments set to take place 2-3y after the end of net asset purchases.



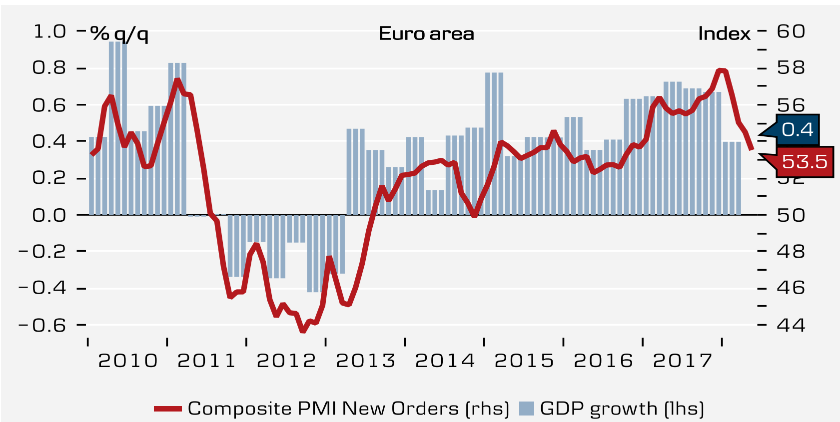
Source: ECB, Macrobond Financial, Danske Bank

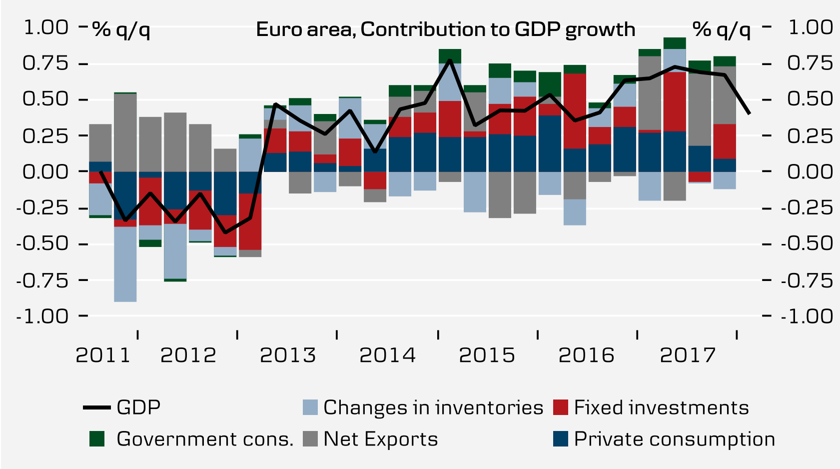


Source: ECB, Danske Bank

Economy heading for soft landing, while inflation rebound will only be temporary

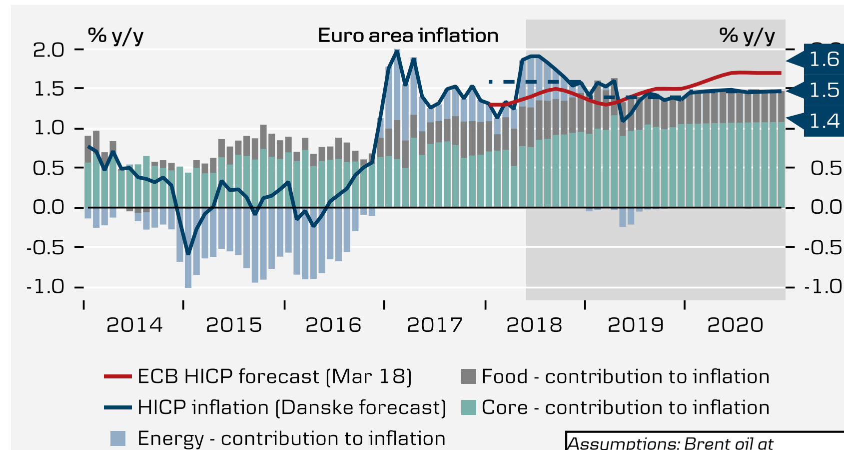
Despite moderation, GDP growth should remain solid and above potential, allowing QE exit this year.

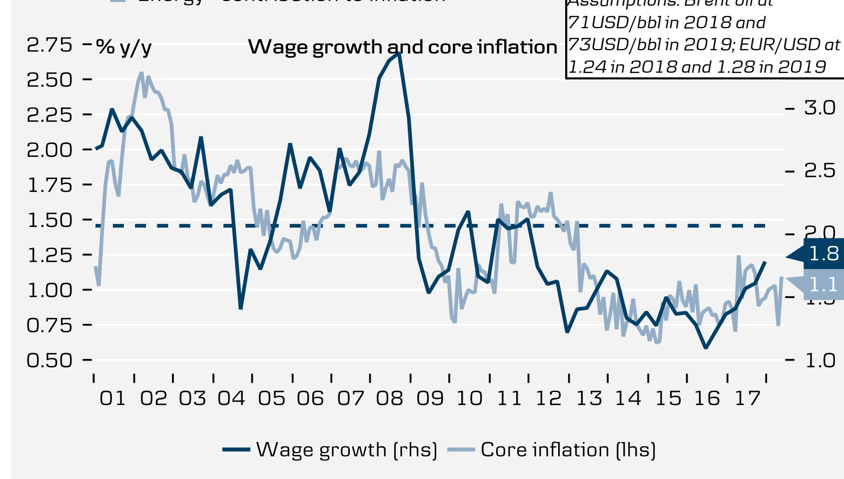




Source: Eurostat, Macrobond Financial, Danske Bank

ECB will look through temporary inflation lift due to energy. Core inflation picking up only gradually with wage growth.





Source: Eurostat, Macrobond Financial, Danske Bank

New ECB forecasts: weaker growth but higher inflation

Inflation

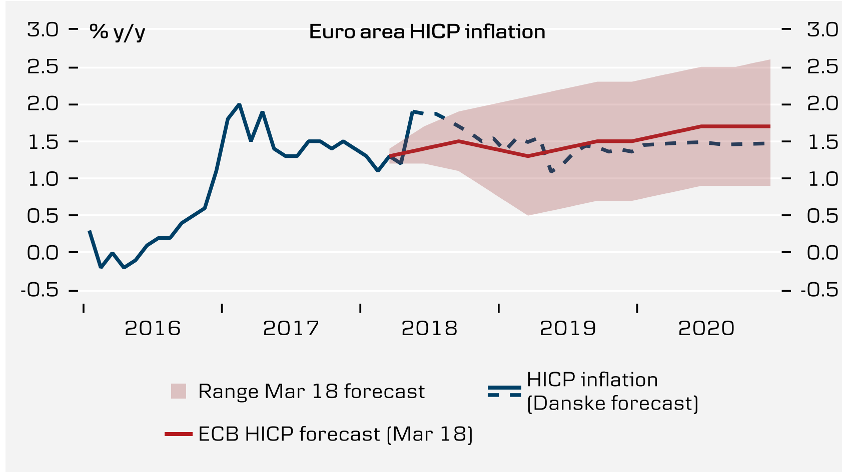
- **We expect the ECB to raise its headline inflation forecast for both 2018 and 2019**, due to a combination of higher energy prices and currency depreciation (see next slide).
- Although headline inflation surged to 1.9% in May on the back of strong energy price increases, we expect the ECB to remain cautious and focus on the underlying inflation pressures.

Core inflation

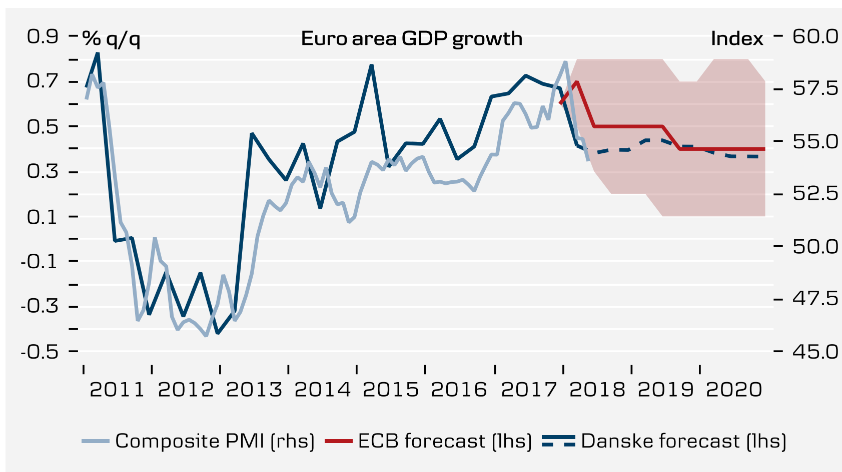
- **We do not expect big changes in the core inflation forecast.** Although wages have started to pick up, core inflation has mostly surprised on the downside in recent months and hence we think the ECB might want to see further evidence before raising its 2019 core inflation forecast.

Growth

- Given that euro area Q1 GDP came in at 0.4% q/q, while the ECB assumed 0.7% q/q in its March staff projection, the lower Q1 print suggests a **downward revision of the 2018 growth estimate to 2.2% from 2.4% in March.**



Source: Eurostat, Macrobond Financial, Danske Bank



Source: Eurostat, Macrobond Financial, Danske Bank

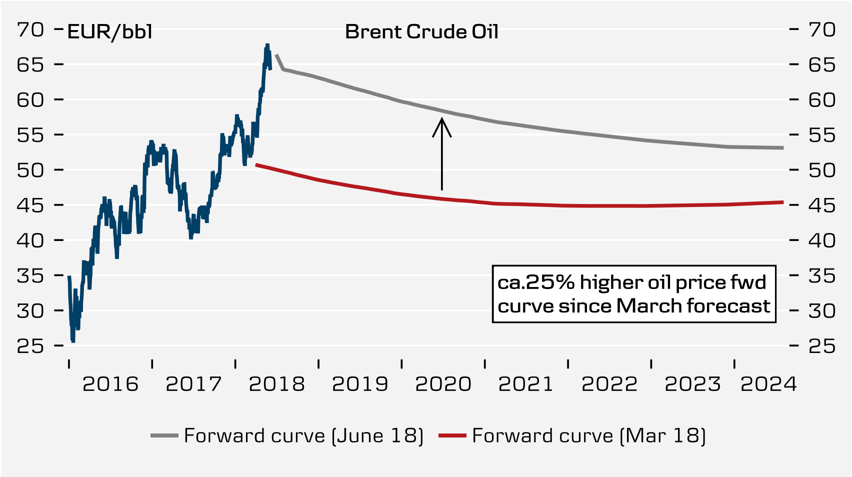
Main driver for a more optimistic inflation outlook set to be a higher oil price and should hence not speed up ECB exit

Expectations for the next staff projections

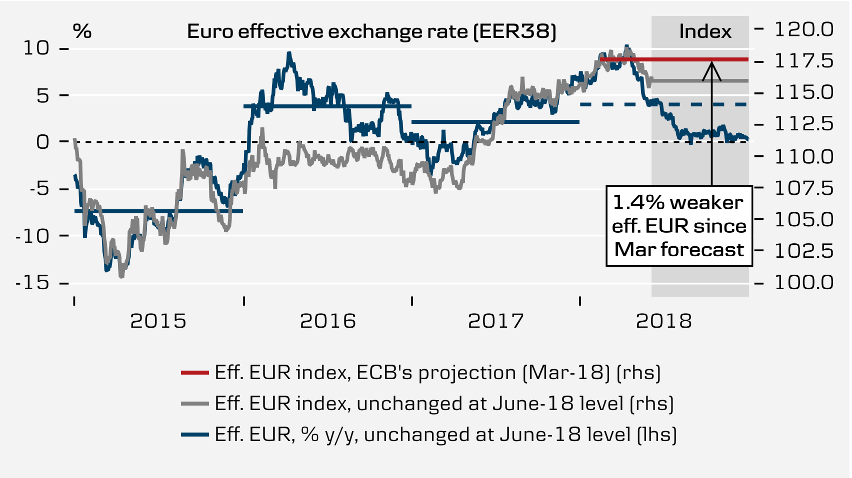
ECB projections June 2018	2018		2019		2020	
HICP inflation	1.6% (1.4%)	↗	1.5% (1.4%)	↗	1.7% (1.7%)	→
Core inflation	1.2% (1.1%)	↗	1.5% (1.5%)	→	1.8% (1.8%)	→
GDP growth	2.2% (2.4%)	↘	1.9% (1.9%)	→	1.7% (1.7%)	→
Unemployment rate	8.4% (8.3%)	↗	7.8% (7.7%)	↗	7.3% (7.2%)	↗
Wage growth	2.2% (2.2%)	→	2.0% (2.0%)	→	2.7% (2.7%)	→

Parenthesis are the old ECB projections (from March 2018)

Source: ECB, Danske Bank



Source: ECB, Macrobond Financial, Danske Bank

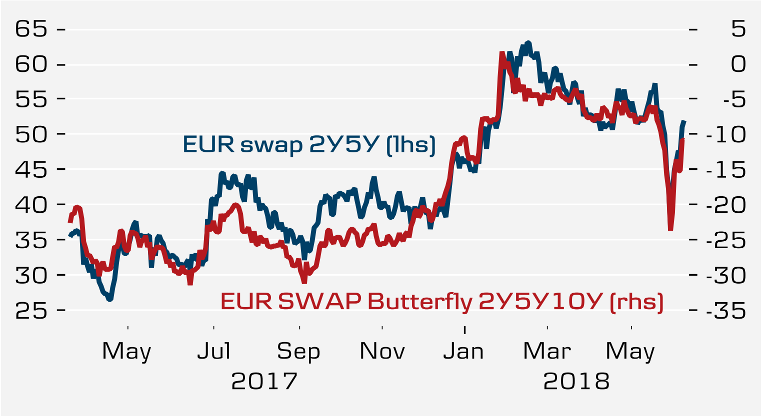


Source: ECB, Macrobond Financial, Danske Bank

The 5Y point is the focal point on the curve

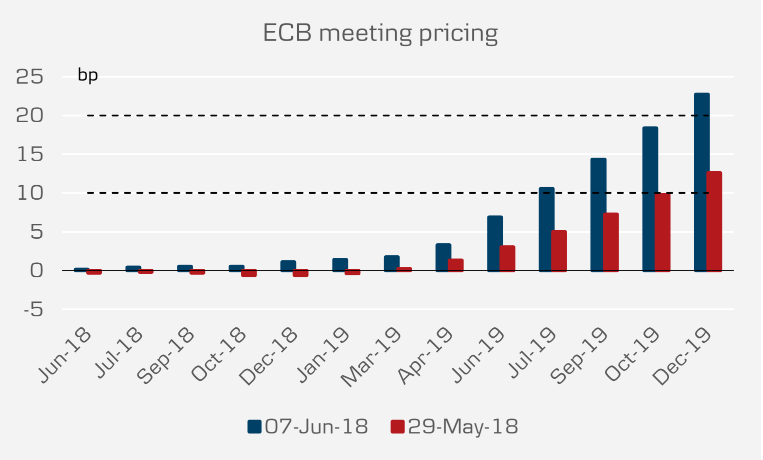
- If - contrary to our expectations – we see a more hawkish signal from the ECB, especially the 5y point on the EUR curve could be exposed.
- It is normally the 5Y point on the curve that becomes the focal point when the market changes its policy expectations.
- In January we saw a pronounced steepening of the 2Y5Y curve and the 2Y5Y10Y butterfly steepened as the market sold off.
- Given our view that the ECB will not assess the APP at this meeting, we should see a small rally in the market cantered around the 5Y point.
- We see little impact on the term-premium in the EGB market from the upcoming meeting and the impact on the long end should be small. See also the comment on the term-premium in respect of an end to APP purchases on the next slide.
- The market is currently pricing the first rate hike (10bp) in July 2019. The first rate hike has been brought forward from October 2019 over the last week.

The 5Y point is focal on the curve



Source: Bloomberg, Danske Bank

Timing of first rate hike brought forward slightly over the past couple of days

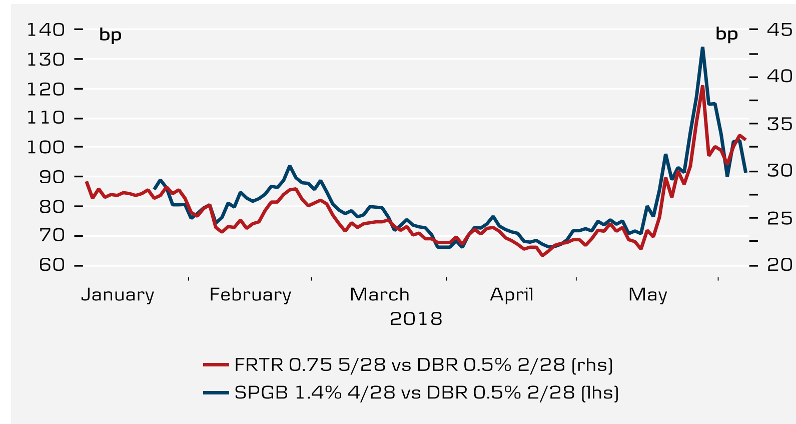


Source: Danske Bank

Periphery and core markets can live with further QE tapering

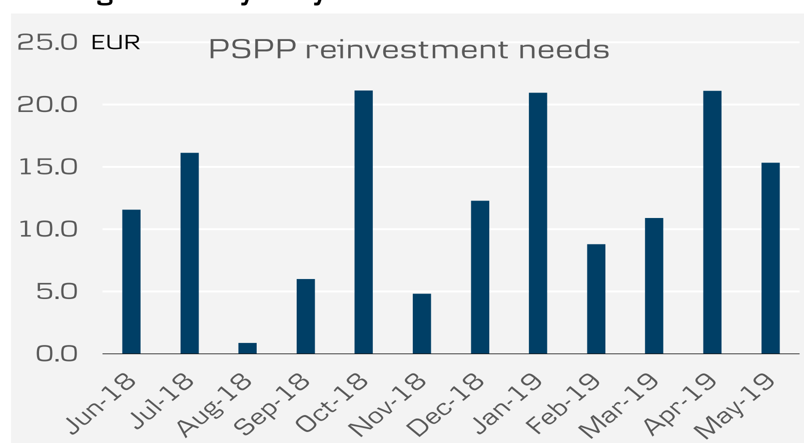
- The possibility that the ECB sets an end-date for the APP programme raises the question if it results in a higher risk/term premium in the European government bond market, adding to the Italy-induced negative sentiment for especially periphery bond markets seen recently.
- The ECB argues that given the low free float of especially German bonds (bonds not owned by the ECB or other central banks), the impact of an end to APP purchases will be nowhere comparable to the tapering sell-off in the US in 2013. See for example this *speech* by ECB Executive Board Member Benoît Coeuré, 23 February. We share the view of the ECB and only see Bund yields modestly higher in 2018. We see 10y Bunds at 1.1% in 12M time as higher US yields drag Bund yields higher and as the first ECB rate hike approaches. The impact from a higher term premium should be modest. See also *Yield Outlook*, 30 May.
- We continue to be positioned for a tightening of periphery markets (ex. Italy) spreads versus Germany/swaps. Even if the PSPP programme ends in 2018, significant reinvestments will be seen in 2019. The first five-month reinvestments will be on average EUR15.4bn a month. The reinvestments are expected to continue past possible rate hikes in 2019-20.
- We also continue to see a positive rating cycle in Spain and Portugal and an ongoing 'search for yield environment' for the time being. For more on our positive periphery views see *Government Bonds Weekly* that we publish each Friday. Note we have a cautious stance on BTPs.

We like Spain and France vs Germany after the recent widening and are not afraid of APP tapering



Source: Bloomberg, Danske Bank

PSPP reinvestment needs are EUR 15.4bn on average January-May 2019



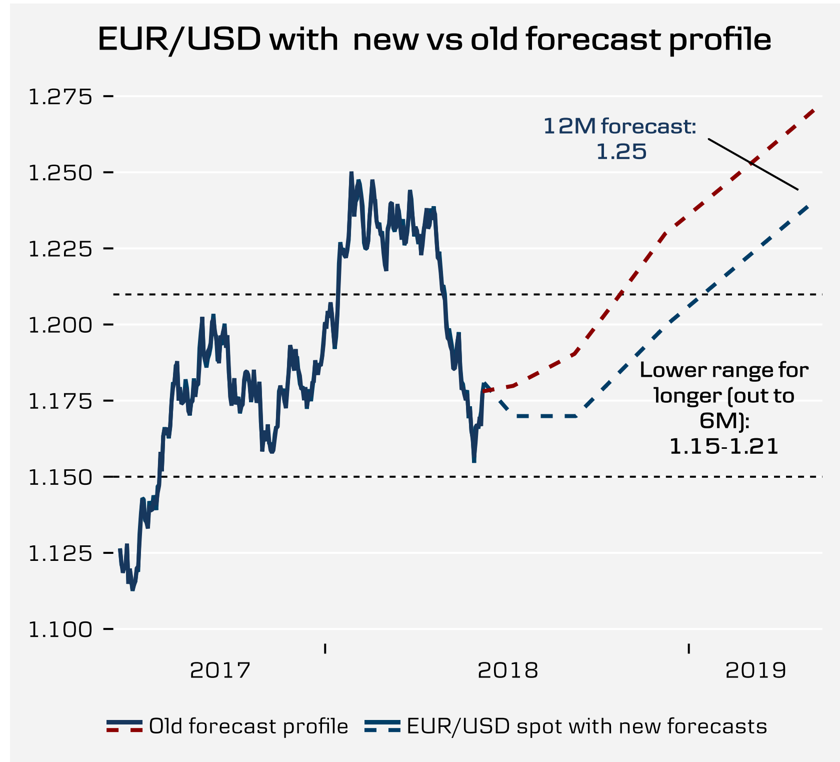
Source: ECB, Danske Bank

FX: ECB to halt the recent rebound in EUR/USD in June

- **ECB to halt the EUR/USD rebound.** With the ECB set to disappoint those looking for a June move, we expect to see EUR/USD halt its recent rebound following the meeting. However, even with US yields on the increase again and the Fed set to hike in June, we stress that the recent low in the cross hit on Italy worries (1.1510) is unlikely to be tested at the meeting.

- **EUR/USD in lower range for longer.** Hawkish hints at the press conference should keep up the sense of the ECB slowly but surely continuing policy 'normalisation'. While the USD is set to stay supported from a rates point of view, the ECB keeping up its exit process should ensure that EUR/USD is kept afloat further out. We look for broadly the 1.15-1.21 range to be sustained on a 6M horizon.

EUR/USD stuck in 1.15-1.21 range on a 6M horizon



Source: Macrobond, Danske Bank.

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ECB buzzword bingo

- Our assessment: the arrows indicate our assessment, if the wording is kept.

ECB Buzzword Bingo					
GC expects the … rates to remain at their present levels for an extended period of time and well past the horizon of the net asset purchases.	→	net APP of 30bn/month are intended to run until Sep18 or beyond	→	solid and broad-based expansion of the euro area economy	→
measures of underlying inflation remain subdued and have yet to show convincing signs of a sustained upward trend	↘	monitor developments in the exchange rate and financial conditions … possible implications for the inflation outlook	↘	risks … the growth … remain broadly balanced. However, risks related to global factors, including … increased protectionism, have become more prominent.	→
growing evidence that labour market tightness is translating into a stronger pick-up in wage growth (Praet's speech)	↗	structural reforms…substantially stepped up	→	government debt remains high	→
Patience and persistence (Q&A)	→	Can't declare victory on inflation yet (Q&A)	↘	Prudence (Only used in the accounts)	↓

The wording in the fields are taken as close to the Introductory Statement, and ECB previous communication as possible.
Our assessment: If the word is kept, the arrows will indicate how we assess this to be (comparead to previous communication)
→ neutral; ↓ dovish; ↑ hawkish

Source: Danske Bank

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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 Analyst), Aila Mihr (Analyst), Arne Lohmann Rasmussen (Chief Analyst) and Christin Tuxen (Chief Analyst).

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