Danske Bank

ECB Preview – Not on Draghi's watch

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New ECB call – not on Draghi's watch

ECB meeting on 26 April 2018. Rate decision at 13:45 CEST, followed by a press conference at 14:30 CET.

- New ECB call: We expect a **first rate hike of 20bp in December 2019, i.e. after Mario Draghi's reign ends (October 2019).** Previously we expected 10bp in June 2019.
- We postpone our estimate of the ECB's first rate hike due to **increased downside risks to growth and inflation** and we believe the ECB will revise its growth forecast down in its next staff projection in June.
- Our key takeaway from the March ECB meeting is that the **ECB will be reactive and not proactive**. This was reflected in the accounts, which six times mentioned 'patience and persistence' regarding monetary policy. Added to this stance is **an inflation profile that continues to be subdued** and, consequently, we expect ECB to prefer taking a cautious stance.
- The still-solid growth dynamics and no deflation risk support ending QE in 2018...but, in our view, **a rate hike will come only once inflation is on a self-sustained path towards the target** of 'below, but close to, 2% over the medium term'.
- Our updated inflation expectations, which also include 2020, are 1.4%, 1.4% and 1.5% for 2018, 2019 and 2020, respectively. We expect core inflation to be 1.5% in December 2019.

Our view on next week's meeting

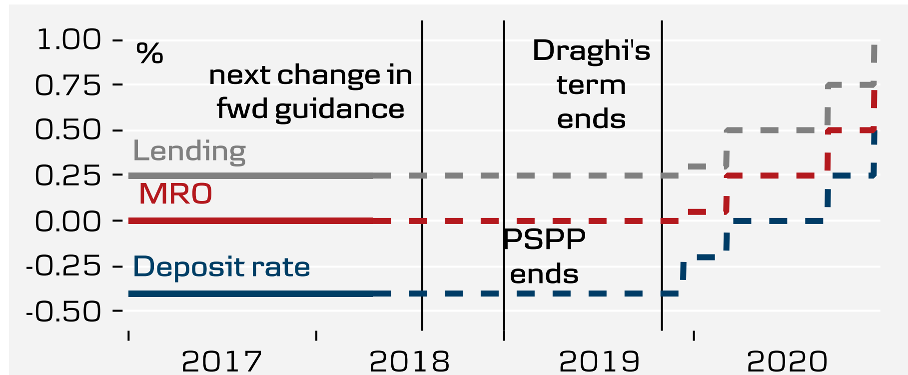
- We expect the meeting to be relatively uneventful in terms of new information.
  - We expect Draghi to acknowledge the FX, trade war risks and downside risks to the ECB's growth forecasts on the back of the moderation in data as the main risks to the downside.
  - In particular, we expect a softer tone in the ECB's assessment on growth, which in March was 'strong and broad-based' and 'projected to expand in the near term at a somewhat faster pace'.
- We present a 'buzzword bingo' at the end of this preview, which includes our view on potential change for next week.

- **Fixed income:** The 10Y German yield has been characterised by range trading. Our tactical trading recommendation is Buy Bunds if the yield is close to 0.8% and sell them if it is close to 0.4%. Buy the Bund spread close to 40bp and sell when it is above 50bp.
- **FX**: A hesitant ECB in April should help EUR/USD slide within the recent range, helped by a relatively cyclical outlook and stretched positioning. We are tactically short the cross for a 1-3M dip. However, medium term, we still project EUR/USD upside on a 6-12M horizon. We remain strategically long the cross via options (December 2018 expiry).

20bp on depo, 5bp on MRO and lending rate

- We discussed extensively the parameters we expect to be part of the ECB's discussion heading into the next policy rate hike in *ECB Research – 10bp, 20bp or ...? ECB in uncharted waters* on 20 March (see also next page).
- We expect the ECB to revise down its growth projections in June, on the back of the recent softer indicators, in particular the hard-data indicators. With the growth and inflation outlook less positive albeit still at solid levels, we postpone our estimate of the first rate hike until December 2019 (i.e. after Draghi's term ends) from June 2019.
- Further, '*some moderation of late*' was acknowledged by the ECB's Peter Praet on 16 April and France's François Villeroy de Galhau on 18 April.
- New rate path
  - December 2019: 20bp hike in the deposit rate, 5bp in the MRO and 5bp in the lending rate.
    - The ECB has historically preferred a symmetric corridor and with the first policy rate step away from 'technical adjustments', we expect the ECB to return to its preferred corridor.
  - Mar 2020: 20bp hike expected in all three policy rates.
    - Going away from the extraordinary Negative Interest Rate Policy (NIRP).
  - September 2020: 25bp hike in all three policy rates.
    - After a six-month pause, gradual tightening of monetary policy.
  - We expect a terminal/neutral rate of c.1.5% on the deposit rate to be reached gradually, in a slow and gradual hiking cycle.

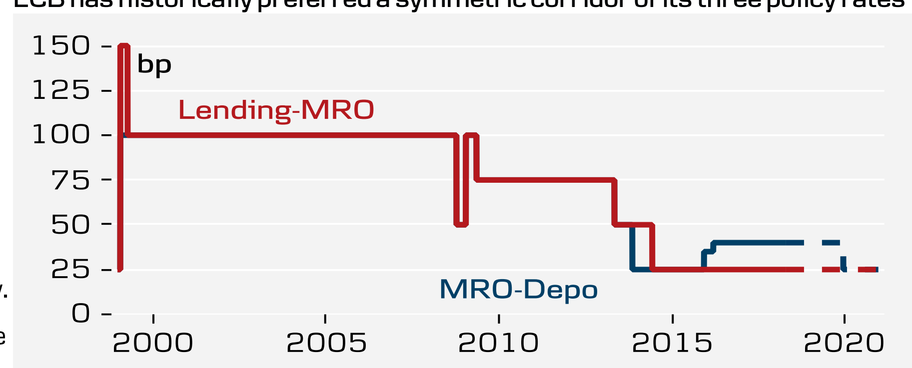
New rate path



Exp change:	Q4 19	Q1 20	Q3 20	Q4 20
Lending	5bp	20bp	25bp	25bp
MRO	5bp	20bp	25bp	25bp
Deposit	20bp	20bp	25bp	25bp

Source: ECB, Danske Bank, Macrobond Financial

ECB has historically preferred a symmetric corridor of its three policy rates



Source: ECB, Danske Bank, Macrobond Financial

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

- Austrian Governing Council (GC) member *Ewald Nowotny* sparked another round of market attention on the rate hike discussion by indicating 20bp could be a possibility…
- …which the ECB stressed was 'not the view of the GC'. We believe this reflects that it is close to the ECB's heart to prevent a strong market sell-off. Recall that in March 2017, markets sold off on the back of comments questioning the sequencing.
- We continue to **doubt that the GC members themselves have a firm view about the size of the hike** but this is part of a wider discussion.
- We expect the ECB to stay put as long as Draghi is still President (until October 2019, see discussion later in this document) and believe the new ECB GC 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.
- We stress that we believe it is **not the size of the first hike but the communicated rate path that is crucial for market pricing.**
- See *ECB Research 10bp, 20bp or …? ECB in uncharted waters*, 20 March 2018

Only depo?

Market reaction to end of QE

Inflation dynamics and expectations

Market pricing in both short and long end of the EUR curve

Pace of expansion

Timing of hike

Communicated as removal of 'technical adjustment'

Composition and decisiveness of the GC

Risk of market perception of start of hiking cycle

Symmetric corridor

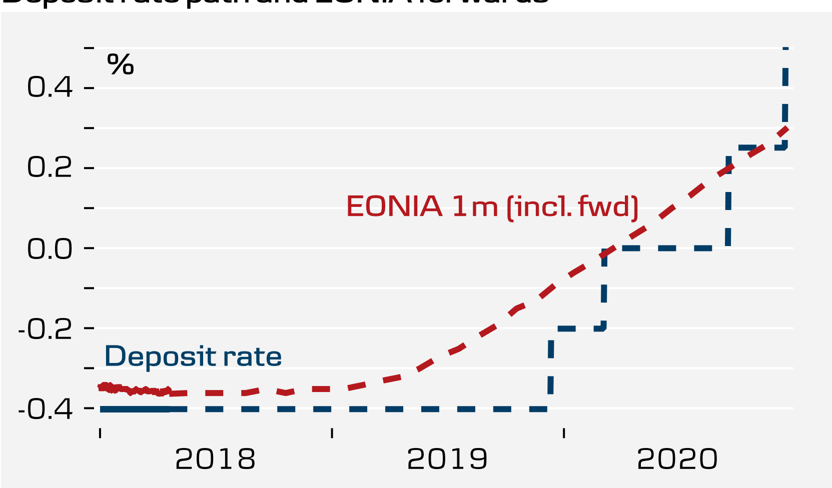
Markets point to 10bp hike in June 2019 and 20bp in September 2019

- EONIA forwards are currently **pointing to a 10bp rate hike priced in June 2019 and 20bp in September 2019**.
- We find the **current pricing to be on the slightly aggressive side but from a risk/reward perspective not to an extent that warrants entering new positions in the part of the curve as an ECB hike position.**
- **As discussed earlier, uncertainties remain on the size of the rate hike,** which complicates the assessment of the pricing timing and size of the first hike.

Month to next 10bp hike in the deposit rate

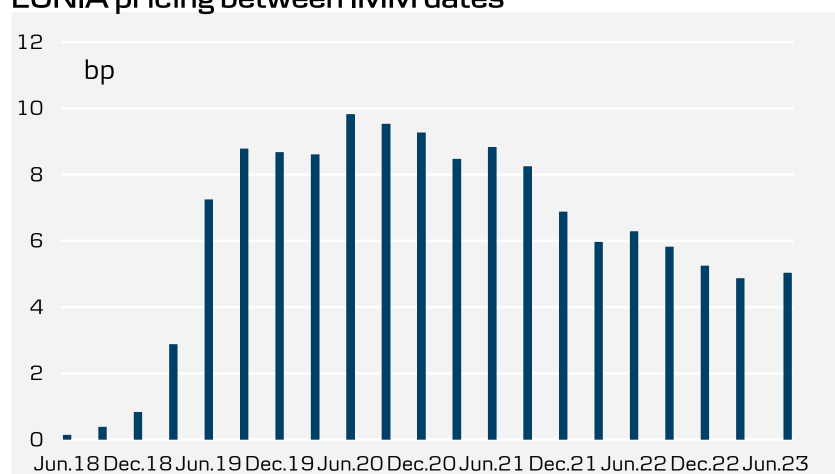
Source: Danske Bank

Deposit rate path and EONIA forwards



Source: Danske Bank, Macrobond Financial

EONIA pricing between IMM dates



Source: Danske Bank

Changing the forward guidance in 2018

With the prospect of the ECB revising its growth forecast lower in June, the **next change in forward guidance could come only in July.**

Jan: No change

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

Apr: No change

Jun: No change

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

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

Sep: (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'.

Tapering in Q4 – reinvestments to become increasingly important

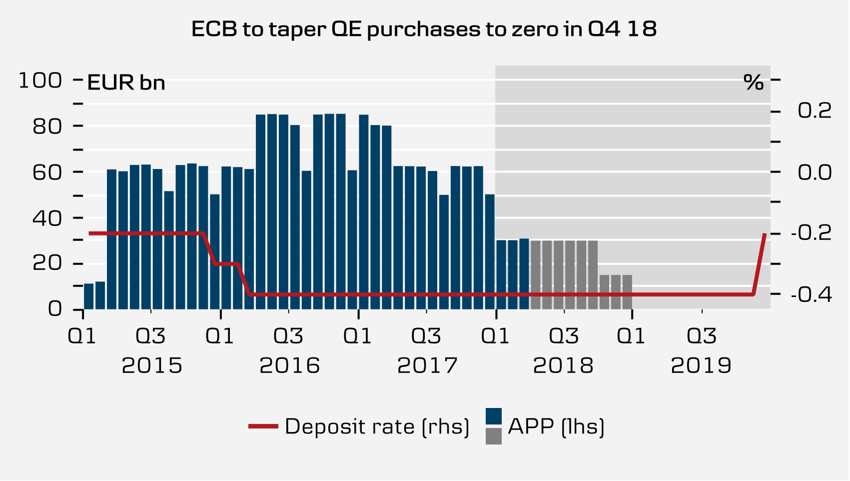
Sequencing is set in stone – no hike prior to ending of net asset purchases

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

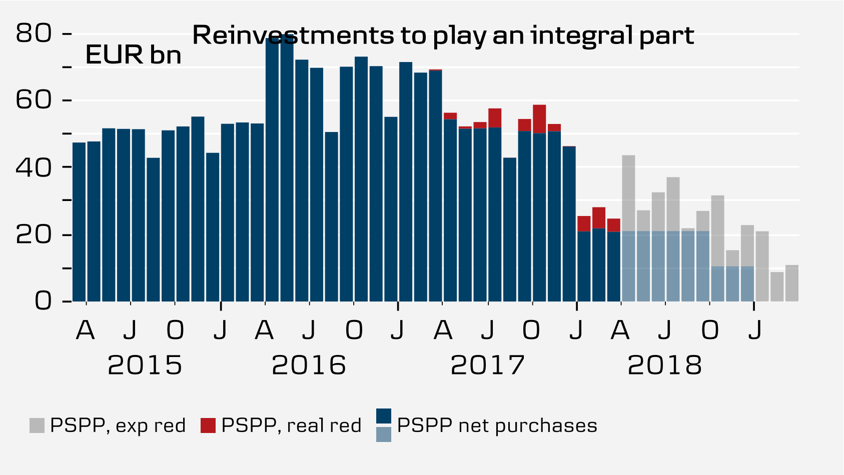
Inflation is expected to pick up somewhat in mid- to late 2019, so we expect the ECB to deliver its first 20bp hike in December 2019.

Reinvestments set to become increasingly important and 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



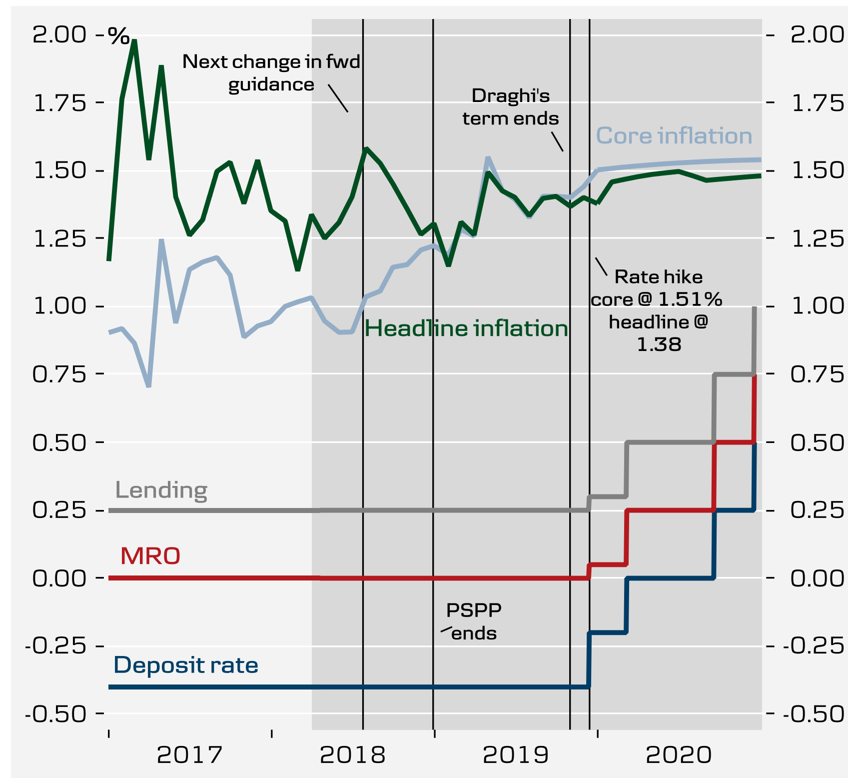
Source: ECB, Danske Bank

Hiking policy rates with core inflation above headline

- We have previously argued that markets should not be too focused on spot headline inflation but instead on medium-term dynamics, to gauge the ECB's expectations of whether inflation is on a self-sustained path towards its aim.

- With core inflation surprising on the downside in recent months despite strong growth, we are even more pessimistic on the near term (core) inflation outlook. We think it would be difficult for the ECB to credibly communicate the necessity of a first hike in Q2 19, with core inflation and headline inflation only around 1.3% according to our projections.

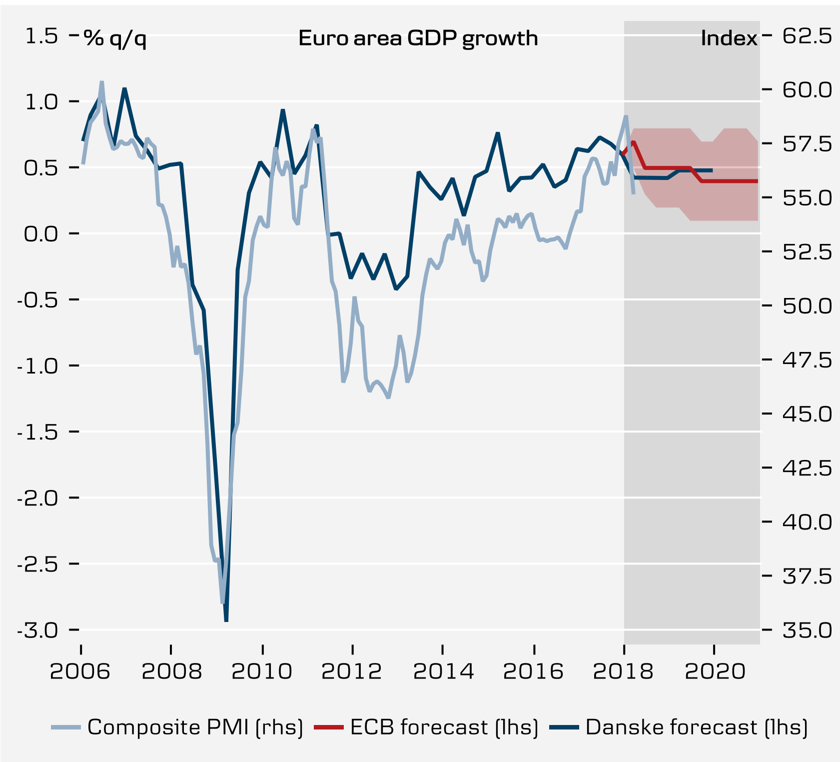
- In contrast, we expect core inflation of 1.5% in December 2019, with the headline slightly below this at 1.4%. In our view, this should give the ECB more confidence in the self-sustained nature of the inflation outlook and thereby enable it to hike rates.



Source: Eurostat, ECB, Macrobond Financial, Danske Bank

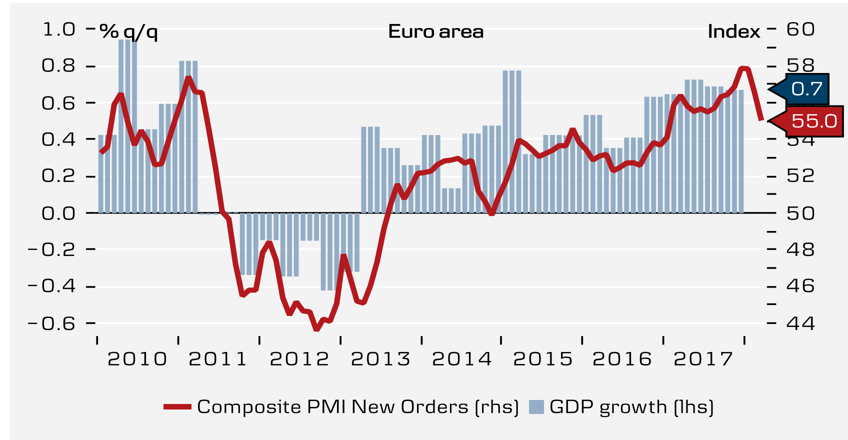
PMIs point to growth moderation – ECB set to revise GDP forecast lower in June

PMIs still consistent with our annual GDP forecast of 2.1% growth in 2018 but downside risks to the ECB's 2.4%.

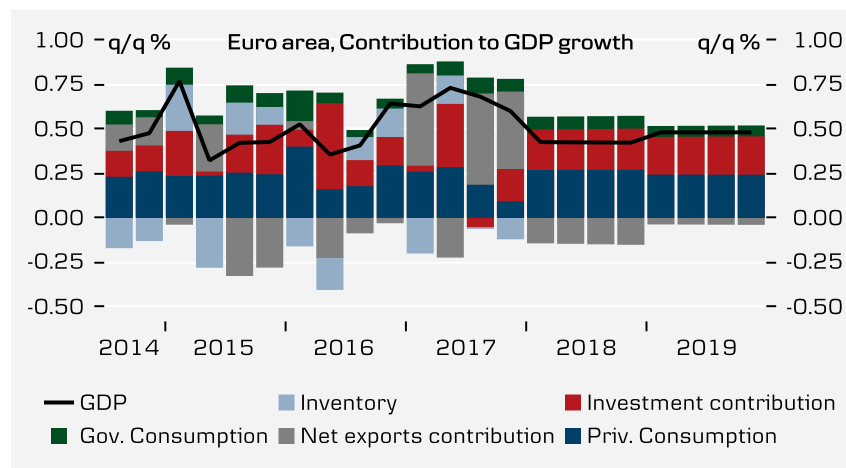


Source: Eurostat, Macrobond Financial, Danske Bank

See also [*Research – Global business cycle moving lower*](), 19 April.



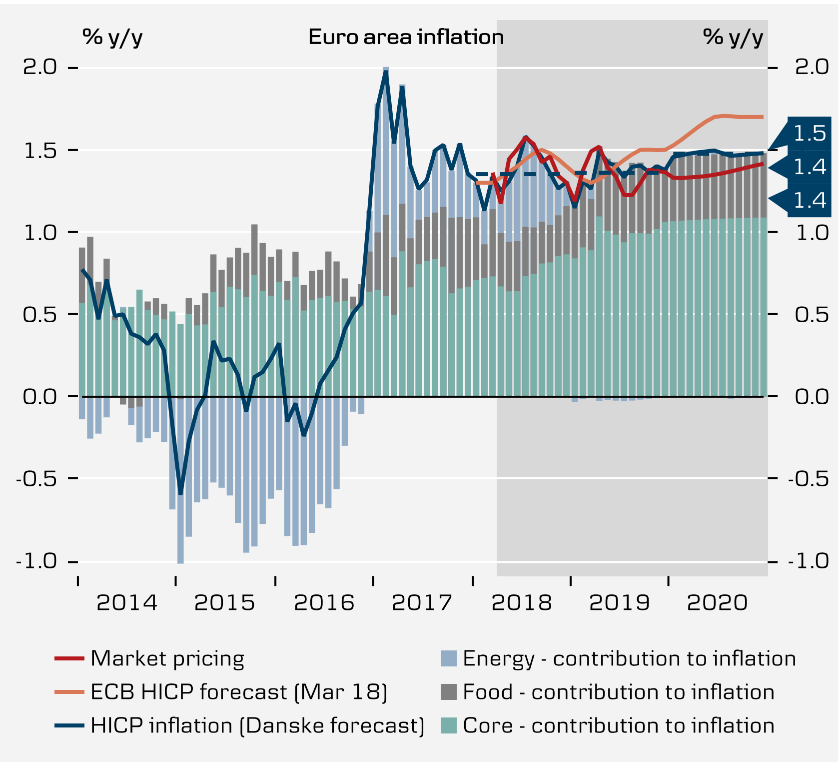
Source: Eurostat, Macrobond Financial, Danske Bank



Source: Eurostat, Macrobond Financial, Danske Bank

Near-term core inflation outlook remains weak but upside risks for 2019

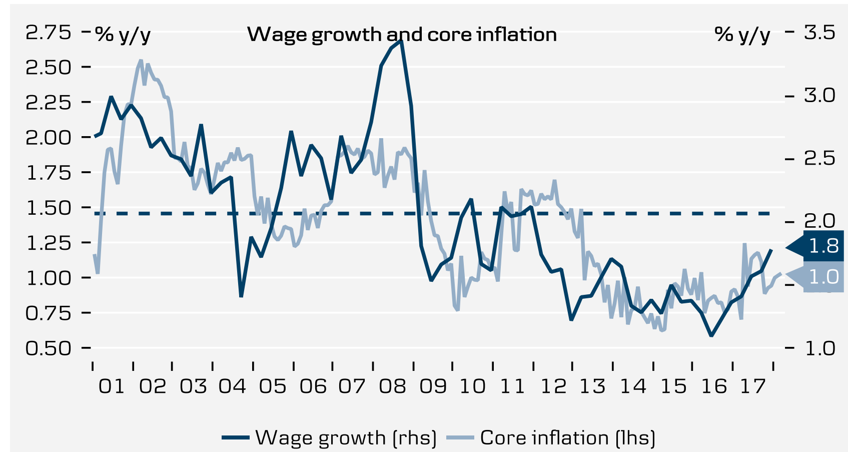
We expect inflation to average only 1.5% in 2020 compared with ECB's forecast of 1.7%

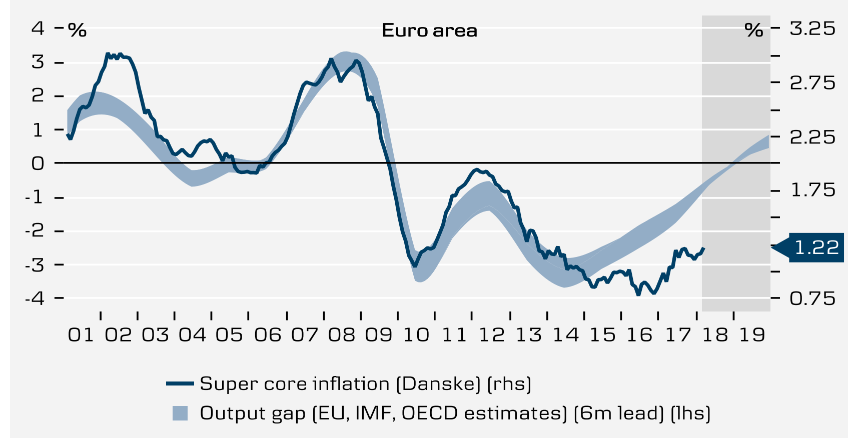


Source: Eurostat, Macrobond Financial, Danske Bank

See also Part 2: Eurozone Inflation – Upside risks from oil prices and rising wage pressures, 27 February.

Underlying inflation pressures remain weak due to muted wage growth





Source: Eurostat, ECB, Macrobond Financial, Danske Bank

Inevitable change in GC composition at a time when inflation outlook is expected to have improved

- It has been long known that the key architects and defenders of the non-standard monetary policy measures, such as NIRP and APP, will be leaving the GC by the end of 2019.
- Vítor Constâncio (May 2018), Praet (May 2019), Draghi (October 2019) and Benoît Coeuré (December 2019) are all set to leave by the end of 2019.
- This is likely to lead to a hawkish shift in the GC. With, for example, Jens Weidmann running the ECB after Draghi, we could see the end of the NIRP shortly after he takes office, at a time when we expect core inflation of 1.51%.
- Further, Weidmann finds a first rate hike in mid-2019 'reasonable', so a delay until end-2019 could be seen as already stretched in his view. Should the likes of Erkki Liikanen resume office, this may be slightly slower but with improving inflation dynamics, the end of NIRP would be near.

ECB's dove/hawk meter

Source: ECB

Range trading in Bunds and the Bund ASW spread set to continue in 2018

- The movement in the 10Y German government bond yield since 2016 has been characterised by a significant form of range trading.
  - In 2016, the range was -0.2% to 0.3%.
  - In 2017, the range was 0.2% to 0.6%.
  - **In 2018, the range is expected to be 0.4% to 0.8%.**

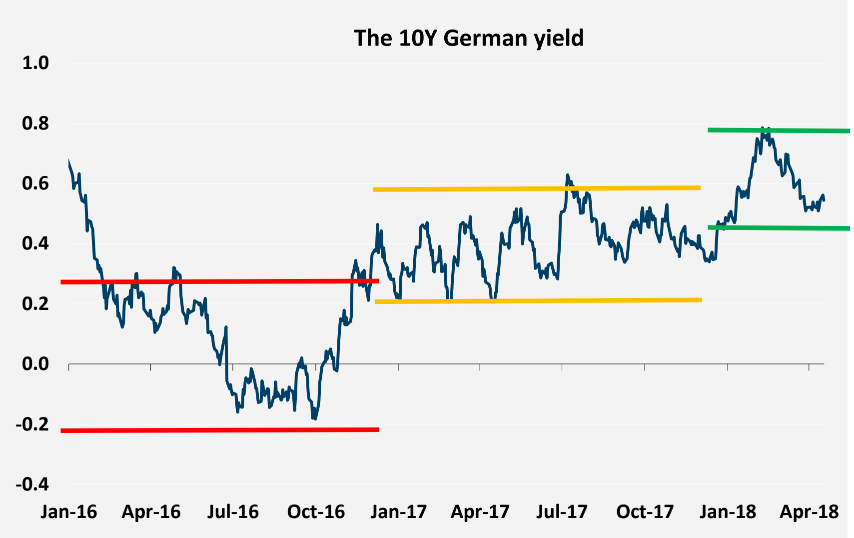
- The level for the 10Y yield has slowly trended upwards over the past two years as the economic outlook for the eurozone has improved and the ECB is very slowly 'normalising' monetary policy.

- We do not expect the upcoming ECB meeting to change this range-trading pattern, as the ECB is very slowly trying to prepare the market for a normalisation of monetary policy.

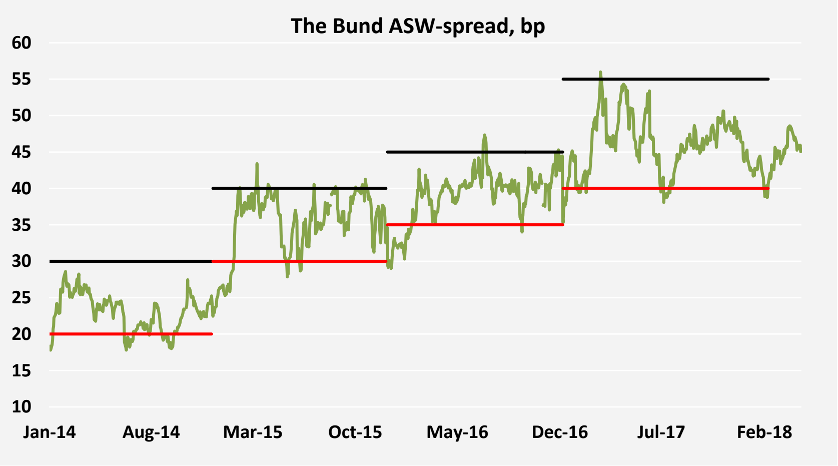
- Hence, the ECB does not want a sudden spike in volatility and/or a significant rise in yields over a short-term period.

- We see a similar pattern in the Bund spread, where we expect the range for 2018 to be 40-55bp.

- Hence, our tactical trading recommendation is as follows.
  - Buy Bunds if the yield is close to 0.8% and sell if it is close to 0.4%.
  - Buy the Bund spread close to 40bp and sell when it is above 50bp.



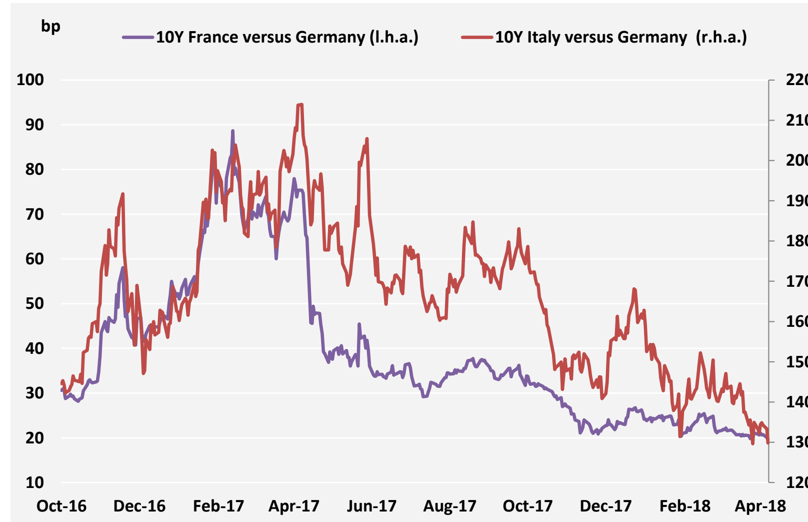
Source. Danske Bank



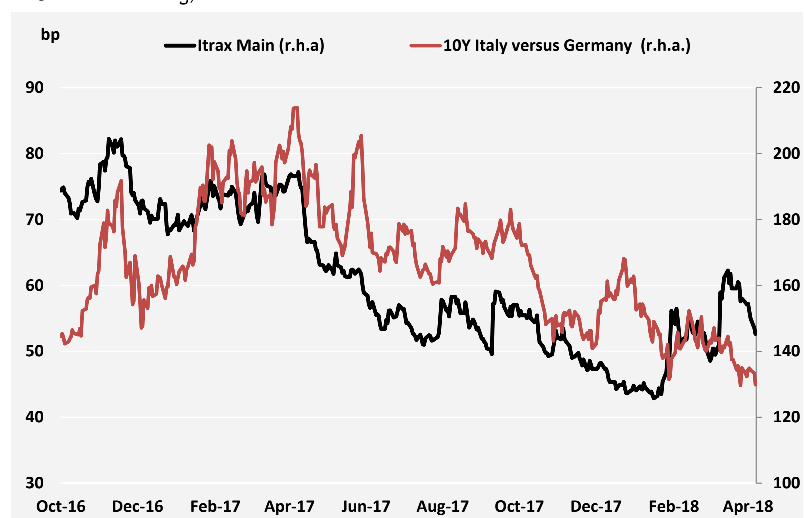
Source. Danske Bank

Steady performance in the peripheral continues

- We saw a solid performance in both Spain and Portugal in Q1 but Italy has lagged the strong performance seen in both Spain and Portugal. This lagged performance can be explained to some extent by the rating difference and uncertain political outlook following the Italian election.
- However, looking at the movement in the BTPS-Bund spread, the potential political risk is almost ignored by the market given the ongoing tightening as shown in the chart on the right.
- The upcoming ECB meeting is not going to change much of this 'slow tightening' between the periphery (Italy) and the core-EU (Germany).
- Given the ongoing search for yield, the positive rating cycle for the periphery and the stabilisation/tightening of the credit spread are supportive factors for the spread between core-EU and periphery.
- The fear of investors shying away from Italy when the ECB ends its QE seems very remote.



Source. Bloomberg, Danske Bank

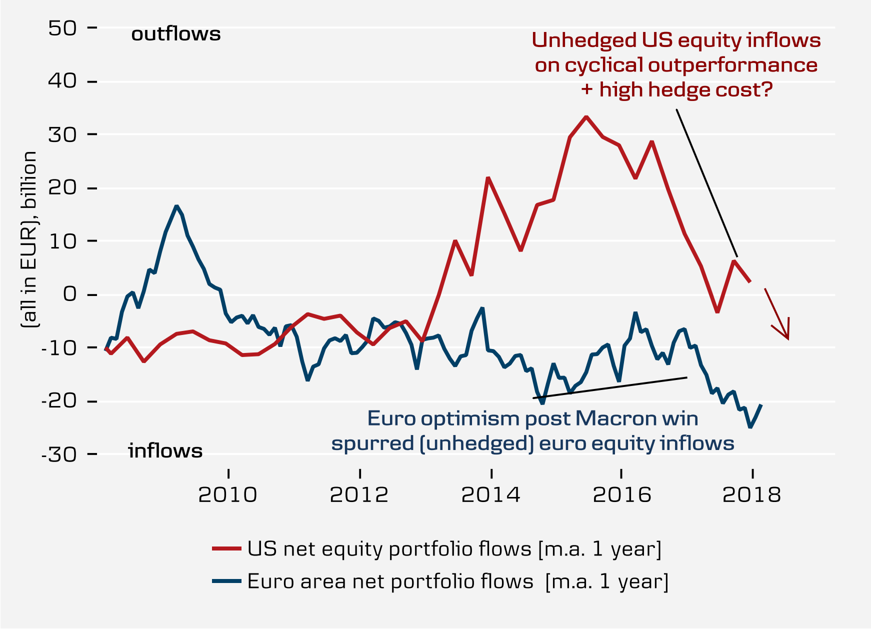


Source. Bloomberg, Danske Bank

EUR/USD: downside from hesitant ECB and cycle near term – but medium-term support from debt flows intact

Short term

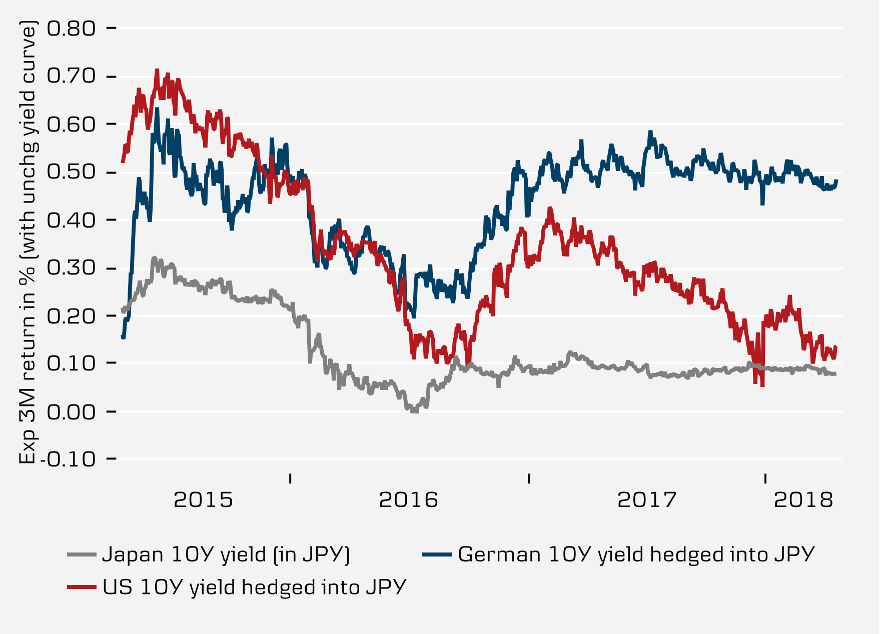
- A hesitant ECB in April should help EUR/USD slide within the recent range, helped by a relatively cyclical outlook (US set to fare better) and stretched positioning (long the cross).
- Notably, we see a case for – possibly to a larger extent unhedged – US equity inflows short term.
- **We are tactically short the cross for a 1-3M dip** (see *Danske Bank FX Trading Portfolio – Sell EUR/USD spot*, 17 April.



Source: BEA, ECB, Macrobond Financial, Danske Bank

Medium term

- We still project EUR/USD upside on a 6-12M horizon, as the ECB takes its next steps and thus fuels further divergence in the relative attractiveness of EU versus US assets.
- This should eventually spur debt-related euro inflows, supportive of the EUR.
- **We remain strategically long the cross via options (December 2018 expiry)** (see *FX Top Trades 2018 – How to position for the year ahead*, 6 December 2017.



Source: Bloomberg, Macrobond Financial, Danske Bank

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	→	strong and broad-based growth momentum in the euro area economy	↗
on growth: … which is projected to expand in the near term at a somewhat faster pace than previously expected	↑	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	→
downside risks to growth … global factors, including rising protectionism and developments in foreign exchange and other financial markets	→	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.

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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), Jens Peter Sørensen (Chief Analyst) and Christin Tuxen (Chief Analyst).

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