Flash

Wednesday, 09 March 2016

Draghi should not underdeliver

Lower inflation forecast will justify extra easing

- Depo-rate will be cut by 10 bps or 20 bps if accompanied by tiered system
- ECB to buy more assets, likely sov. bonds, but new asset classes may be elligible
- Other ‘modest‘ measures are possible
- Important for Draghi not to underdeliver, but hard to get ECB consensus for dramatic moves
- Market positioning quite extreme: we shy to short rates, less risk for LT bonds

Ahead of the December ECB meeting, **Mr. Draghi suggested markets that a “shock and awe” response of the ECB to deteriorating inflation outlook was appropriate.** However, for the first time during Draghi’s tenure“ markets were sorely disappointed by what was seen as a very limited ECB decision to cut the deposit rate by 10 basis points and extend the duration of the bond buying programme by 6 months. Many saw this outcome as a major blow to Mr Draghi’s credibility and authority. While he responded forcefully to his critics only days later in a bid to restore his authority, doubts remained whether he had full control of his ECB council and focussed on the likely opposition of a small but influential group around the council table who publicly expressed doubts about the wisdom of continuing with Mr Draghi’s aggressive way of policymaking in current circumstances. Memories of the surprise and adverse market reaction to December’s policy changes **will certainly colour Thursday’s decision and market reaction just as it has notably influenced both the public comments of ECB policymakers and market expectations of what might be announced in the run-up to Thursday’s decision.**

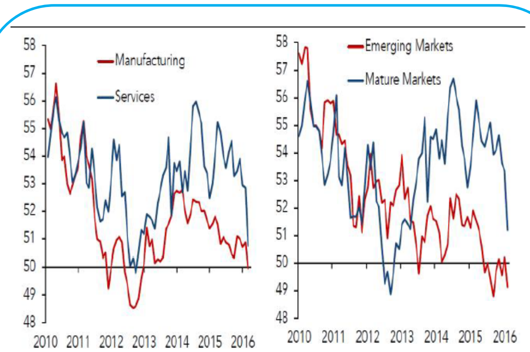
At the January ECB meeting, Draghi effectively pre-announced a March policy easing as he highlighted increased downside risks to inflation and activity amid intensified market turmoil. He said the ECB would “review and possible reconsider” its policy stance in March, while its forward guidance was that “key ECB rates are expected to remain at present or lower levels for an extended period”. Also important was Draghi’s comment that the council was unanimous in being committed to this line of communication”

So, the big question for the March meeting is not whether policy is eased, but about what and how much will be done; what tools will be used and how aggressive the scope of the easing will be. Such decisions will as usual partly be decided by the new staff forecasts that will now also include the ECB’S first public estimates for 2018 as well as their assessment of the likely importance and impact of recent global developments. However, a more fundamental consideration could be the ECB’S willingness to take its policy further into very uncharted territory.

Recent developments

Pressure to do something on Thursday has been heightened by the latest consumer price data for the Euro area. The February 2016 inflation report was a real disappointment. The headline CPI fell again in negative territory (to -0.2% Y/Y) and the core CPI slowed to 0.7% Y/Y from 1% Y/Y previously, barely above the 0.6% Y/Y all-time low. While lower energy prices were a key factor in the inflation report, there are also tentative signs that the low headline inflation is beginning to exert second round effects on core inflation, something ECB chief economist Peter Praet had warned about. We don't exclude that seasonal factors played some role in the surprisingly weak report (details are not released) but this report clearly provides ammunition to the more dovish members of the ECB's governing council. Other influences have not changed markedly of late.. Compared to the 17 November cut-off date when the assumptions of the previous forecasts were fixed, there have not been any important changes in the exchange rate of the euro, oil prices or even forward rates. **Inflation expectations (5-yr/5yr forward) moved off the lows, but are currently still below 1.50%, which won't give the ECB much comfort**. We strongly suspect that recent inflation developments will trigger a lowering of both the December 2016 and 2017 inflation projection of 1% and 1.6% respectively .We expect a particularly large downward adjustment to the 2016 forecast . How limited the reduction is to 2017 and how close to target the initial estimate for 2018 is will say quite a lot about the extent of concern there is within the ECB about the persistence of current troublingly low inflation. Our best guess is that the new estimates will be close to the ECB'S target of an inflation rate 'below but close to 2%' by the end of the new forecast period. **While this would mean that the ECB will miss its inflation objective again in 2016 and 2017, it could suggest sufficient if slow progress to limit the need for particularly aggressive easing measures on Thursday.**

In December, **the staff projections for growth were not unrevised for 2016/17 at 1.7% and 1.9% respectively**. This was logical as the eco data were still reasonably good and little changed from the previous period. The staff might be slightly more cautious on growth this time around. The confidence surveys showed since the start of the year a loss of momentum, market turmoil tightened financial conditions at least temporarily and the IMF and OECD both lowered their growth estimates for the global economy, and equally importantly warned of continuing downside risks.



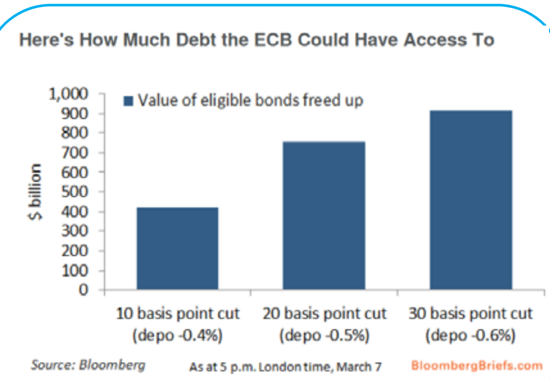
Source: IIF Global Economic Chartbook, March 2016

This is visible on the IIF chart above (PMI's) which shows a **contagion in sentiment erosion from EM to developed markets and from manufacturing to services sectors**. Nothing irreversible has happened, but it is a warning signal that also the EMU economy may be hit by troubles in EM/China. The very recent recovery in riskier markets is due to the combination of higher oil prices, better US eco data, Chinese RRR lowering and confirmation of ambitious growth projections for the next 5-year period combined with expectations of further ECB easing and a much more limited tightening in terms of speed and scale by the US Federal Reserve. **It is unlikely though that the ECB would take too much comfort from these positive developments**. If the US economy continues to improve and markets start speculating again about higher rates, there easily may be renewed turmoil in EM/China whose debt overhang partly in dollar denominated creates particular vulnerabilities for them and the broader global economy.

What to expect from the ECB?

A recent Market news article based on ECB "sources" said that there was no consensus found yet between governors on what package of measures might be taken this Thursday. Market expectations show very large variations in thinking among traders and analysts about the nature and scope of the measures that might be announced.

It looks likely that the deposit rate will be cut further. **Given recent expressed concerns by key ECB member Coeuré about its impact on bank profitability, a relatively limited 10 basis points cut is our best guessimate**. Alternatively, a **20 basis points reduction might be accompanied with a tiered system to lessen the blow for banking profitability**. The market has currently discounted 12.6 bps cut in March and another 11 bps in June. Going slow on the depo-rate means keeping some powder dry (arguably a double edge argument). **Lowering the depo-rate also increases the amount of eligible bonds** (as no bonds can be bought that yield less than the depo-rate). Of course, lowering the depo-rate might push bond yields again lower too. (graph below shows impact)



Changes to purchases program

The enlargement of the eligible pool of assets makes it possible to raise the amount of purchased assets by maybe €10B or so, bringing it to about €70B/month. The ECB might also prolong the programme by another 3 or 6 months to June or September 2017.

To confront the scarcity of eligible assets, other possibilities have been suggested going from scrapping the rule that yield of assets should be above the depo-rate to buying other assets like corporate or even bank bonds, or raising/scrapping the cap of 25/33% per individual bond. **To put more the focus on being credit-supportive instead of yield-lowering** (as is the case with buying government bonds), the **ECB could organize extra TLTROs, which are based on the loan provision of individual banks, or reintroduce very long term tenders (LTROs).**

Conclusion

The market already discounts a depo-rate of -0.55% (not in one shot), which makes us think that the very short end is vulnerable. Buying more sovereign bonds should flatten the curve which is also bad for bank profitability. **Nevertheless, we think not altering asset purchases would have negative effects on bonds** and would also threaten to push euro higher. Therefore we expect such additional purchases in Thursday's ECB package. Other measures may be included, but we have no strong opinion on these. Mr Draghi will want to deliver some surprise, but for a range of reasons he will also have to tread carefully. **How he manages this delicate balancing act should make for an interesting afternoon on Thursday.**

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