27 November 2015

ECB Preview

Time to fulfil the high expectations

- **We have changed our view and now expect the ECB to cut the deposit rate by 20bp (previously 10bp) accompanied by a two-tier deposit rate system.**
- **Our changed view reflects that none of the ECB members have argued against the aggressive pricing of more than a 10bp cut together with this week's Reuters' article suggesting the ECB is considering a larger deposit rate cut.**
- **We still expect the ECB to introduce its old forward guidance, stating that policy rates could go lower, but we do not believe the ECB will actually have to cut further. Instead, we see this as the end of the easing cycle.**
- **We also look for the ECB to expand QE purchases to EUR75bn per month and believe it will extend the purchases until December 2016. The actual ending point should still be dependent on a sustainable adjustment in the inflation path.**
- **A lot is already priced in fixed income markets, implying an initial bullish steepening of the curve led by the short end should be only limited. Over time, the curve should steepen from the long end in a usual end-of-easing move.**
- **We have lowered our EUR/USD forecasts given the prospect for a more aggressive ECB: we now look for 1.02 in 1M (previously 1.04) , 1.02 in 3M (1.06), 1.06 in 6M (1.12), and 1.16 in 12M (1.20). That is, a sharper dip is seen in the cross near term but we still forecast a rebound in 6-12M.**

A 'menu' of ECB easing measures including an aggressive deposit rate cut

Instrument	Change	Market reaction
QE programme	Extend QE purchases by three months	The open-endedness of the QE programme implies this would not be a big surprise
QE programme	Expand QE purchases to EUR75bn p/m	Signals the ECB is committed to fight low inflation and supports inflation expectations
QE programme	Expand eligible assets to include corporates bonds	The market is already pricing a high change of the ECB buying corporate bonds
Policy rates	Cut the deposit rate by 20bp	The October meeting strengthened the aggressive pricing of further rate cuts
Policy rates	Introduce two-tiered deposit rate system	Banks' costs will be lower which opens up for a potentially more negative deposit rate
Policy rates	Strengthen forward guidance on policy rates	No signal of a new lower bound would imply a continued pricing of further rate cuts

Source: Danske Bank Markets

ECB research papers

In early November, we published a series of research papers on the 'menu of monetary policy instruments' the ECB could consider at the December meeting.

- *ECB will surprise the markets again*
  2 November 2015
- *ECB cutting through the lower bound – Danish experiences*
  4 November 2015
- *ECB will finally lower its core inflation forecast*
  6 November 2015

See also:

- *CBPP3: Update on latest figures and the bigger picture*
  3 November 2015
- *ECB and two-tier deposit rate system – the Danish lesson*
  26 November 2015

Senior Analyst
Pernille Bomholdt Henneberg
+44 20 7410 8157
perni@danskebank.com

Senior Analyst
Anders Vestergård Fischer
+45 4514 69 96
afis@danskebank.dk

Senior Analyst
Christin Tuxen
+45 4513 7867
tux@danskebank.dk

A 'small' deposit rate cut would be a 'huge' disappointment

On the back of the dovish stance at the ECB meeting in October, we expect the ECB to deliver an aggressive package of monetary easing measures in December. Specifically, we expect it to cut the deposit rate by 20bp accompanied by a two-tier deposit rate system (previously we expected a 10bp deposit cut) and to keep the door open for further rate cuts. At the same time, we expect an expansion of QE purchases to EUR75bn per month and believe the ECB will continue the purchases until December 2016 while keeping the open-endedness of the programme, as ending it should still be dependent on a sustainable adjustment in the inflation path. In order to reach the higher monthly purchases, we expect the ECB to expand the eligible assets under the QE programme to include corporate bonds and possibly regional bonds.

Importantly, we expect the easing to be the end of the easing cycle, although we believe the ECB will signal it is ready to cut the deposit rate further. This is because we expect the recovery to gain momentum in 2016, implying the unemployment rate should approach its structural level and eventually put upward pressure on inflation. However, euro appreciation pressure will remain a challenge for the ECB and for inflation to go up.

We have changed our view and now expect a deposit rate cut of 20bp versus our previous expectation of a 10bp cut. We have changed our view because (1) none of the ECB members have argued that pricing of more than a 10bp deposit cut seems aggressive and most ECB members have supported the willingness to act strongly at the December meeting, (2) a *Reuters* article claiming the ECB is considering a two-tiered deposit rate system suggests the ECB is considering a larger deposit rate cut (see more below) and (3) before these changes, we had already seen the risk as skewed towards the ECB cutting more aggressively in an attempt to send a strong signal of commitment to comply with its inflation mandate (see *ECB cutting through the lower bound – Danish experiences*).

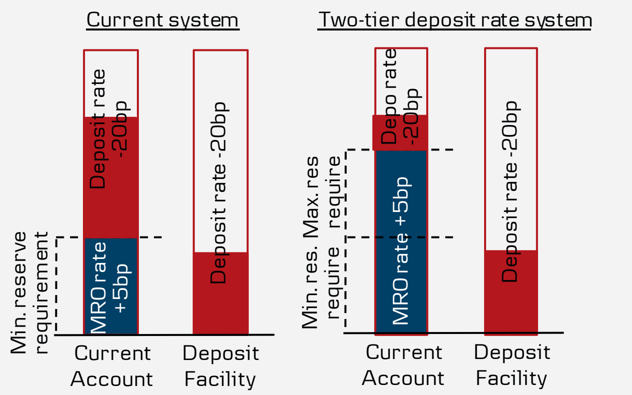
We expect a 20bp deposit rate cut to be accompanied by a two-tier deposit rate system, with banks charged a different deposit rate depending on the level of excess liquidity deposited with the ECB. The benefit of such a system would be that banks' profitability would be hurt less by the more negative deposit rate as some of the liquidity would be placed at a higher deposit rate. Moreover, the risk of cash hoarding would be less, as the risk of banks passing on the negative rate to retail customers is lower when banks' costs are lower. Denmark, where certificates of deposit are at -75bp, has a two-tiered deposit rate system (see *ECB and two-tier deposit rate system – the Danish lesson*).

We expect a 'menu' of aggressive ECB easing measures

Instrument	Change	Market reaction
QE programme	Extend QE purchases by three months	The open-endedness of the QE programme implies this would not be a big surprise
	Expand QE purchases to EUR75bn p/m	Signals the ECB is committed to fight low inflation and supports inflation expectations
	Expand eligible assets to include corporates bonds	The market is already pricing a high change of the ECB buying corporate bonds
Policy rates	Cut the deposit rate by 20bp	The October meeting strengthened the aggressive pricing of further rate cuts
	Introduce two-tiered deposit rate system	Banks' costs will be lower which opens up for a potentially more negative deposit rate
	Strengthen forward guidance on policy rates	No signal of a new lower bound would imply a continued pricing of further rate cuts

Source: Danske Bank Markets

Deposit cut accompanied by a two-tier deposit rate system



Source: ECB, Danske Bank Markets

The ECB's 'menu' of aggressive easing measures

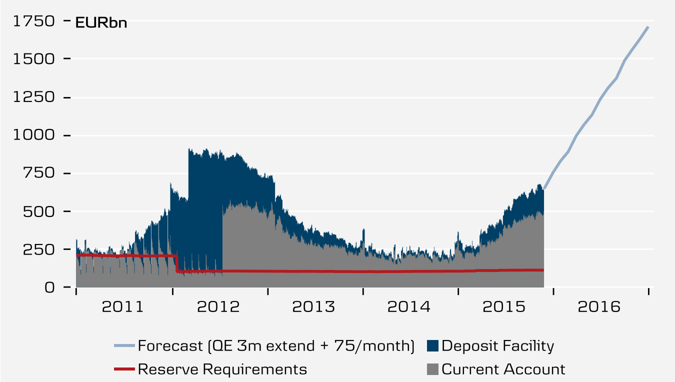
Cutting the deposit rate by 20bp

- The main reason we expect the ECB to deliver a deposit rate cut is the turnaround at the ECB meeting in October when Mario Draghi sent a strong signal that the ECB is now considering further rate cuts. He has more or less cornered the hawkish ECB members again and preannounced additional easing (see more in *ECB cutting through the lower bound – Danish experiences*).
- Although we now expect a more aggressive deposit rate cut of 20bp, we do not believe the ECB will cut much more than this, as we expect it will want to maintain some room for manoeuvre on policy rates. Related to this, we expect the cut to be accompanied by a strengthening of the ECB's forward guidance (see more below).
- Fixed income markets are aggressively priced ahead of the meeting, with a roughly 16bp cut priced in for December, implying if the ECB cuts the deposit rate by 'only' 10bp it will be a disappointment. None of the ECB members have argued that the pricing seems aggressive, which suggests they are satisfied with it and hence ready to live up to the high expectations.

Introducing a two-tier deposit rate system

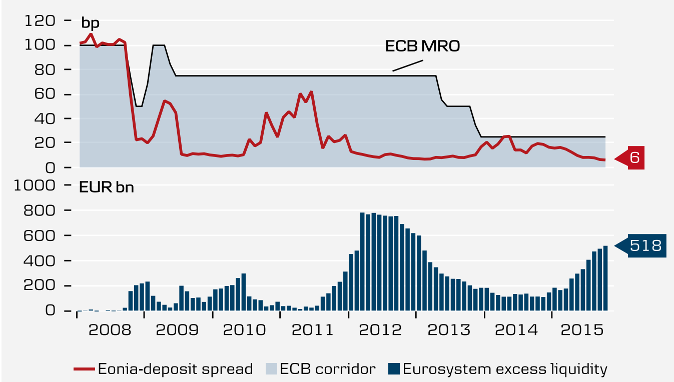
- A two-tiered deposit rate system would result in a second effective deposit rate. This could happen by changing either (1) the conditions on the current account by, e.g., introducing a minimum-maximum for the reserve requirement or (2) the conditions on the deposit facility by, e.g. introducing a penalty for deposits above a certain level.
- We expect the relatively implementable approach of a minimum-maximum for the reserve requirement. Currently, around EUR640bn is deposited overnight at the ECB. Of this, around EUR110bn covers the minimum reserve requirement (1% of the deposit base), which is remunerated at the MRO rate (5bp). This leaves around EUR530bn of excess liquidity, which is subject to the ECB deposit rate regardless of whether it is placed in the current account or the deposit facility. If a maximum of say 3% was introduced, the excess liquidity could fall to just above EUR300bn (if banks were to use the maximum).
- In theory, if a higher share can be placed at the higher deposit rate, it should not lead to higher Eonia fixings, as it is the marginal rate that determines the overnight fixing. However, the Danish experience shows that the average rate has a large impact on the fixing. (see *ECB and two-tier deposit rate system – the Danish lesson*).

Liquidity deposited overnight at the ECB and forecasts



Source: ECB, Danske Bank Markets

High level of liquidity results in Eonia fixing low in the corridor

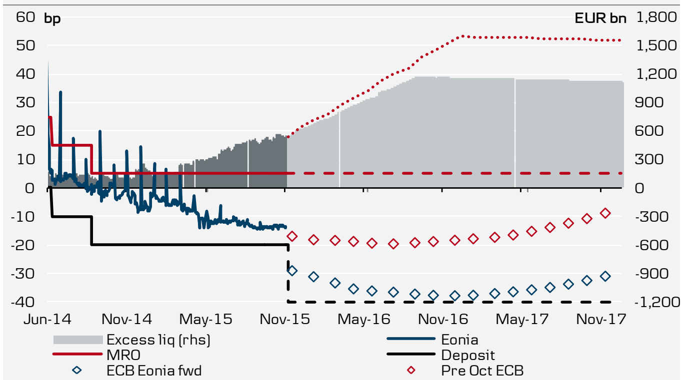


Source: ECB, Danske Bank Markets

Reintroducing forward guidance on policy rates

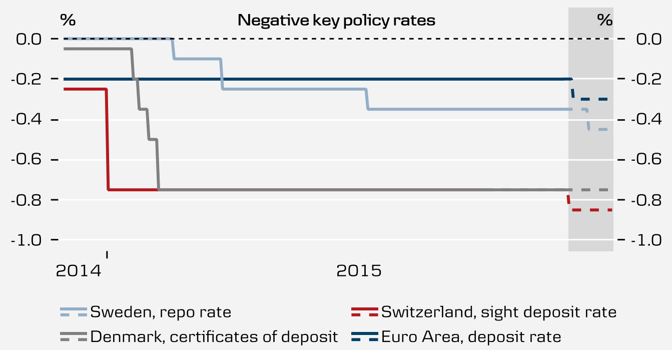
- We expect the ECB to reintroduce its old forward guidance on policy rates, stating that it *'expects the key ECB interest rates to remain at present or lower levels for an extended period of time'*. In our view, this would be likely to lead the market to price in some probability of further deposit rate cuts immediately after the ECB delivers a cut at the December meeting.
- We do not believe the ECB will announce a new lower bound on policy rates. Even if, on the back of the experiences in other countries, the ECB concludes with a new much lower bound, we do not believe it will commit to not cutting below a certain level again. Instead, by use of forward guidance, it should be able to anchor longer term yields.
- Currently, the short-end of the yield curve is inverted with an accumulated 23bp deposit rate cut priced in over 2016 compared with 16bp in December. If the ECB cuts in December, we believe some probability of an additional cut should still be priced in, as the ECB wants to keep the door open for further easing if needed.

Forward guidance should anchor longer term yields



Source: Bloomberg, ECB, Danske Bank Markets

ECB is set not to conclude on a new, very low lower bound



Source: Danmark Nationalbank, ECB, Riksbanken, Swiss National Bank, Danske Bank Markets

Extending and expanding QE purchases to EUR75bn p/m until Dec-16

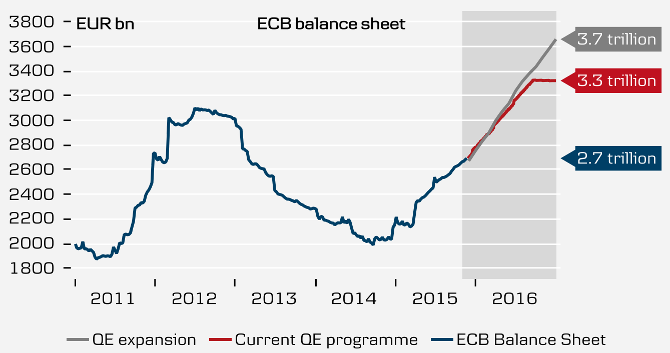
- Draghi and a number of ECB members have repeatedly argued for flexibility in the QE programme in terms of its size, composition and duration and we believe there are many ways to design more easing (see *Draghi will surprise the markets again*). Most importantly, we believe the ECB sees an urgent need to boost the balance sheet and hence expect it to increase monthly purchases by EUR15bn.
- We expect the ECB to stick to having a non-binding end-date on the QE programme, as we believe the purchases would otherwise not be within the legal limitations of the German Constitutional Court. This said, the actual ending point should remain dependent on a sustainable adjustment in the inflation path and not the stated date.
- Increasing the QE purchases should not be a big surprise as 81% of analysts in a Bloomberg survey expected the ECB to step up its QE programme ahead of Draghi's dovish stance at the October meeting. Of these analysts, 81% expected the ECB to extend the programme beyond September 2016, 42% expected an increase in the monthly purchases and 28% expected the ECB to broaden the range of assets bought**.**

- Recently, ECB chief economist Peter Praet strongly hinted that the ECB will taper QE purchases, as he said the ECB was very well aware of avoiding the so-called 'cliff effect' if they were to come to a sudden end. Assuming the ECB tapers the expected monthly purchases of EUR75bn over four months, this implies an additional EUR150bn of asset purchases. A benefit of announcing this now would be to avoid a later taper tantrum discussion and corresponding higher yields.
- In the same interview as mentioned above, Praet also noted that quite a lot of securities are due to come into maturity after September 2016. It is likely the ECB will take the same approach as the Bank of England and the Fed, which have reinvestment policies in place in order to maintain the size of the assets purchased.

Expanding eligible assets to include corporate bonds

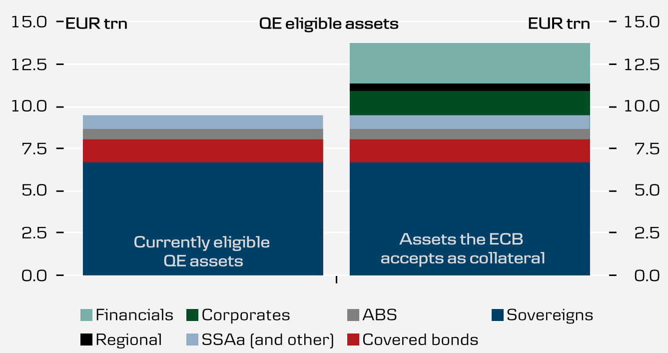
- We expect the ECB to include corporate bonds in the QE universe, as the account of the January ECB meeting stated this would be the most appropriate instrument for additional monetary stimulus, while it also stated that it could be complemented by purchases of supranational bonds (see *Account of the monetary policy meeting* from January).
- Following the ECB meeting in October, some members have indicated the ECB could include bonds issued by regions. This would increase the pool of eligible assets from close to EUR10bn to above EUR11bn (without considering issue limits). An even higher increase requires including the relatively large amount of financial bonds.
- According to the *Reuters*' article mentioned above, the ECB is also considering buying non-performing loans of banks' balances. According to the ECB *'a further reduction of problem assets is needed as high nonperforming loans dampen banks' potential lending capacity'*. Hence, this – somewhat controversial – tool would support the traditional bank lending transmission of the monetary policy.

QE look for expanded and extended QE purchases



Source: ECB, Danske Bank Markets

The ECB should also broaden assets in the QE universe



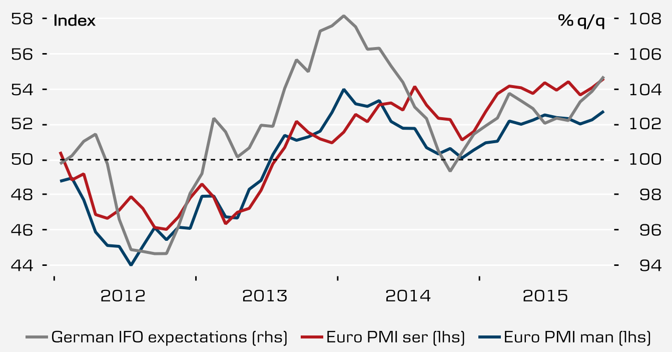
Source: ECB, Danske Bank Markets

End of easing as euro recovery strengthens

In our view, the expected significant easing from the ECB will be the end of the easing cycle, although the ECB will signal it is ready to cut the deposit rate further. The end of easing should follow if the measures delivered in December are enough to lead to higher growth and put upward pressure on inflation. This should follow via three channels: (1) cheaper and more accessible credit, (2) higher exports through a weaker euro and (3) higher confidence if the easing is deemed strong enough to restore longer term growth.

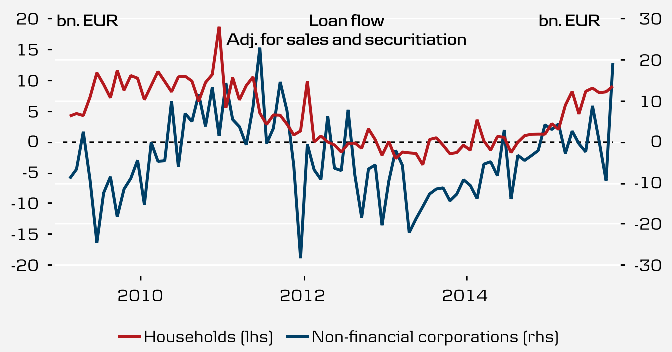
We look for the recovery to gain momentum in 2016, which should take some of the pressure off the ECB. The economic data released this week (PMI and ifo expectations) improved again and have generally been surprisingly resilient to the emerging market turmoil and the weakness in the US manufacturing sector. In particular, as the service PMI is at a new cycle high, this suggests domestic demand in the euro area is still doing well. Added to this, the bank lending figures continue their upward trend. Also, since 2009 loan flow to non-financial corporations has been at the current level only in June 2011. Overall, the recovery has so far struggled to gain momentum as bank lending has been a headwind particularly to investments but the problem seems set to fade going forward, see *More signs of stronger euro growth in 2016*.

Economic data point to stronger recovery in 2016



Source: Ifo, Markit PMI, Danske Bank Markets

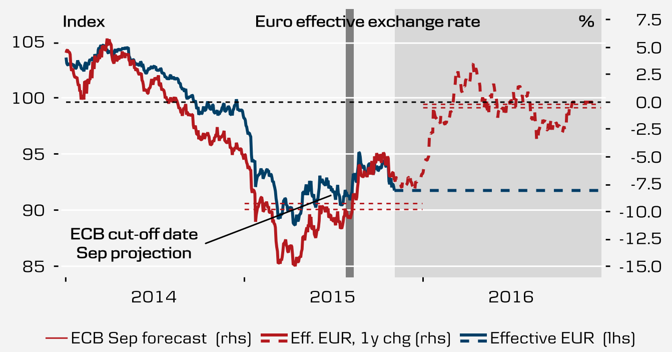
ECB easing supports the recovery through bank lending



Source: ECB, Danske Bank Markets

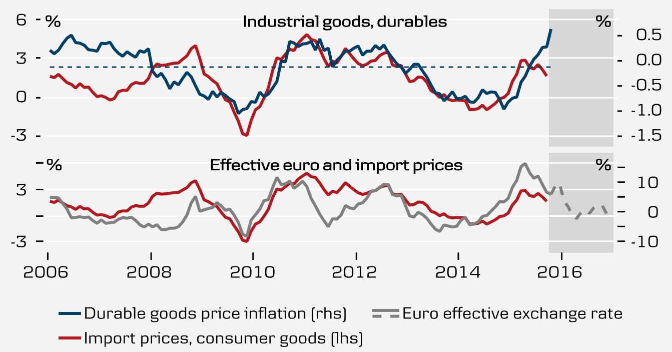
This said, in our view the ECB will continue to be challenged by appreciation pressure on the euro and the consequent negative impact on inflation. Based on expected easing measures, we doubt it will continue to send EUR/USD much lower beyond Q1: with the ECB then set to await the economic impact of past easing and US money markets adjusting to a shallow hiking cycle from the Fed, the downside from relative rates is set to wane and EUR supportive factors should gradually take over (see more about the ECB's inflation outlook in *ECB Research: ECB will finally lower its core inflation forecast*, 6 November).

Unchanged effective euro will result in a higher yearly change



Source: Bloomberg, ECB, Danske Bank Markets

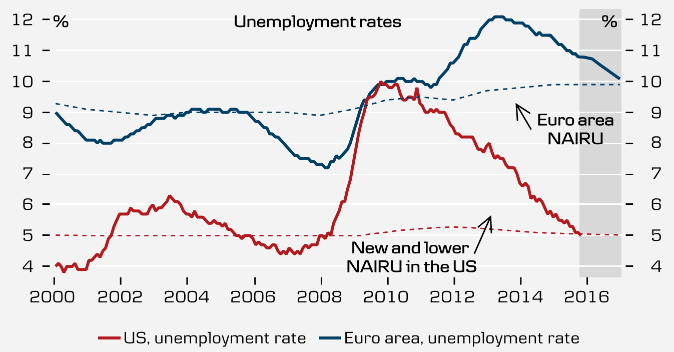
The unchanged euro will be a headwind to inflation



Source: Bloomberg, ECB, Danske Bank Markets

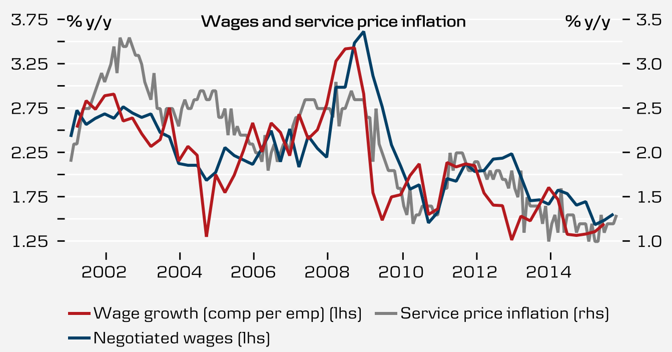
As the stronger euro is set to remain a headwind to higher inflation, we expect inflationary pressure from other channels to follow. The US and UK experience is that it takes a long time for the upward pressure on wages to return, but that it happens when the unemployment rate approaches its structural level. In the euro area, the unemployment rate is currently only 0.9pp above its estimated structural level (NAIRU) of 9.9% and due to very low potential GDP growth it is set to continue quickly towards its structural level. We expect the unemployment rate to reach its structural level in H1 17, which should imply the wage pressure will return and hence that it will result in higher core inflation.

The euro unemployment rate approaches NAIRU quickly



Source: BLS, European Commission, Eurostat, Danske Bank Markets

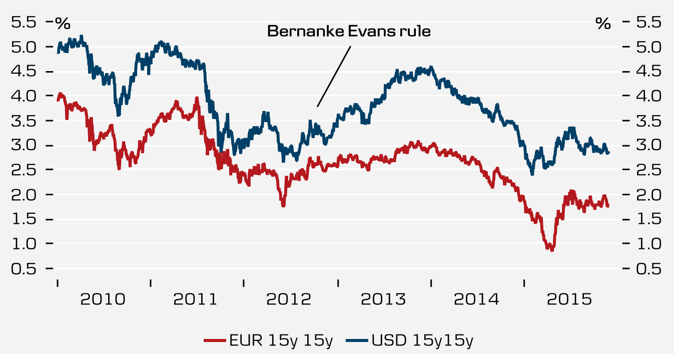
Higher service price inflation when wage pressure resumes



Source: ECB, Eurostat, Danske Bank Markets

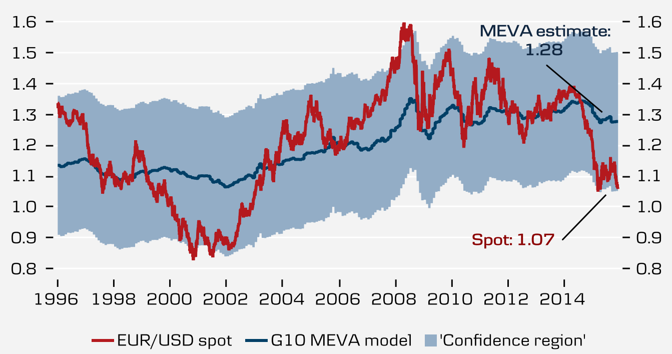
From a market perspective, we could see a long-end led steepening, if the market deems the ECB easing measures are credible in terms of restoring long-term growth and inflation expectations. This was what happened in the US, when the Bernanke-Evans rule of open-ended QE was announced in September 2012. As much is already priced in fixed income markets, an initial bullish steepening of the EUR swap curve led by the short-end should only be limited but, over time, the curve should steepen from the long end.

The EUR swap curve should steepen from the long-end



Source: Bloomberg, Danske Bank Markets

Fundamentals warrant a higher EUR/USD further out



Source: Bloomberg, Danske Bank Markets

More aggressive ECB easing should result in lower EUR/USD

We are lowering our EUR/USD forecasts given the prospect for a more aggressive ECB: we now look for the cross to trade at 1.02 in 1M (prev. 1.04) , 1.02 in 3M (1.06), 1.06 in 6M (1.12), and 1.16 in 12M (1.20).

Near term, the ECBs will to surprise and the further opening up of the probability space for EUR rates (two-tiered deposit charges, ECB to signal no floor under rates, and re-introduction of forward guidance) suggest that EUR downside will be more extensive near term and somewhat prolonged than we envisaged earlier. Coupled with that fact that the Fed still looks set to outhike the market next year notwithstanding that a December hike is now widely expected, the downside to EUR/USD from relative rates will weigh for longer than we previously anticipated. A dip towards parity in 3M is a possibility but should mark the end of the USD rally.

Indeed, further out, we stress that EUR/USD will stage a rebound towards the higher levels warranted by fundamentals (cf Danske MEVA and PPP estimates): EUR/USD have reached levels on positioning and is already so stretched on fundamentals that it will become increasingly difficult for the market to send the cross much lower. With December set to mark the end of ECB easing, euro-zone growth picking up, and the Fed wary of not hiking faster than data warranted, we think fundamentals will start to drag EUR/USD higher beyond 3M. That is, an end to the USD rally will be at the top of the FX market agenda in 2016.

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