Week ahead

ECB – Will they use further munition to bring inflation back towards 2%?
Eurozone – Italian banks pressured by non-performing loans

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ECB: Decision in March about further loosening of monetary policy

The statements of ECB President Draghi during yesterday's press conference (see our short note) surprised the markets, obviously, as yields declined substantially and the euro weakened vs. the USD. The most important message was that, **on March 10**, when the **new ECB staff projections for inflation** and GDP will be available, it will be **'necessary to review and possibly reconsider our monetary policy stance.'** These statements did not surprise us at all, as, since the last meeting in early December, important economic factors have changed. The oil price, for example, has dropped nearly 40% and oil price futures have dropped below the levels seen in early December. Furthermore, the growth prospects for Emerging Markets have deteriorated further, in turn dampening global demand. In early March, the ECB staff is not only going to revise its inflation projections for 2016 and 2017, but will furthermore release a first inflation estimate for 2018.

The ECB will be vigilant if second-round effects are a threat and oil and commodity prices will feed through to other prices, and could thus trigger a downward spiral (we have already described such dynamics in our last week ahead). Draghi emphasized the power, willingness and determination to act. There would also be no limits on how far the ECB would be willing to exploit the available tools in order to achieve its mandate (inflation close to/below 2%). In this context, it was interesting that the ECB will in the meantime carry out work to ensure that the technical conditions are in place in order to be able to make use of the full range of measures. We conclude from this that, among other things, the ECB could revise the technical specifications of the asset purchase program (e.g. issuer limit, issue limit). Draghi already indicated in December that the **ECB has figured out that asset purchases and negative interest rates are 'extremely effective',** and that asset purchases in particular have helped to slow down the decline in inflation expectations and the general deflation risk. Consequently, **the rate on the deposit facility could be lowered again in March.**

The **high volatility on the capital and commodity markets is in our opinion a big challenge** for monetary policy and the choice of appropriate measures. Steering through the implications of external factors on the economy and the inflation of the Eurozone - in consideration of delayed impacts - is in our opinion very difficult. Even though there are concrete indicators (e.g. financing costs for businesses, the exchange rate) that suggest that the **measures implemented thus far have been effective, with the continuation of the existing measures and their adaptation, it will be increasingly difficult to gain additional benefits.** Nevertheless, the ECB has only one objective (mid-term inflation rate close to/below 2%), and will for as long as there is room for maneuver use it in order to maintain its credibility - even though the member states of the Eurozone would be required to provide more fiscal

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support (within the boundaries of the stability and growth pact) for quite some time.

The **lower oil and commodity prices prompted us to revise our inflation forecast for 2016 down from 1.1% to 0.6%.** We expect the ECB to announce a similar inflation forecast in March and at the same time announce the enhancement and modification of existing measures. As Draghi 'warned' markets in advance yesterday, we expect sentiment on markets to remain influenced by the expectation of further various steps. Therefore, **we lower our yield forecasts for 10Y German Bunds (for March) from 0.9% to 0.6% and by 20bp for the remaining forecast horizon**. Basically, we expect yields on the long end to moderately increase over the course of this year, as the overvaluation on the bond market should decline in consonance with the strengthening of the economic recovery. In the case of a further rate cut on the deposit facility, we expect yields of short maturities to remain at low levels.

Eurozone – Italian banks pressured by non-performing loans

Italian banks are currently under pressure, due to their high level of non-performing loans (NPL ratio[1)]: 17.3%, Eurozone average: 6.8%). At the beginning of this week, the ECB furthermore asked top Italian lenders for data on their bad loan portfolios. Italy's **banking sector is highly fragmented,** due to a high number of mid-sized regional banks. The government therefore recently approved a **bank reform bill that should speed up the consolidation of the financial sector**. On one hand, the current situation of the banking sector has a dampening effect on Italy's economic recovery. On the other hand, the recovery should gradually improve the solvency of creditors, which should ease the pressure on banks' non-performing loans. Leading indicators and the declining unemployment rate are confirmation of an economic upswing in Italy. For 2016, we expect GDP growth of 1.5% for Italy.

1) Source: BIS, Dec. 2014

Economic calendar

Date	Time	Ctry	Release	Period	Consens	Prior
22-Jan	9:00	FR	PMI Manufacturing	Jan P	51.3index	50.0index
	9:30	DE	PMI Manufacturing	Jan P	53.0index	52.1index
	10:00	EA	PMI Manufacturing	Jan P	53.1index	52.3index
	16:00	US	Existing Home Sales	Dec	5.2thd	4.8thd
25-Jan	9:00	AT	Ind. Prod. y/y	Nov		1.5%
26-Jan	16:00	US	Consumer Conf.	Jan	95.6index	96.5index
27-Jan	n.a.	DE	Retail Sales y/y	Dec	1.7%	2.3%
	16:00	US	New Home Sales	Dec	500.5thd	490.0thd
	20:00	US	Target Rate	-	0.50%	0.50%
28-Jan	10:00	AT	PMI Manufacturing	Jan		50.6index
	11:00	EA	Consumer Conf.	Jan F	-6.3index	-6.3index
		EA	Business Conf.	Jan	106.5index	106.8index
	14:00	DE	Inflation y/y	Jan P	0.4%	0.2%
		DE	CPI m/m	Jan P	-0.9%	0.0%
	14:30	US	Durable Goods Orders	Dec P	-0.7%	0.0%
		US	Jobless Claims	Jan 23	278.6thd	293.0thd
29. Jän.	7:30	FR	GDP y/y	4Q A	1.1%	1.1%
		FR	GDP q/q	4Q A	0.2%	0.3%
	8:45	FR	CPI m/m	Jan P	-0.8%	0.2%
		FR	PPI y/y	Dec		-2.4%
		FR	Inflation y/y	Jan P	0.4%	0.3%
	9:00	AT	PPI y/y	Dec		-2.0%
		AT	GDP q/q	4Q		0.3%
		AT	GDP y/y	4Q		1.0%
	10:00	IT	PPI y/y	Dec		-4.2%
	14:30	US	GDP q/q	4Q A	0.7%	2.0%
	16:00	US	Univ. Michigan Index	Jan F	92.4index	93.3index

Source: Bloomberg, Erste Group Research

FORECASTS

GDP	2013	2014	2015	2016	2017
Eurozone	-0.5	0.9	1.5	1.8	1.9
US	1.9	2.4	2.4	2.7	2.3

Inflation	2013	2014	2015	2016	2017
Eurozone	1.3	0.5	0.1	0.7	1.5
US	1.5	1.6	0.1	1.6	2.1

	current	Mar.16	Jun.16	Sep.16	Dec.16
EURUSD	1.08	1.06	1.07	1.08	1.10

	current	Mar.16	Jun.16	Sep.16	Dec.16
ECB MRR	0.05	0.05	0.05	0.05	0.05
3M Euribor	-0.15	-0.25	-0.25	-0.25	-0.25
Germany Govt. 10Y	0.49	0.60	0.80	1.10	1.40
Swap 10Y	0.80	0.90	1.10	1.40	1.70

	current	Mar.16	Jun.16	Sep.16	Dec.16
Fed Funds Target Rate*	0.37	0.63	0.88	1.38	1.88
3M Libor	0.62	1.00	1.30	1.80	2.20
US Govt. 10Y	2.07	2.40	2.70	3.00	3.20
EURUSD	1.08	1.06	1.07	1.08	1.10

*Mid of target range

Source: Bloomberg, Erste Group Research

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