Liquid Insight

ECB preview: words now, but action to follow

Bank of America Merrill Lynch

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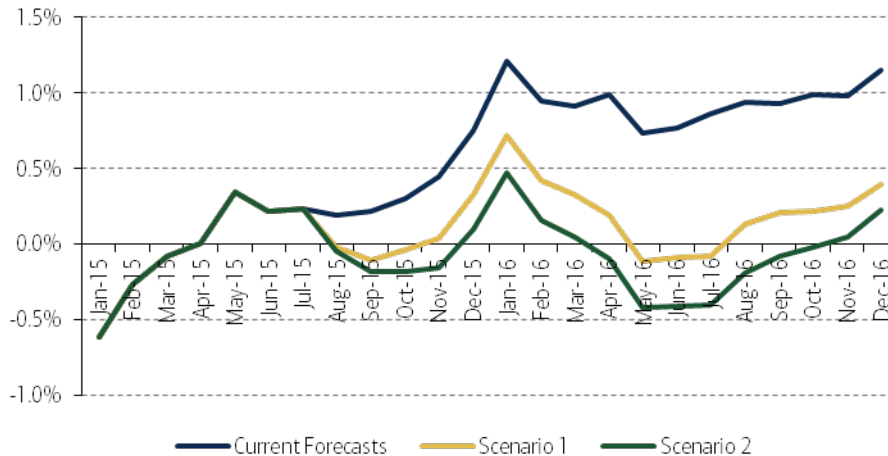
Chart of the Day: Can the ECB fully disregard the oil price drop? (EA inflation, %yoy)



Source: BofA Merrill Lynch Global Research estimates. Scenario 1 keeps oil constant at current levels. Scenario 2 keeps oil and EURUSD at current levels.

Avoiding more euro re-appreciation is the short run priority – the weak euro is QE's most tangible result. In our view "talking dovish", i.e. unambiguously recognizing the risks to their outlook and underlining the possibility to do more, should be the ECB's first port of call for this week, while the resilience in the real economy data flow and uncertainty over the Fed stance makes it hard to get into action in September already, beyond possibly some minor tweaks to asset eligibility as a sign of goodwill. In the medium run though, we believe the negative risk to consumer prices from the China-related turmoil matters more than the adverse shock on growth.

The ensuing revision in the ECB's inflation trajectory – with Praet already acknowledging downside risks there – might force the Governing Council's hand on beefing up QE by the year-end, in line of our long-held view that the inflation outlook would force the ECB into "more for longer". In our view, announcing that QE will continue beyond September 2016 would be a powerful form of forward guidance, allowing it to maintain a suitable "policy gap" with the Fed.

This report is an extract of a report of the same name published 01 September 2015

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Events colliding with the ECB's yearning for plain sailing

In an interview with Boersen Zeitung last week, ECB board member Benoit Coeuré stated that "we do not wake up every morning and look at the economic indicators in order to decide whether to raise or lower interest rates or whether to stop or expand QE", conveying a sense that QE should be allowed time to work through the economy and is not designed to "micro manage" the cycle. The decision to reduce the frequency of the Governing Council meetings – announced in July 2014 – also signalled the ECB's willingness to wean the market off speculating on how the central bank would react to short-term "noise". Finally, we also believe that with QE, as it was designed in January, the central bank has found a delicate internal compromise, and that the bar for any material tweaking is quite high.

Still, the ECB has been "asymmetric" for quite some months, firmly dismissing any tapering of the programme before September 2016, but open to more action. Draghi noted in July that it was ready to do more "*if any factor were to lead to an unwarranted tightening in monetary conditions or if the outlook for price stability were to materially change*". The issue then is whether the China-related turmoil would qualify as a "material change". We believe there is enough room for more dovish talking, but not – yet – for action, even if the latest developments sit well with our view that the ECB, by year-end, will have to make a continuation of QE after September 2016 a baseline and not a possibility, given a deteriorating inflation outlook.

Monetary conditions: the ECB probably needs to wait for the Fed

Monetary conditions are a combination of market interest rates and exchange rates. On the former, the market has eased back from the July hiccup, with the Greece-related risk premium disappearing – at least provisionally. Peripheral 10-year yields are still above the level they had reached just after QE was launched, but arguably in the ECB's eyes, Spanish long-term rates at 1.15% (trough on 12 March) were always a bit of an over-reaction. What probably matters to them is whether or not this "normalization" translates into higher borrowing costs for households and corporations. By June 2015 (latest available data point) there were only faint traces of the retracing in govies' yields in retail rates in the periphery. The return to a quieter bond market probably insures against any tension on lending rates, which would leave intact the ECB's view, expressed in the press conference on 16 July that *"the latest information remains consistent with a continued pass-through of our policy measures to the cost and availability of credit for firms and households".*

The picture is quite different for the exchange rate. On Monday, the euro dollar crossed the 1.15 level which had acted as a sort of "natural ceiling" since the launch of QE. In trade-weighted terms, the European currency has appreciated by 3.0% since the ECB's last monetary policy meeting, against 2.3% for the dollar. On Friday last week, the euro's trade weighted index stood only 1.3% below the level reached the day before QE was announced.

Obviously, for the ECB, mid-December 2014 (i.e. just before QE started to be aggressively priced by the market) may be a more relevant reference point; from there, the depreciation in the euro's TWI is more pronounced (-6.6%). Still, the recent dynamics are not encouraging, and we argued some time ago that on these issues, the *level* of the exchange rate also matters, i.e. that in a region of 1.10/1.15 a majority of French and Italian corporations would feel competitive, which could have a facilitating effect on investment decisions. Breaking the upper end of this territory would be costly in terms of business confidence. It is also a risk for the ECB's credibility since, during the last episode of euro re-appreciation towards 1.15 in the spring, many Governing Council members were busy talking down the currency, creating the impression that the central bank had embarked on "soft exchange rate targeting".

A revision in market expectations regarding the probability of a Fed rate hike in September probably explains, at least partly, the recent re-appreciation of the currency.

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Thus, the normal course of action for the ECB would be to respond by another layer of accommodation to maintain unchanged the "stance gap" with the Fed. However, the ECB will have to speak before the Fed, and even if the Fed decides not to hike on 17 September, the FOMC's choice of communication around such a "non-decision" could have quite different implications (would it simply be "skipping" a meeting to wait for the dust to settle on the market, or would it reflect a more fundamental change of heart on the timing/necessity of normalization?). Given this uncertainty, "talking the currency down" by insisting on the possibility to do more rather than big, hard to reverse decisions, should be the natural slope.

Outlook for growth: So far, so good …

In any case, moving straight into action is likely to be resisted by a strong constituency within the Governing Council given the absolute lack of materialization of the lack of EM traction in Euro area data. The disappointing Q2 GDP figures areŁin our view, entirely explainable by one-offs (inventory gyrations, exceptional weather conditions and strikes). Business sentiment in Germany, the only Euro area country with substantial exposure to China, continues to improve.

More fundamentally, we consider that the market is both exaggerating the direct impact of lower Chinese demand on European – and German – growth and failing to understand that in "general equilibrium" terms, a decline in Chinese demand is undeniably negative for Europe's foreign trade, but is a positive for Europe's consumer spending via its powerful impact on commodity prices. Hence, ultimately this should have a larger impact on the breakdown of GDP growth (more services, less manufacturing) than on the pace of growth itself.

That is a strong reason, in our view, that the ECB's approach this week could be confined to words rather than action. We do not think the ECB can be confident on any China forecast in the short run – e.g. cannot rule out a major stimulus package that would significantly reduce the risk of a hard-landing in China. They could be seen as having jumped the gun if they were to engage in emergency accommodation ahead of a shock that would ultimately fail to significantly dent European growth – much like the Asian crisis of the late 1990s had little effect.

…but the inflation outlook is deteriorating

During his July press conference, Draghi mentioned in the prepared statement that "*market based inflation expectations have, on balance, stabilised or recovered further since our meeting in early-June*". This no longer holds with "5 year/5 year" down to 1.62%.

It is always tempting for central banks to dismiss market-based inflation expectations, given their tendency to over-react to the latest developments, but even before the materialisation of the Chinese turmoil, we had reservations about the ECB's inflation trajectory. On the basis of the move in oil prices alone, we estimate the central bank will have to revise down its forecasts by 0.3 pp in 2015 and by 0.2 pp in 2016. Because of the quirk in the slope of the oil futures curve, the central bank should be able to claim that 2017 will still be consistent with their definition of price stability, but this comes at a cost in terms of price level gap.

Since the cut-off date for the technical assumptions was 12 August, the forecasts to be released next Thursday will have missed the latest – and significant – moves in the currency and oil prices.

Recent comments from Constancio suggest the need to discount the recent oil price move when assessing the inflation outlook, but the Governing Council decided this was not the case at end-2014. And rightly so. When inflation is low, the output gap is negative, and rates are at the zero lower bound, the reaction function of a central bank to a sudden drop in oil prices should differ from that of normal times. Otherwise it would risk disinflationary forces being entrenched in long-term inflation expectations.

As an example, given uncertainty on these variables remains high, we run a couple of alternative scenarios for inflation, departing from our central case. We always use the evolution of the exchange rate given by our FX strategists (they expect the EURUSD to go to parity by the year-end and remain there through 2016). For oil prices, we take the 15-day moving average futures curve at the cut-off day for our forecasts. To be fully agnostic on the evolution of those two variables, the two alternative scenarios we run are:

Scenario 1: We keep FX as in our central scenario but assume oil prices remain at current levels in USD terms ($44 per barrel).

Scenario 2: We assume both EURUSD and oil prices remain at current levels (1.15 for the EURUSD).

The Chart of the Day shows the results of these two scenarios. Recall that our current forecast is for inflation to average 0.1% in 2015 and 1.0% in 2016. At constant oil prices, we would see inflation pretty much below 0.5% yoy until end-2016, averaging 0.0% in 2015 and 0.2% in 2016.

In a scenario where the currency does not move much either, inflation would likely remain negative for most of this year and next, reaching 0.2% at end-2016 and averaging -0.2% for the whole year.

And all this assumes the absence of second-round effects, although the indirect effects of the drop in the path for oil prices and the direct effect of the stronger currency would bring core inflation to 0.8% on average in 2016 in Scenario 1 (from our forecast of 0.9%) and to a low of 0.5% in Scenario 2.

The Governing Council has kept the programme open-ended by committing to keep it in place until we see a sustained adjustment in the path of inflation that is consistent with its medium-term inflation objective. These are scenarios where, in our view, QE clearly continues even if the drop in inflation is (mostly) oil driven, since they would seriously call into question whether we are on the path to the medium-term objective.

Conclusions & likely ECB moves

In our view, the short-term fix to the forecasts' obsolescence "on arrival" is for the ECB to detract attention from mid-points and focus on "downside risks" to the expected trajectory. This is what Praet has started to do on Wednesday 26 August. This could be accompanied by Draghi making the point that while the outlook has not materially changed yet, the risk that it does is high and that they are in "heightened monitoring mode", re-listing, as Praet did, that the programme offers flexibility on "size, content and duration".

We do not think that Draghi will elaborate much on the choice between these various options at this stage.

In our view, increasing the size of the programme – without changing the eligible assets – would make sense if the bond market gets in trouble again – and there is little sign of that. This week, we would not be surprised if the ECB tweaked eligibility rules – the way it did by extending it to state-controlled corps in July – or relaxing some of the rules on the type of ABS it buys. Going beyond this will be difficult, in our view. Moving into corporate bonds more generally would be the right response if the high yield turmoil in the US had significant effects over this side of the Atlantic, but we are not there yet. Greatly expanding purchases of ABS still collides with the need to get the new regulation out first.

We think that extending the duration of the programme beyond September 2016 is the likely first port of call. Indeed, in our view the biggest challenge to QE's efficiency is the risk of a re-appreciation of the currency. From that point of view, what's crucial is to reassure on the "policy gap" with the Fed. Extending QE in time would help to maintain

the gap – in a form of super-committed forward guidance – if the Fed delays its own lift-off. Incidentally, also prolonging the TLTROs (the last one is scheduled for June 2016) would make sense.

In principle, there would be a case for taking the deposit rate further down, since it was an efficient instrument to take the currency down last year. However, beyond the fact that it would make banks' life even more difficult in the Euro area, this could dent the ECB's credibility since the Governing Council signalled that the last move on this was intended to be the final one.

Still, in our view, this discussion on the content of the next layer of accommodation is for later consumption, once it becomes clearer, in the coming months, to a wide majority of the Governing Council that, irrespective of the China risk, the risk of missing the inflation target for too long becomes obvious.

Implications for the rates & FX markets: ECB defers to the Fed

As the intensity of the Greek crisis faded from the headlines in July, the hope had been that FX markets would revert back to trading currencies based on fundamentals. That hope has been derailed by the latest bout of volatility to hit the FX markets and within the space of a month, EUR/USD has appreciated by over 7% as China has dominated the headlines. With the exception of JPY, EUR has so far been the strongest performing currency in August, underlining its status as a major funding currency whilst the USD has suffered as the US rates market pares back expectations for a September rate hike.

Our baseline scenario remains for EUR/USD to the end the year lower than current levels as the underlying message from the ECB will likely be a dovish one and that QE will more than likely continue beyond September 2016, while our US economists still expect the Fed to hike this year. However, there are risks to our call, the most notable being a delayed first Fed rate hike and the ongoing developments in China that could trigger a further bout of market volatility.

In the rates market, the drop in government bond supply, coupled with large coupons and redemptions over July have allowed yields to correct lower, as we had expected. The sharp drop in commodity prices further supported Bunds, settling 10y yields back into the 50-75 bp trading range we were looking for.

While we look for Bund yields to remain range-bound in the next couple of months, we also note the possible start of a new dynamic, whereby the traditional directionality between EUR and USD rates markets would be restored. In this matter, the September ECB meeting is key. If, as stated above, the ECB restricts itself to dovish rhetoric and does not announce further easing, all eyes will turn to the Fed. Given the directionality of the UST-Bund spread is likely a result of the different activism of the two central banks, we believe that a first Fed hike in September would likely see Bunds surrender the leadership role in the rates market back to USTs at least until the ECB is forced into more accommodation, potentially in December. This suggests that in a sell-off, we would expect the Bund-Treasury spread to widen.

Should the ECB announce further easing as early as this week, both our views of range-bound Bund yields and changed UST-Bund directionality would be challenged. In particular, a significant increase in the overall size of Euro sovereign bond purchases may result in a rally towards the low-end of the 50-75bp range in the 10y. Alternatively, an expansion in the list of QE eligible assets with an expected increase in the overall size of purchases could be read positively for risky assets and contribute to 10y Bunds selling off beyond 75bp.

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