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ECB PREVIEW: CHANCE FOR A DOVISH SURPRISE?

Berenberg Macro Flash

Not so fast. With the Eurozone economy improving but price and wage pressures still subdued, the ECB is in no rush to stop its asset purchases yet. We expect the ECB to scale down its monthly purchases, but by less than the market anticipates. Look out for a dovish surprise.

At next Thursday's Governing Council meeting (26 October) we expect the ECB:

- to scale back its monthly asset purchases from €60bn to €40bn as of January 2018 and commit itself to maintain that pace for at least six months;
- to maintain the forward guidance on policy rates (at present levels "well past" the horizon of QE);
- to keep the asset purchase easing bias (ready to increase programme in size and/or duration);
- and to stress the continuation of reinvestments of payments from maturing assets.

In our base case, following six more months of asset purchases at €40bn per month, the ECB will likely take one further step change to €20bn in July 2018, before ending its monthly purchases in late 2018. As always, there are risks to the outlook. If the economy were to disappoint in 2018, the ECB could simply keep the €40bn per month going for longer. We see a significant chance that above trend growth in the Eurozone this year, and upside risks to the outlook, could prompt the ECB to reduce its monthly purchase by more than €20bn from January 2018 onwards. The most likely alternative to our base case scenario is that the ECB will commit to asset purchases of €30bn for 9 months.

Macro outlook has not changed much since September, so only small and gradual adjustment warranted: The Eurozone has enjoyed 17 consecutive quarters of growth. In H1 2017 economic growth at 2.4% annualised was faster than we and the ECB expected, and compares to trend growth of c1.5%. Forward-looking components of the PMI (new orders) at their highest levels since 2011 suggest growth continues unabated. Despite a firming recovery and strong employment gains, underlying inflation is only creeping up gradually. As slack in the economy continues to be absorbed, wages and prices will gradually rise and the traditional Phillips curve connection between inflation and the business cycle should eventually reassert itself. Because underlying inflation is rising only gradually, the ECB can afford to go slowly towards the exit.

Markets ready for policy recalibration: Repeated comments from Governing Council members over the recent weeks regarding a lower intensity level of monetary accommodation did not ruffle markets' feathers. Bond spreads and the euro have remained basically flat amid those comments.

Pace versus duration trade-off: At the 7 September meeting the ECB discussed two options for the way forward: 1) A greater reduction in pace combined with a longer intended purchase horizon, possibly €20-30bn for at least 9-12 months, or 2) a relatively smaller reduction in the monthly volume but a shorter period of purchases, such as €40bn for at least 6 months. The merit of the first option would be that the ECB would push back expectations of a rate expectations well into 2019, as it will likely maintain rates at present levels until "well past" the end of QE. Moreover, the ECB has shown sympathy for a "lower for longer" approach before. Back in December 2016, the ECB chose to reduce monthly asset purchases to €60bn from April 2017 onwards for 9 months compared to market expectations of maintaining a pace of €80bn for 6 months.

Flexibility to adjust likely to guide QE decision: Over the recent months flexibility has been an issue that has become more important to the ECB. The Governing Council has increasingly argued for “more policy space and flexibility” to adjust stimulus “if and when needed, in either direction”. We see this as a signal that the ECB will be cautious locking itself into a policy for too long. Protracted gyrations following from the Italian elections in spring next year could be a reason for the ECB to have more accommodation in place over the first six months of 2018, hence the smaller cut in QE for now. On the other hand, a faster-than-expected rise in underlying inflation could warrant an earlier end to asset purchases. Providing a guidance of purchasing asset for 9-12 months seem very long, likely too long for the ECB. Committing to €40bn for 6 months looks like a better balance between continuity and flexibility. A “sunset clause”, a potential pre-commitment to end QE in 2018, also does not seem to be in the cards for that reason as it would limit the ECB’s policy space too much.

What’s left for December? We may have to wait until December for the ECB to decide on whether the composition of the monthly asset purchases across sovereign bonds, corporate bonds, covered bonds and ABS will change. The ECB could tilt towards a reduction in purchases of sovereign bonds only, while leaving corporate bonds untouched. The commitment to do more, including to expand QE again, if needed, is all the more credible as (German) sovereign bond scarcity is less of an issue. Scaling back the monthly purchases of sovereign bonds would push the date when German bond issuer/issuance limits are hit further into the future. This would give the ECB more flexibility for the implementation of QE.

The ECB will stress that policy remains accommodative, also by trying to shift focus to other policy instruments: While edging closer to normalising its policy, the ECB is wary to cause an unwarranted tightening in financing conditions, and renewed momentum for the euro. For that reason, it will stress – probably even more than in the past – that despite scaling back its monthly asset purchases, and eventually stopping them altogether, monetary policy will remain accommodative well into the medium-term. The ECB will also try to shift the focus to other policy instruments and the total stock of the asset purchases, rather then the monthly flow. The first 25bps refi rate will likely not happen before September 2019, extensive liquidity measures, such as the TLTROs, provide banks with enough long-term funding and the ECB will continue reinvesting the proceeds from maturing bonds for the time being, probably until policy rate normalisation starts. Real policy rates will remain negative and the balance sheet big for years to come.

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