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Florian Hense, Economist | florian.hense@berenberg.com | +44 20 3207 7859

ECB PREVIEW: NO CHANGE YET AS ECB TRIES TO REIN IN THE EURO

Berenberg Macro Flash

Waiting for more inflation: While the ECB's communication may have changed recently, the Governing Council will probably not tweak its formal guidance yet at its upcoming 25 January meeting. Although the economy is doing fine, underlying inflation is still too low for the ECB's liking. Following the recent rise in the euro, the ECB will try to avoid any comment that could boost the exchange rate further. We expect ECB President Mario Draghi to echo his colleagues' optimism regarding growth, but he will stress that, as long as underlying inflation is not picking up, the ECB has no reason to speed up the exit of the monetary stimulus.

Economic backdrop vs. monetary stance: This year's economic prospects look very encouraging. The Eurozone is likely to expand at well above trend for the second year in a row (2.5% yoy versus trend of 1.5%). Strong demand gains should eventually pull up underlying inflation (core inflation was at 0.9% yoy in December). But despite the solid economic performance, the ECB has bound itself to asset purchases until at least September and its current rate corridor including a negative deposit rate until 'well past' the end of asset purchases. In a seemingly concerted effort over the recent weeks, ECB hawks have tried to bridge the gap between an improving economy and its very accommodative monetary policy stance. Of course, the monetary policy stance will eventually follow the economy and will also return to more normal. The minutes of the December meeting signalled that a change in communications could come in "early" 2018. However, this week is probably too early for any significant tweak in the ECB's formal forward guidance. We see a small chance that the ECB could drop the notion that it is ready to increase the size of the monthly asset purchases. But it does not seem likely yet. At its next meeting on 8 March, just after the Italian elections on 4 March, the ECB will probably feel free to adjust its guidance in this manner. This week, the ECB will be weary to push the euro up even if the rise in the euro amid firm global demand is not a big deal for the Eurozone economy yet.

No policy changes, no forward guidance tweaks – is this an ECB press conference to skip? Possibly, but those that don't skip it could find out how serious the ECB takes the recent gains in the euro. The stronger euro is unlikely to cause the ECB to revise its forecasts and delay its exit. First, the trade-weighted exchange rate is only about 1.2% above the rate used in the December 2017 staff macroeconomic projections. Second, ECB calculations have shown that a stronger euro does not weigh on the Eurozone economy as much as in the past. So far, the stronger euro would translate into an inflation rate that would be less than 0.1ppt lower than the current projections. Therefore, even if the euro were to gain further but stops short of 1.25 per US dollar in Q1, the dampening effect on inflation and the ECB's forecasts would be limited. Currently, the disinflationary impact is more than offset by stronger oil prices which suggests the ECB could rather raise its inflation forecast for 2018 by 0.1-0.2ppt. We get new staff projections on 8 March.

Putting a lid on the euro – how could Draghi pull it off? When the euro strengthened significantly over a short period in the past, the ECB often intervened verbally by saying that "the recent volatility in the exchange rate represents a source of uncertainty which requires monitoring", as it did in September 2017. The ECB could try the same trick this time. If the Governing Council would refer to the exchange rate already in the introductory statement, rather than using Draghi's Q&A for it, it would signal a slightly greater attention towards the recent rise of the euro and a greater intention to slow down its gains. Another way to defuse strong euro fantasies would be for Draghi to reiterate his October statement that a sudden stop of monthly asset purchases from €30 bn to zero would not be an option. In December, Draghi, however, sof-

tened his statement by saying a sudden stop was not discussed. In any case, we expect Draghi to stress that rates will not rise until "well past" the end of net asset purchases.

Fewer public bonds, more corporate bonds: The ECB still has not clarified the composition of monthly asset purchases in 2018. An ECB press release that followed the October press conference saying "the purchase volume under the three private sector programmes … will remain sizeable" suggested both an absolute and relative cut of sovereign bond purchases. Data for January so far suggests that the cut in the purchase programme has fallen largely, if not completely on sovereign bonds – if one were to extrapolate the weekly data to the whole month, from currently €50bn monthly down to €20bn in 2018, with €10bn monthly for the sum of corporate bonds, covered bonds and ABS.

ECB outlook – QE ends after September 2018, rate cycle starts in March 2019: We expect speeches of ECB board members to sound gradually more hawkish, followed by changes to the official forward guidance well ahead of actual policy action. More precisely, we look for the ECB to

- draw attention throughout H1 2018 further away from net asset purchases towards interest rates, the reinvestment of maturing bonds and the stock of assets already purchased,
- drop the specific notion that it may increase its asset purchases in size and duration in March 2018, leaving only the more general commitment to continue asset purchases beyond September 2018 "if necessary",
- announce in June 2018 that it expects to end asset purchases at the end of September 2018,
- adjust in September 2018 the pledge to maintain rates at present levels "well past" the horizon of QE,
- raise the deposit rate from -0.4% to -0.25% in March 2019, re-establishing a symmetric rate corridor of 25bp either way around the 0.0% main refinancing rate, and
- lift the entire rate corridor by 25bp in June 2019, followed by a further 25bp rate hike in December 2019 and roughly three further such steps in 2020.

If core inflation fails to edge up over the course of the year, and remains rather flat, the ECB may wait a little longer before eventually tightening its policy. If growth continues to surprise to the upside while core inflation edges up, the ECB may raise all three rates rather than just its deposit rate in March 2019 already.

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Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7859
www.berenberg.com
florian.hense@berenberg.com