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

ECB PREVIEW: SENDING A TWO-PRONGED MESSAGE

Berenberg Macro Flash

No easy task for the ECB. After its meeting this Thursday, the ECB will likely want to send a two-pronged message. On the one hand, we expect the ECB to acknowledge that the Eurozone economy lost some momentum in early 2018 partly due to special factors and that downside risks now loom larger than before due to trade tensions. On the other hand, expect the ECB to emphasise that underlying fundamentals remain solid. As a result, the ECB will likely keep its policy guidance unchanged and continue to prepare markets for a step-by-step removal of its policy stimulus without committing to any firm schedule yet.

Subdued start to 2018: Since the ECB's last Governing Council meeting on March 8, incoming data have disappointed. Sentiment surveys have receded further. Industrial production and export data also missed expectations. Some correction after the outsized surge in industrial output in late 2017 (+1.5% qoq in Q4) seems normal. Exceptional factors (weather, influenza, rebasing of some data series) also weighed on measures of activity. But the elephant in the room is, of course, the risk of protectionism stoked by US President Donald Trump that is weighing on Eurozone businesses. After strong quarters of growth at around 0.7% qoq on average in 2017, GDP growth probably slowed down to around 0.4% in Q1 (see chart 1). As a result, we lowered our full-year forecast for 2018 from 2.5% to 2.3%, after 2.5% in 2017, two weeks ago. A first Eurostat reading for Eurozone GDP in Q1 will be published on 2 May.

H2 forecast looks more promising: While the slowdown in GDP growth is significant, it is likely to be temporary, for two reasons: (1) After some escalation in late March/early April, trade tensions seem to have cooled off slightly in the last two weeks. Both US and Chinese officials sounded more confident that an outright trade war could be avoided. This supports our call that both sides will settle for a deal. A concerted effort by French President Macron and German Chancellor Merkel, who are both meeting Trump this week in Washington, may also help to exempt the EU permanently from the new US steel and aluminium tariffs and pave the way for a broader deal (see Defusing trade tensions?). (2) Today's PMIs for April suggest that sentiment has stabilised and the underlying economic momentum remains solid. Despite the euro's appreciation by 7% on a trade-weighted basis last year and a slower pace of incoming orders in recent months, the amount of unfinished work is still rising. As manufacturing companies have more orders than they can handle in a timely fashion, they are unlikely to curtail production in response to a temporary dent in incoming new orders. Also, services, the far bigger sector of the economy, benefits from the healthy consumption-driven gains in domestic demand. Slowly but steadily, confidence among businesses should rebound from June onwards, with a chance that the upturn may start earlier. From Q2 onwards, we expect GDP to expand by 0.6% qoq in 2018 (see chart 1).

Is the ECB looking through the less stellar Q1 data or is it concerned about downside risks? The ECB is ultimately interested in how economic growth translates into inflation. Quarters of slower demand growth suggest a slower absorption of slack and, therefore, a more delayed adjustment of inflation towards an annual rate of "below, but close to, 2%". This would justify an even slower path in policy normalisation. Recent speeches by Governing Council members suggest that the ECB sees the slowdown in Q1 growth as temporary. But, uncertainty whether the trade tensions will be resolved (soon) or not clouds both the growth and inflation outlook. As inflation remains subdued, caution reigns supreme, so the ECB can take it slowly.

Inflation outlook – skittish in the short-term, slow upwards adjustment in H2: Measures of underlying inflation suggest that price pressures are building only very gradually (see chart 2). Over the short-term, both core and services inflation are affected by volatility. A base effect (the expensive Easter holiday season ended earlier this year than in 2017) could reduce core inflation from 1.0% in March to 0.9% in April before bouncing back in May. The unexpected drop of prices for non-energy industrial goods in March may point to a rising pass-through from the stronger euro on imported prices. It could, however, also be influenced by one-off factors stemming from lower price gains for semi-durable goods. In March, sales prices especially for clothing and footwear were hit by bad weather – usually they rise in spring as shoppers flock to the stores to buy summer clothing. In the months to come, it may be useful to pay attention to price changes of haircuts, see chart 2, which usually correlate closely with increases in wage costs. A 2.7% mom increase in pump prices will raise the energy contribution to headline inflation in April, likely offsetting the small drop in the core rate. We expect headline inflation to come in at 1.4-1.5% yoy in April (data will be published on 3 May) and continue to edge up driven by higher oil prices. As the economy rebounds in H2 from the modest and temporary dent to growth now, measures of underlying inflation are likely to follow suit and edge up gradually later this year.

The ECB's response this week: The Governing Council will almost certainly keep the policy rates (deposit: -0.4%, refi: 0.0%, marginal: 0.25%) unchanged. Having just tweaked its statement in March, the ECB will likely maintain its official forward guidance in April unchanged. We expect the ECB to mention that downside risks have intensified slightly, but that underlying economic momentum remains healthy enough. Such a message would imply that further steps of monetary policy normalisation would be warranted in the foreseeable future. Suggesting a possible downward revision in the next staff projections published in June, or an extension of asset purchases beyond December already now, or an endorsement of the market's re-pricing of the first rate hike from summer to autumn 2019 would be a dovish surprise. If the German Ifo published tomorrow confirms today's steady PMIs, the ECB will probably abstain from saying anything else than just emphasising the downside risks more than before.

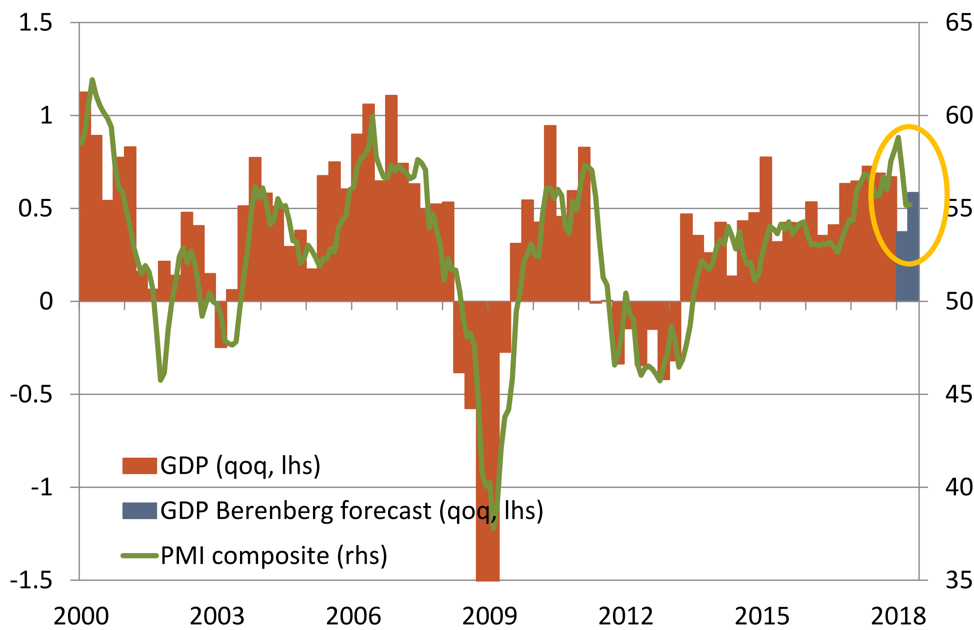
Medium-term ECB outlook: Going forward, we expect the ECB to adjust its guidance and policy stance in a series of baby steps. If the trade tensions are resolved over the next few weeks, the Eurozone economy rebounds in the summer and price pressures rise gradually, the ECB will probably:

- announce on 14 June (less likely) or 26 July (more likely) that it will scale back the amount of monthly asset purchases from the current €30bn from October onwards and link its guidance on interest rates more closely to the inflation outlook;
- declare on 13 September that it will purchase assets of €15bn (or €10bn) net per month from October onwards until at least the end of December 2018;
- announce on 13 December that asset purchases will indeed end in December 2018, with a chance that the ECB may disclose this on 25 October already;
- raise the refi rate by 25bp in June 2019 coupled with a hike in the deposit rate to 0% and the marginal lending rate to 0.5%;
- increase rates again by 25bp in December 2019, followed by roughly three further such steps in 2020;
- and keep the balance sheet sizeable with reinvestments of all maturing bonds to continue probably until 2021.

To make the rate corridor around the refi rate symmetric again before the first refi rate hike in June 2019, we still see a chance that the ECB may raise the contentious deposit rate from -0.4% to -0.25% in March or April 2019 already.

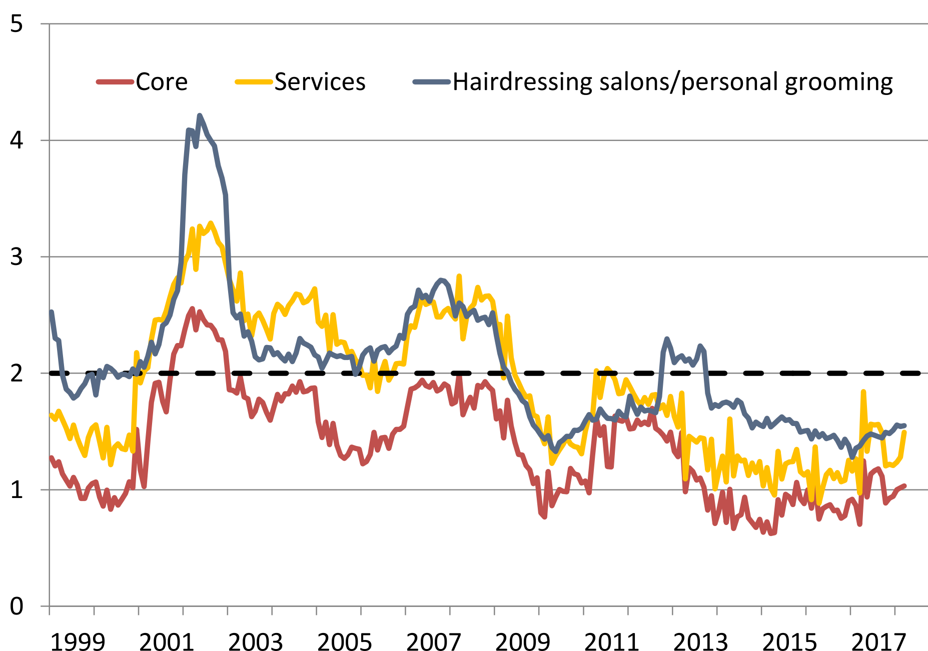
As usual, we need to watch the risks to our outlook: If the trade tensions take more time to resolve, if the economy suffers a longer than just a temporary slowdown and/or if core inflation fails to edge up over the course of the year, the ECB may delay its first refi rate hike beyond June 2019.

Chart 1: GDP growth (qoq, in %) versus PMI composite



Quarter over quarter growth of GDP, in %. Sources: Markit, Eurostat, Berenberg forecasts.

Chart 2: Measures of underlying inflation (yoy, in %)



Annual growth rate in %. Source: Eurostat

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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