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KEEP CALM AND COME BACK IN JUNE - BERENBERG MACRO FLASH

Berenberg Macro Flash

Staying calm in uncertain times is part of a central bank's job. Better to send a broadly reassuring message than to spook observers by overreacting to the latest twists in the data or policy debates. Today, the European Central Bank duly noted the recent softening in many data and acknowledged that the trade tensions pose a "more prominent" downside risk to growth. Despite an apparent moderation after high growth rates before, the ECB expects a solid and broad-based economic expansion. As a result, it did not shift its official policy stance today. Having tweaked its statement in March, the ECB left its forward guidance as well as its asset purchase programme and its interest rates unchanged. As before, the ECB pledged to maintain the current pace of asset purchases of €30bn per month at least until the end of September and to leave interest rates at their record-low levels until "well past" the end of such purchases.

In its statement, the ECB's Governing Council maintained its assessment that risks to its growth outlook "remain broadly balanced". However, the ECB dropped the notion it had emphasised in March that "the prevailing positive cyclical momentum could lead to stronger growth in the near term". Of course, after the upward revision to Q4 growth from 0.6% to 0.7% qoq and the softer data for early 2018, the hint at a further acceleration of growth had to go. Still, this change means that the ECB now lists only downside risks to growth in its statement, namely those "related to global factors, including the threat of increased protectionism, (which) have become more prominent." **We can see this as a shift in the ECB's risk assessment in disguise.** Along the same line, the ECB today called the economic upswing "solid", having used the more forceful label "strong" in its March statement. In the question&answer session, ECB President Mario Draghi acknowledged more pointedly that "trade spats" can have a profound and rapid impact on confidence.

Despite emphasising downside risks more than before, the ECB tried to not sound overly concerned. Explaining the apparent "moderation" in growth in early 2018, the ECB statement refers to "temporary factors and a "pull-back" following "several quarters of higher than expected growth" rather than to any fundamental change. Emphasising the "underlying strength" of the economy and continuing to project a "broad-based expansion", the Governing Council expressed its continuing confidence that "inflation will converge towards" the ECB's inflation aim over the medium term. Asked about the potential harm which the recent rise in bond yields could do to the growth outlook, Draghi called higher yields a "natural development".

We broadly agree with the ECB's assessment for growth, inflation and the potential impact of higher yields. Following the weaker data for industrial activity in early 2018 after a stellar 1.5% qoq rise in output in Q4, and in response to the drop in business expectations caused largely by the trade tensions stoked by US President Donald Trump, we shaved our 2018 growth forecast for the Eurozone from 2.5% to 2.3% three weeks ago. Near-term, the risks are clearly tilted to the downside.

ECB outlook: The ECB did not provide any new clue on the outlook for its policy stance. According to Draghi, the Governing Council today did not even discuss what they may say or do at the June meeting when the Council will base its deliberations on new staff projections for growth and employment. Today's ECB comments thus do not change our 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 largely resolved over the next six weeks, the Eurozone economy can rebound in the summer from its current dent to growth. With core inflation like to rise gradually, the ECB will probably:

- announce on 26 July (most likely) or 14 June (less 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.

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 to make the rate corridor around the refi rate symmetric again before the first refi rate hike in June 2019.

As the current asset purchases are intended to run until the end of September 2018 anyway, the ECB is under no pressure to take decisions soon. If uncertainty persists and – after softer growth in Q1 2018 – sentiment data continue to fall in the next few months, the ECB could easily delay any decision about its asset purchases in late 2018 until its September meeting.

Of course, we need to watch the risks to our outlook very carefully: If (i) the trade tensions escalate much further for much longer and the economy suffers worse than just a temporary slowdown, and/or if (ii) core inflation fails to edge up over the course of the year, the ECB may delay its first refi rate hike beyond June 2019. While we cannot rule out that the ECB may prolong asset purchases beyond the end of 2018, that still seems quite unlikely, in our view.

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