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ECB PREVIEW: STAYING THE COURSE THROUGH THE SUMMER BREAK

Berenberg Macro Flash

You are probably safe to skip this week's ECB meeting, even if you are a Governing Council member. After changing its net asset purchase and rate guidance already in June, the ECB will not have much new to say at this point already. More specific comments about the outlook for rates (on hold "through the summer of 2019") or reinvestments (think "operation twist") seem unlikely. Instead, expect the ECB to largely reiterate its previous messages this Thursday. A fresh take on how escalating trade tensions could affect the Eurozone economy and ECB policy may be the most interesting take away from this week's meeting.

Recap of the June surprise: Six weeks ago, the ECB announced that it intends to reduce its monthly asset purchases from €30bn to €15bn at the end of September and stop these purchases at the end of December 2018. To balance the pre-announced conclusion of net asset purchases, the ECB declared that it would keep rates at current levels at least through the summer of 2019. The ECB justified the guidance changes by its continued confidence in the underlying strength of the economy and noted that price pressures had started to converge towards an inflation rate of 2% in a sustained way.

Mixed data since the June meeting: In June, surveys of service sector sentiment and activity such as the Purchasing Managers' Index (PMI) and Economic Sentiment Index (ESI) stabilised and, together with a strong labour market, provided comfort that the virtuous circle of domestic growth in employment, disposable income and consumption was driving overall demand. Yet, already in June, manufacturing continued to suffer from the trade tensions. While industrial production rebounded in May, the manufacturing subindices of the PMI and the ESI weakened further in June. Today's lower PMI composite for July adds to the concerns, also raised by the ZEW survey two weeks ago, that the external environment may weigh on the domestic economy a little bit more than expected. According to the PMI survey, faster growth in Germany contrasted a slight slowing in France and the weakest growth for 21 months elsewhere in the Eurozone. Taken together, the recent slew of data creates a downside risk to the ECB's forecast of GDP growth of 0.5% qoq in Q2 and Q3 each. We expect the soft patch to continue a little longer and project 0.4% qoq gains for both Q2 and Q3 before the pace could pick up again to 0.5% qoq from Q4 onwards. The first GDP reading for Q2 will be released on 31 July. Meanwhile, core inflation has fallen back to 0.9% yoy in June, surely not to the ECB's liking, while headline inflation, driven by higher energy oil prices, has come in line with our and the ECB's expectation at 2% for June and 1.7% for the Q2 average.

Keeping options open: As the data remain mixed and the uncertainty stemming from trade tensions has increased, we look for the ECB to reiterate that the end of net asset purchases and the rate outlook are subject to data developing in line with the ECB's projections. Yet, the ECB will unlikely diverge from its message of double confidence in the underlying strength of the economy and a convergence of inflation towards target. As long as the trade tensions do not escalate into an outright trade war, we see no reason for the ECB to change its June guidance. At this week's press conference, ECB President Mario Draghi may well be asked as to how bad the data or trade tensions would have to turn out for the ECB to extend its net asset purchases beyond 2018. However, Draghi is unlikely to provide a clear answer beyond a general reminder that the ECB would adjust its stance if required.

Any more clues on "through the summer" rate guidance? Barring a major surprise, ECB President Mario Draghi will stick to the current and somewhat vague wording of its rate guidance. So far, the ECB seems to be in no rush in resolving the confusion around what exactly "through the summer" means. We expect the first rate hike in September 2019.

"Operation twist" not part of the policy package (yet): Although the ECB Governing Council has probably started to discuss the issue, we do not expect the ECB to provide more guidance on the timeline and other details of its reinvestment policy. Currently, the official guidance is that proceeds of maturing assets will be reinvested for an "extended period of time after the end of the net asset purchases". In our view, the ECB has roughly 2-3 years in mind, so that full reinvestments would continue until at least 2020/2021. For H1 2019 redemptions worth of 17bn euros a month on average are planned. While Draghi will probably be questioned on the speculation that the ECB could follow the Fed's step of re-profiling the maturity structure of the asset portfolio, he will probably not provide a clear answer yet. In a move that came to be known as "Operation Twist" in 2011 the Fed sold short-term bonds for longer-dated assets, a qualitative rather than a quantitative easing. The idea was to push long-term bond yields lower and, thereby, to provide an extra boost for the economy from low long-term borrowing costs. It is uncertain whether and by how much this re-profiling affected the US economy. At some point the ECB will probably have to declare whether or not it will engage in such re-profiling eventually. In June, the weighted average of remaining maturity for bonds across the Eurozone fell, that of German bonds increased somewhat.

Policy outlook: We expect the ECB to follow up on its guidance. Short of a major downside surprise in growth and/or inflation, the ECB will end its net asset purchases on schedule in December 2018. We look for the ECB to raise its rates in September 2019, probably with a 25bp increase in the deposit rate from -0.4% to -0.15%, while adjusting its main refinancing rate and its marginal lending rate by 10bp at the same time to 0.1% and 0.35%, respectively. That would restore a symmetrical 25bp corridor around the main refi rate. The move may be followed by a further 15bp increase in all three rates in December 2019 and two 25bp rate hikes in 2020. Of course, if the trade tensions escalate further and/or if underlying inflation fails to edge up over the next 12 months, the ECB may delay its first rate hike beyond September 2019. As a possible risk scenario, the ECB may also decide to raise only the deposit rate in September 2019 and leave the main refi rate unchanged until December next year.

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