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INVESTMENT MANAGEMENT

Expect the Unexpected from the ECB

FIXED INCOME | GLOBAL FIXED INCOME TEAM | MARKET PULSE | July 25, 2019

AUTHOR

ANTON HESSE

Executive Director
Global Fixed Income Team

The July European Central Bank (ECB) monetary policy meeting pretty much confirmed that policy is likely to be eased in September. The interim period will be used to build a consensus in the Governing Council around what exactly the policy response should be. Guided by some pretty explicit language in the statement, our expectation is for the ECB to announce a package of easing measures, most likely including rate cuts, changes to its forward guidance, renewed quantitative easing (QE), and mitigating measures to offset some of the cost of more negative interest rates on the banking sector. While the main measures may be easy to anticipate, the unexpected details may matter more: the ECB under Draghi has excelled at surprising the market with its dovishness by coming up with policy measures that few anticipated; we expect the same at his swan song.

This ECB meeting was important because it confirmed a shift in monetary policy bias which President Mario Draghi signalled at Sintra in mid-June. In that speech he stated that “In the absence of improvement … additional stimulus will be required,” a clear indication that the ECB was far closer to easing monetary policy than previously thought. Prior to that it stood ready to act only if things got worse; now he was saying things needed to get better for the ECB NOT to act.

It was not definite following that speech if ECB policy had changed, as several Governing Council members gave speeches or interviews which suggested easing would only happen if things got worse. However, the July ECB meeting confirmed that, unless things got suddenly better, an agreement to ease policy was reached even if there was no agreement yet on what exactly those easing measures should be. It seems that, once again, Mario Draghi has moved ahead of the rest of the Governing Council, and then pulled it in line with his thinking.

So what caused the ECB to change its position, and what policy options are likely?

The reason for the change is not immediately obvious because the recent Eurozone macroeconomic environment, while not exactly flourishing, has not been struggling too badly. The manufacturing sector is weak, but the labour market and construction sectors remain strong. We think the change comes from three factors:
first, Eurozone core inflation has failed to pick up, despite the fact that the labour market has tightened and wage growth has been robust for some time now;
second, both survey and market-based measures of medium-term inflation expectations, i.e., inflation breakevens have fallen this year, casting doubt about whether the ECB can achieve its inflation mandate;
third, the ECB continues to worry about international geopolitical and trade risks, which pose hard-to-predict downside threats to the Eurozone economy.

As Draghi stated explicitly, the ECB is currently failing on its inflation mandate, and is increasingly not expected to achieve it any time soon, all while the economy is not getting better. The Governing Council does not like what it sees.

So the ECB needs to act, not only because it is failing to meet its inflation mandate and believing risks are skewed to the downside, but also because it is concerned about losing credibility as a central bank that specifically targets inflation. This is slightly different to the situation in which the U.S. Federal Reserve (Fed) finds itself, where moderate inflation gives it leeway to ease if it wants. For the ECB, weak inflation is forcing it to act.

In terms of policy response, we think the ECB is likely to announce a package of easing measures in September. This is something it has favoured doing in the past, as a collection of complimentary policy initiatives is more effective than a piecemeal approach. It is debateable whether the ECB has a big policy "bazooka" left, so getting the most out of the tools it does have is important, and getting maximum "bang for the buck" involves combining them. Given the details given in July's announcement, the package we envision is:

- **A 20 basis point cut in the Deposit rate**: rate cuts were not mentioned in July's release, but the ECB hasn't pushed back on the market pricing in of cuts, and the mention of "mitigating measures" (see below) suggests they are likely. In our mind, cutting by less than

20 basis points achieves little, and cutting more may be counterproductive due to the negative impact on the banking sector. Rate cuts are the conventional tool for central banks to stimulate the economy, and Draghi has highlighted their effectiveness in the Eurozone given their impact on the currency, i.e., rate cuts should provide additional stimulus and inflationary pressure if they cause the euro to depreciate.

- **Changes to forward guidance**: the guidance the ECB provides on when it plans to change interest rates and other policy settings in the future is a key tool, as it enables it to influence interest rates across the yield curve. As in the past, it may be combined with QE and other measures (e.g., the ECB will not raise interest rates until after it has finished new QE purchases).

- **A resumption of the QE programme**: July's statement referred to "options for the size and composition of potential new asset purchases." So we do not only expect a resumption of quantitative easing, but changes to the parameters of the previous programme as well. An increase in individual issuer limits to 40% or 50% will be necessary to make a new programme credibly large, but we will also be keeping an eye out for any innovative additions to purchases, like senior bank debt.

- **Mitigating measures to offset the rate cuts**: it is estimated that the negative interest rates banks currently "earn" on their ECB deposits actually costs them EUR 8 billion per year, although the cost falls mainly on northern European banks rather than being evenly spread across the system as a whole. A tiering system, whereby a higher rate is paid on some initial portion of a bank's excess reserves, would alleviate some of the cost, although the programme would need to be carefully designed not to raise money market interest rates, which would reduce the effect of cutting rates.

- **Something else:** the ECB, under Draghi, has excelled at developing innovative policy initiatives. His reputation for surprising the market primarily comes from designing policy measures investors didn't anticipate, rather than doing more of what they were expecting. We're not quite sure what the ECB might pull out of its "bag of tricks" this time, but we wouldn't be surprised to see something different from just vanilla rate cuts, more QE and forward guidance.

If we're correct about our expectations, what do we think the impact on fixed income markets is likely to be? The market has already priced in more than 20 basis points of rate cuts by the end of 2020, so we think the fall in the yield of German government bunds, and other high quality government issuers, is limited, even if they are once again supported by renewed ECB buying. However, we expect euro sovereign spreads to tighten as yield-hungry investors are forced into holding lower-rated paper. Sovereign spreads have already tightened significantly this year – for example, 10-year Spanish bonos now only yield 70 basis points more than German bunds, down from nearly 130 basis points in early January. However, the fiscal fundamentals of most of these countries have also been improving, justifying tighter spreads. We think there is more to go.

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