GENERALI INVESTMENTS

Focal Point

Outlook to keep ECB on a dovish normalization path

December 7, 2018

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- Weaker data are set to trigger a downward adjustment in the ECB's macro outlook at the Dec 13 meeting. Yet comments from ECB officials suggest that the growth narrative is still viewed as fundamentally intact. At the press conference a dovish tone is set to prevail emphasizing the contingency of the policy path.
- We see the ECB ending QE in December and leaving rates constant at least throughout summer 2019. However, given the latest data and higher risks, we now look for a first deposit rate hike only in December 2019.
- We look for the announcement of an APP reinvestment period of three years to keep the term premium down but a tilt towards longer dated bonds ("operation twist") will be hard to engineer. When outlining the details of its reinvestment policy, the ECB may hint at some flexibility in shifting from government to corporate bonds.
- We do not expect a new TLTRO announcement as it would water down the normalization. But the ECB will not close the door; the mid-2019 cliff effect will need to be addressed if financial conditions or the economy deteriorate further.

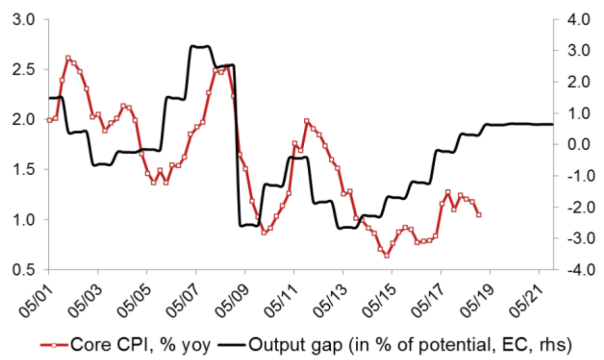
One year ago the euro area economy powered ahead with a 0.7% qoq growth rate while the outlook was favorable. As of Q3/2018, growth has come down to just 0.2% qoq with economic data consistently surprising on the downside and the composite PMI falling to the lowest level since December 2014. Moreover, headwinds related to protectionism, the risk of a crash Brexit and the political situation in Italy are taking their toll and could – depending on their evolution – further drag on activity. Against this backdrop, markets increasingly question whether the ECB will be able to proceed on its normalization path that it had already been embarked on by bringing down its monthly asset purchases to currently € 15 bn, from € 60 bn one year ago.

The upcoming ECB Governing Council meeting on December 13 will be an important meeting not only because of the macro situation but also because the expected end of bond purchases will shift the focus on the post QE policy stance.

Macro softer but still in line with normalization

At the forthcoming meeting the ECB staff will present updated growth and inflation projections. In its latest projections from September growth was seen at 1.8% in 2019 and 1.7% in 2020. We deem this too high and see the need for a downside adjustment. Our own forecasts are 1.6% (2019) and 1.5% (2020). While the ECB inflation projection of 1.7% for the coming two years all in all still appears reasonable, the projected 2020 average core inflation (excluding energy and unprocessed food) of 1.8% looks ambitious: As of November, core inflation was only 1.1% yoy and the latest patch of weak data softens the outlook. While the recent drop in oil prices supports purchasing power it also works in the direction of a lower path of underlying inflation. The updated projections will include a forecast for 2021 for the first time; from a policy perspective it will be crucial whether the ECB expects that its inflation target of below but close to 2% will still be reached.

EA: Core inflation and output gap



Inflation expectations have recovered considerably from the lows before QE was launched. In any case, in the medium term the growth outlook is crucial for inflation. According to the IMF and the European Commission, the output gap has become positive in 2018. Hence, if growth were to stay in line or above potential upside pressure on underlying inflation would persist or even amplify. ECB officials emphasized in speeches that the recovery still has potential to advance by historical yardsticks. For instance, Draghi (16.11.2018) stated that "*The average duration from trough to peak is 31 quarters, with GDP increasing by 21% over that period. The current expansion in the euro area, however, has lasted just 22 quarters and GDP is only around 10% above the trough*." While the ECB is aware of the risks surrounding the outlook, it emphasized that temporary factors like disruptions in the car industry come on top of a gradual slowdown which is seen as "*normal as expansions mature and growth converges towards its long-run potential*" (Draghi, 26.11.2018). Instead, it has been consistently put forward by Governing Council members that the underlying drivers of domestic demand remain in place.

Indeed, employment growth continues, albeit at a lower speed (+0.2% qoq / +1.3% yoy in Q3) and surveys on firms hiring intentions indicate a continuation of this development. The current unemployment rate of 8.1% is the lowest since late 2008. Business investment is supported by above-normal capacity utilization, solid demand and favorable financing conditions.

Likewise, Governing Council members maintain a constructive view on the inflation outlook. A key signpost to watch for the ECB is the wage development. With the labor market tightening and wage growth rising (e.g. negotiated wages 2.2% yoy in Q2/Q3, above long-term average of 1.9% yoy) the ingredients for higher core inflation remain in place.

All in all, we expect the ECB to adjust its macro projections to the downside but to still stick to a constructive growth outlook with annual growth not falling below potential and underlying inflation trending higher.

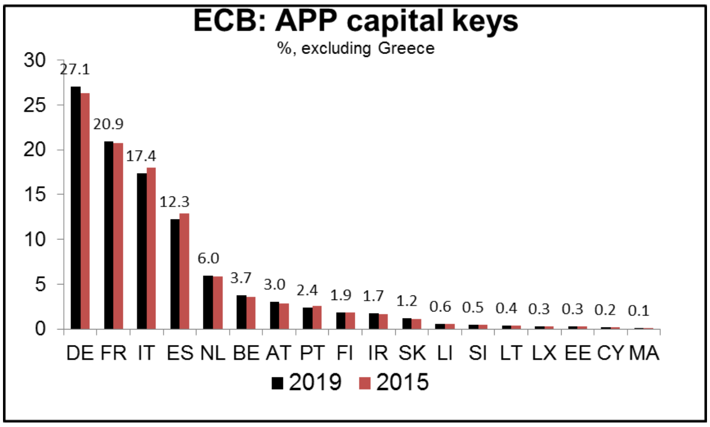
However, since July the ECB has stepped up its tone on growth risks, shifting from "*broadly balanced*" in June to "*still be assessed as broadly balanced*" from July onwards. While a shift to an outright negative tilt of risks is not imminent in our view, we look in any case for reassuring statements emphasizing the path dependence of monetary policy.

End of QE does not mean end of stimulus

Given the ECB's assessment of the macro backdrop as well as latest statements, QE will be terminated in December. That said, Draghi recently reiterated that "*prevailing uncertainties still call for patience, prudence and persistence*" in calibrating the ECB monetary policy. It already committed itself to reinvest the principal payments of maturing securities bought under the APP for an extended period of time after QE. However, the details will have to be outlined at the December meeting. This will offer the ECB the possibility to fine-tune its policy normalization path.

Capital key buying limits to induce flexibility

Country assets under the Public Sector Purchase Program were bought according to capital keys. One of the few pieces of information about reinvestments stated already is that capital keys will "*remain the guiding principle*". However, new capital keys will become effective in January and it is still uncertain whether the new (2019) or the old ones (2015) apply with regard to reinvestments or whether there will be a gradual transition. Applying the old ones would leave the stock of country-purchases constant and not put additional pressure on the BTP market as the Italian share falls by 0.6 pp from 18.0% to 17.4%.



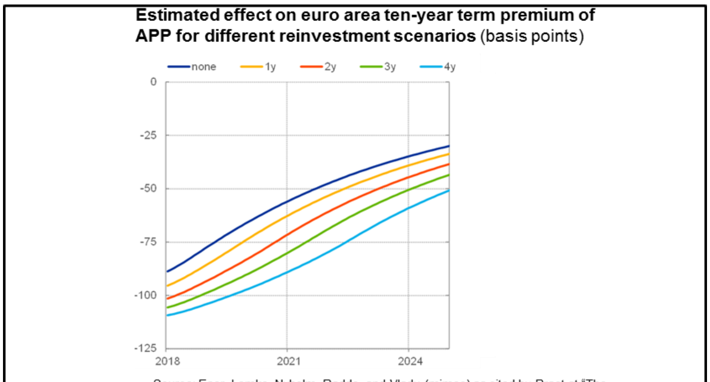
In any case, the 2019 reinvestments will be dominated by German papers. According to estimates, about 35% of the 2019 redemptions will be Bunds, well above even the new (increased) German capital share (27.1%). In order to account for this, the ECB could accept temporary deviations from capital key buying and apply the target share only to the stock at the end of the reinvestment period.

Moreover, we see a non-negligible chance that the ECB will signal some flexibility to shift some proceeds from govies into corporates where the issuer limit is 70% and no capital rules exist, if needed. Any commitment to this seems unlikely just yet, but hints in this direction would help to stabilize corporate bond markets in uncertain times as corporate spreads are currently back to the levels just before the ECB extended QE to corporates in March 2016.

Powerful forward guidance on reinvestments

Without QE the ECB's impact on the long end of the curve and hence its ability to keep the term premium contained becomes weaker. In order to address this issue the ECB could tilt its reinvestments to long-dated bonds. In the past the Fed even decided to switch short dated into long dated maturities ("Operation Twist"). As we have already discussed, such a tilt entails several technical problems, e.g. insufficient availability of very long dated bonds, and could not stop the APP stock from losing maturity.

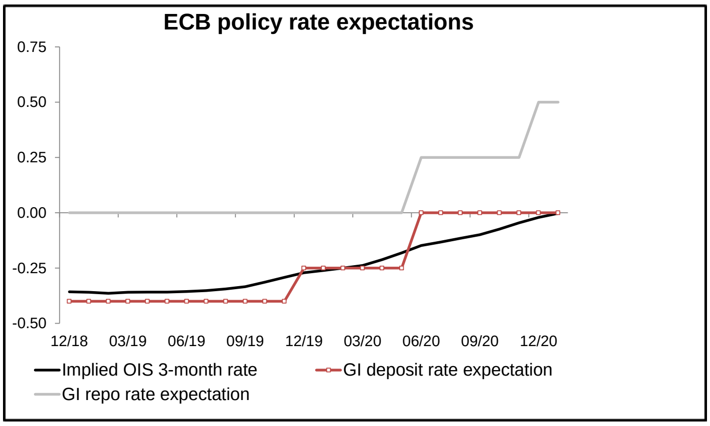
What we deem more likely is something Governing Council members like Praet and Coeuré have discussed in recent speeches, namely forward guidance regarding the reinvestment period to keep the term premium down. Our preliminary estimates assess the APP-induced term premium on 10-year Bunds at currently around -40 bps. According to ECB estimates the dampening effect from APP holdings on the term premium on 10-year bonds even varies from 85 bps (no reinvestments) to 110 bps (a 4-year reinvestment period) in 2018 and in any case becomes weaker as the portfolio matures. We expect a three year period to be announced with an easing bias (e.g., "at least three years" or "as long as warranted in order to achieve our goal …"). This period would be in line with the blueprint from the Fed which ended QE in October 2014 and started to shrink its balance sheet three years later.



Source: Eser, Lemke, Nyholm, Radde, and Vladu (mimeo) as cited by Praet at "The ECB and Its Watchers XIX Conference", FaM, 14 March 2018

First rate hike not before December 2019 likely

Regarding key rates, the ECB has committed itself to leave them "*at their present levels at least through the summer of 2019*". That said, the deterioration of the inflation trajectory, our expectation of euro strengthening (effective trade-weighted euro +2-3% in 2019) and ongoing risks related to activity will likely induce the ECB to maintain this statement while signaling in the accompanying communication that the timing might be delayed further without giving a precise date. As a consequence, we postponed the expected timing of the first (depo) rate hike (by 15 bps) to December 2019, from September 2019 before. Thereby, we are slightly more constructive than markets which see a rate hike by only 9 bps in Dec 19.



Another TLTRO would water down normalization

There are speculations that the ECB could announce a new TLTRO. The rationale is that in June 2019 the remaining maturity of the first TLTRO (53% of all outstanding stock) will fall below one year. As a result, these liabilities no longer count as stable funding for banks when calculating the Net Stable Funding Ratio required (to match at least the required stable funding) under the Basel III regulation. The EBS estimated a shortfall of € 50.9 bn in its March report. In June this gap could increase significantly and cause a cliff edge for total liquidity even in the ECB sticks to its fixed-rate full allotment procedure in repo operations.

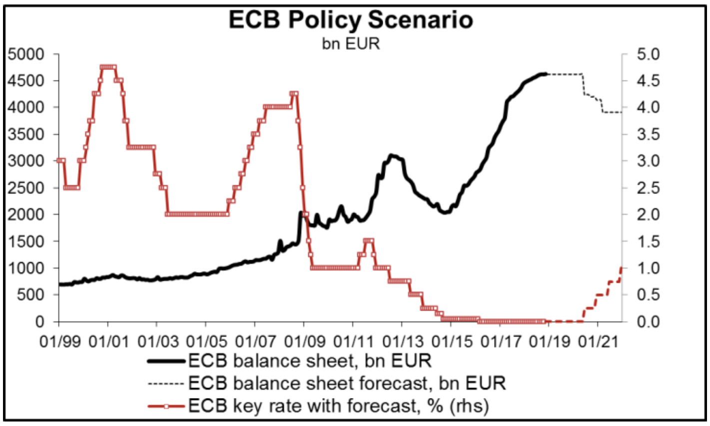
TLTROs: Repayment schedule and expiry dates
bn EUR

Maturity	Allotted amount	Voluntary early repayments Jun-18	Sep-18	Dec-18	…	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Total Re-payments	Outstanding amount
24/06/2020	399.29	11	2.7				END				13.7	**385.59**
30/09/2020	45.27		0.93					END			0.93	**44.34**
16/12/2020	62.16								END		0	**62.16**
24/03/2021	233.47									END	0	**233.47**
Total TLTR	**740.19**	11.00	3.63	0.00	0.00	0.00	0.00	0.00	0.00	0.00	**14.63**	**725.56**

However, a new TLTRO would water down the normalization message and might be politically controversial if mainly Italian or Spanish banks were to take liquidity. Moreover, the end of the TLTRO is long known and individual banks had time to prepare. In line with this view, the net bond issuance by euro area financials which averaged € -9.0 bn over the past two years rose to above € 80 bn in 2018 and is expected to rise slightly further in 2019. After assessing the pros and cons, we do not expect a new TLTRO announcement at the December meeting – but the ECB will probably leave the door open. Further TLTROs – with less favorable conditions than currently – would only be announced next year in our view if activity were to slow significantly further or serious banking sector funding stress emerged.

Conclusions

The ECB has embarked on the normalization path and will continue to proceed on it at the December meeting. With QE ending, the doubling of the ECB's balance sheet since the start of QE comes to an end. It will stabilize in 2019 before starting to shrink in 2020 due to TLTRO repayments – unless the ECB offers an alternative scheme to soften the cliff effect. However, with the negative interest rate policy lasting into 2020 and together with forward guidance on reinvestment policy only a soft normalization is underway. Assuming no new TLTRO, excess liquidity will according to ECB simulations remain fairly stable throughout 2019 before starting to decline sharply in 2020 while still remaining ample by historical standards. This policy approach will likely constitute only a moderate headwind to financial markets.



In our view, the major risk is that ECB will be stuck in a negative or zero interest rate policy stance if the macro data continue to disappoint and rate normalization will have to be stopped. In this scenario new TLTROs could even keep the balance sheet around the current level.

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Sources for charts and tables: Thomson Reuters Datastream, Bloomberg, own calculations

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