ECB EXIT STRATEGY

A FORCED TAPER

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SUMMARY

POLICY NORMALISATION IS SET TO BEGIN

With the economic recovery in the euro area looking increasingly robust and broad-based, the ECB appears set to embark on a policy normalisation path, gradually phasing out of negative interest rate policy (NIRP) and quantitative easing. The ECB's new narrative implies that the era of crisis-fighting unconventional monetary measures is over, as deflation risks have all but disappeared.

QE IS FINITE IN ANY CASE

Another consideration for the ECB is that it is getting closer to the limits of what monetary policy can do within its mandate. Technical constraints (scarcity of bonds to buy in particular countries, notably Germany), will, in our view, force the ECB to end QE in H2 2018 in any case.

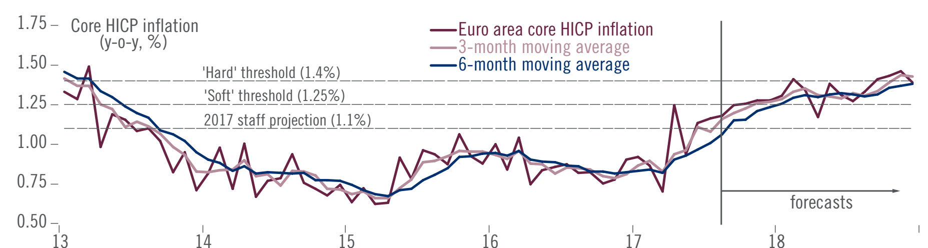
THE ECB WILL SEEK TO AVOID A 'TAPER TANTRUM'

For the Governing Council to try and avoid a 'taper tantrum', any reduction in asset purchases will likely be described not as tapering, but as an "adjustment in parameters" aimed at keeping the monetary policy stance "broadly constant" amid improving economic fundamentals, i.e. in order to keep implied real rates stable when (core) inflation eventually picks up.

SEQUENCING: TAPERING WITH A ONE-OFF RATE HIKE

Our baseline scenario is for the ECB to announce by the end of this year that it will reduce the pace of asset purchases, from EUR60bn to EUR40bn, starting in January 2018, with the aim of winding down the programme completely by the end of 2018. We have long expected a one-off deposit rate hike in 2018, but do not expect a proper rate rate-hiking cycle to start before 2019--and risks are tilted towards an even slower policy normalisation. The EUR's recent appreciation may also complicate the ECB's task.

CHART 1: DEFLATION RISKS HAVE ALL BUT DISAPPEARED



Source: Pictet WM AA&MR, ECB, Thomson Reuters; 31 August 2017.

INVESTMENT CONCLUSIONS

The pace and timing of the ECB's exit from its highly accommodative monetary policies will be a major focus for markets in the coming months. Unless carefully handled, the gradual withdrawal of central bank support is liable to increase anxiety on markets. Our interpretation is that the FX market has started to price in ECB QE tapering to a larger extent than the bond market, which could experience volatility spikes in coming months. Given the robust growth outlook, we remain bullish on European equities, especially domestically-oriented stocks, although we recognise that further EUR strengthening could weight on export-oriented ones. In any case, the risk of increased volatility in markets as central bank support is gradually withdrawn remains consistent with the need to build some degree of protection into our portfolios ahead of policy shifts.

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THE PATH TO NORMALISATION

2017 will likely be remembered as the year when the ECB embarked on a 'normalisation' path, although the jury is still out over what this will mean in practice. It seems fair to expect a very gradual end to the ECB's most emblematic yet unconventional tools: quantitative easing (QE) and negative interest rate policy (NIRP). The way the ECB describes it, any shift in its monetary stance would imply no outright tightening as yet, but a gradual removal of exceptional monetary accommodation that is no longer justified amid a more robust and broad-based recovery. This new narrative implies that the era of crisis-fighting unconventional monetary measures is over, as deflation risks have all but disappeared. In other words, the ECB has gone from President Mario Draghi's famous 2012 "whatever it takes" quote to "it will take less and less".

> The ECB's new narrative implies that the era of crisis-fighting unconventional monetary measures is over.

Although any ECB exit strategy is likely to prove gradual and bumpy–pauses, setbacks and reversals are all possible–this sense of renewed confidence has led to a notable shift relative to previous rhetoric. In late 2015, when QE was already in full swing, Draghi was using more aggressive wording, insisting that the ECB's inflation target should be reached "without undue delay". In his recent speech in Sintra in June 2017, the main messages were "confidence, patience, persistence and prudence", implicitly accepting that the return of inflation to the ECB's 2% target will take longer than expected. Also reflecting this shift, early changes to ECB's communication this year included a hawkish shift in the assessment of the economic outlook (with "balanced" risks to activity for the first time in six years), as well as the removal of the bias for even lower policy rates.

Against this background, Draghi set the stage for the central bank's broader exit strategy:

- First, the ECB is likely to emphasise the importance of the whole package of measures still in place, including negative rates or long-term loans, rather than focusing on asset purchase flows.
- Second, any adjustment to one of these policy tools is likely to be described as a recalibration aimed at keeping the overall monetary stance broadly unchanged as nominal growth improves.

QE IS FINITE: TECHNICAL CONSTRAINTS TO BE HIT IN H2 2018

This is the optimistic take. Taking a step back, another interpretation is that the ECB is getting closer to the limits of what monetary policy can do within its mandate, and that Draghi is desperately trying to pass the baton to national governments and euro area institutions to implement the necessary reforms. From that perspective, the Merkel-Macron duo offers some hope, but patience will be needed.

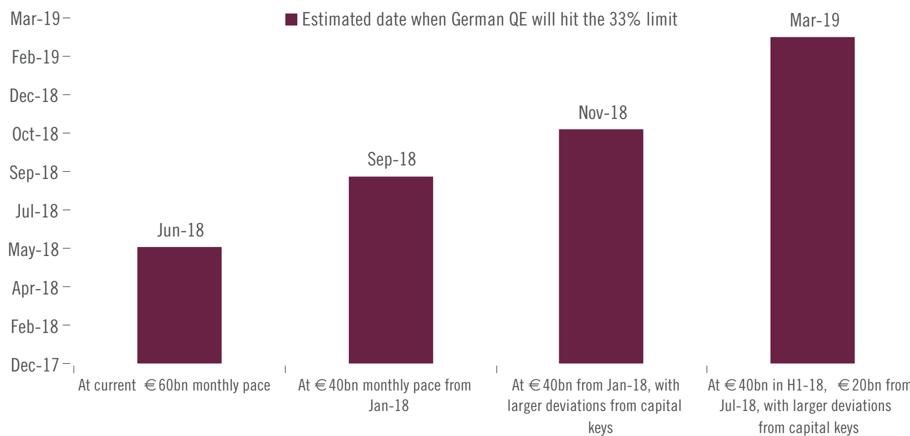
Behind the scenes, another story has been playing out which, in our view, will force the ECB to end QE in 2018 regardless of economic and political developments. Rising scarcity of German government bonds to buy has led the Bundesbank to deviate from capital keys (the ECB's rules for balancing its sovereign bonds purchases across euro area member states based on the relative size of each economy) in the past few months, and we expect this trend to continue until the end of the programme. Indeed our analysis suggests that ECB QE can hardly continue beyond the middle of 2018 without either a reduction in the pace of asset purchases or a more radical change in QE rules (which, in the case of the latter, would be very politically sensitive).

We have long argued that bond scarcity would become a binding constraint on the implementation of ECB QE. The simple reason is the self-imposed rules of QE, especially the breakdown of purchases according to the size of each economy, not the size of national bond markets. The fact that the largest economy (Germany) is also one of the least indebted is at the core of the problem facing the ECB. Smaller countries have also been affected by scarcity constraints, including Portugal, Ireland, Finland and the East European member states, either because the outstanding amount of public debt is too small, or because other ECB bond portfolios like the Securities Market Programme are included in the calculation of issuer limits. In those smaller countries, we expect a slower and more volatile pace of buying to continue, including deviations from capital keys and a reallocation of purchases to other countries in proportion to their size.

> We have long argued that bond scarcity would become a binding constraint on the implementation of ECB QE.

For Germany, we have laid out our methodology to estimate QE limits with the important caveat in mind that the estimates can vary considerably depending on assumptions made about 'known unknowns', including the share of central government debt purchases, their distribution across maturities, their average price, or the legacy bond portfolios. Our best guess is that German QE can run until June 2018 at the current EUR60bn monthly pace, and until Q4 2018 at a reduced EUR30-40bn pace, provided that the ECB increases total deviations from capital keys by an acceptable 5%.

CHART 2: ESTIMATED DATE WHEN GERMAN QE WILL HIT THE 33% LIMIT



Source: Pictet WM AA&MR, ECB, Thomson Reuters; 31 August 2017.

ACCOMPANYING THE RECOVERY

Ultimately, the decision to embark on policy normalisation will be driven by core inflation and wage growth, the latter being highlighted again as a key factor in the ECB's reaction function. The more robust and broad-based economic recovery, and the rapidly falling unemployment rate, should make the ECB confident that the output gap will close at a faster pace, eventually pushing wages and core prices higher.

Earlier this year, Draghi described four inflation criteria that would need to be met for the ECB to tighten. We forecast that only two out of four criteria will be fully met by the end of 2017, yet the ECB is still likely to signal a further 'scaling down' in the monthly pace of asset purchases, starting in January 2018, reflecting the new narrative outlined by Draghi in Sintra. Specifically, our forecast is for euro area core HICP[1] inflation to start to rebound more significantly from Q4 2017 on, ending the year around 1.2-1.3% and edging closer to a peak of around 1.5% in 2018, but probably not much higher.

One important risk is from financial conditions, and currency developments (the recent strengthening of the EUR) in particular, supporting our view that a detailed tapering announcement could be delayed until later this year.

TABLE 1: ECB INFLATION CRITERIA

Inflation criteria	Gauge	Latest	Taper threshold	Estimate date when criteria will be met
Medium termhorizon	Long-term ECB staff projection (headline HICP)	1.60%	1.90%	Dec. 2017
Durable	6-month average of core HICP inflation	1.06%	1.1-1.2%	Dec. 2017
Self-sustained	Long-term staff projection excluding QE effect	1.35%	1.75%	Dec. 2017
Broad-based	Share of countries with HICP inflation>1.5% (forward-looking)	69%	66%	Already met

Source: Pictet WM AA&MR; 31 August 2017.

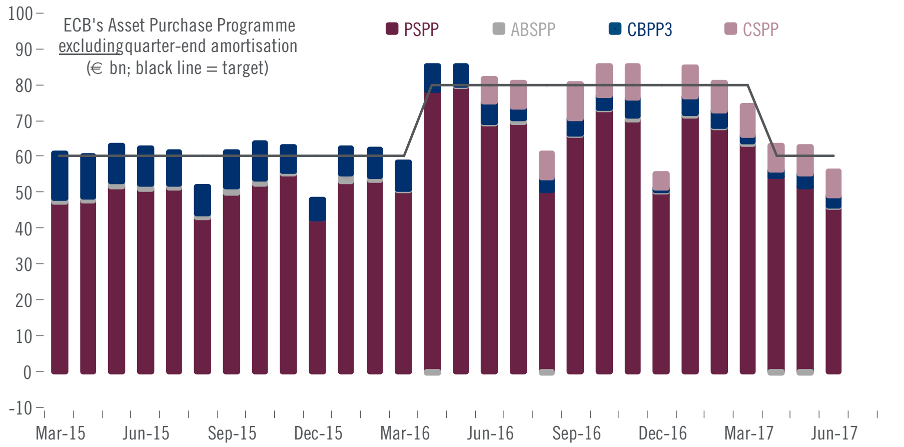
Scaling down is no tapering; tapering is no tightening

For the Governing Council to try and avoid a 'taper tantrum', any reduction in asset purchases will likely be described not as tapering, but as an "adjustment in parameters" aimed at keeping the monetary policy stance "broadly constant" amid improving economic fundamentals, i.e. in order to keep implied real rates stable when (core) inflation eventually picks up. The ECB will aim at avoiding EUR overshooting in the short-term, but also more generally any "unwarranted financial tightening" including a widening of peripheral spreads.

One question that the ECB has never really addressed is whether stock effects are still believed to be more important than flow effects, which would provide the Council with another argument for tapering. This strategy has been reflected in recent comments from ECB officials, as well as in the accounts of the July meeting emphasising the importance of the "overall degree of

[1] *Harmonised Index of Consumer Prices ; inflation across the euro area measured on a unified methodology*

CHART 3: ECB'S ASSET PURCHASE PROGRAMME (EXCLUDING QUARTER-END AMORTISATION; EUR BN).



Source: Pictet WM AA&MR, ECB, Thomson Reuters; 31 August 2017.

accommodation" determined by the "combination of all monetary policy measures" and that "the stock versus flow effects of asset purchases" needed to be considered.

We expect the ECB to announce by year-end that it will reduce the pace of asset purchases.

Our baseline scenario remains unchanged. We expect the ECB to announce by year-end that it will reduce the pace of asset purchases, from EUR60bn to EUR-40bn, starting in January 2018, with the aim of winding down the programme completely by the end of 2018, depending on the inflation trajectory. We have long expected a one-off deposit rate hike in 2018 as a concession to the most hawkish members of the Governing Council.

However, regardless of what the ECB delivers next year, we do not expect a proper rate-hiking cycle to start before 2019--and more generally we continue to see risks tilted towards an even slower policy normalisation. The EUR's recent appreciation may also complicate the ECB's task. As a result, and given the technical constraints on QE, o more unconventional exit options are possible.

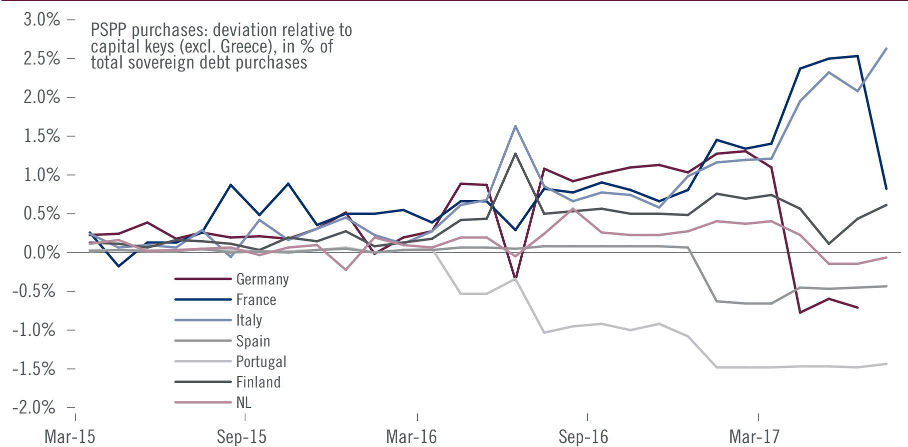
Fifty shades of tapering

The fact that a large consensus has built around QE tapering in 2018 does not rule out surprises. The ECB could follow a pre-defined timetable aimed at winding down QE step-by-step, or it could reassess the situation every three to six months, depending on progress towards inflation criteria. The emphasis on flexibility suggests to us that the ECB will lean towards the latter strategy.

Meanwhile, the ECB could adjust the composition of asset purchases in the tapering process. For instance, the share of corporate bonds purchases under the CSPP[2] programme could be increased and/or the issuer share limits for supranational bonds could be raised. Those changes would help mitigate the scarcity constraints on the margins in the event that QE has to continue for longer than expected.

Other 'taper sweeteners' are also likely to play a role in the exit strategy, starting with the reinvestments of maturing bonds, which the ECB committed to for "as long as necessary". We estimate that reinvestments are likely to peak at around EUR10bn on average per month over 2018-19, helping to mitigate the reduction in net asset purchases.

CHART 4: PSPP PURCHASES, DEVIATION RELATIVE TO CAPITAL KEYS (EXCL. GREECE; % OF TOTAL SOVEREIGN DEBT PURCHASES).



Source: Pictet WM AA&MR, ECB, Thomson Reuters; 31 August 2017.

[2] *Corporate Sector Purchase Programme; the ECB's corporate bond-buying programme*

Finally, if core inflation fails to rise, the ECB could make yet further changes to QE rules to allow the programme to run for a little longer. Assuming issuer limits for sovereign bonds cannot be raised and capital keys stay, we believe that the natural move for the ECB would be to do the same for Germany as it did for small countries –in other words, reallocate asset purchases that cannot be achieved to countries where there are enough bonds to buy, using the programme's flexibility in full. The result would be greater deviation from capital keys in countries like Italy and France, but at least on paper the broad framework would remain unchanged. Once QE reduction has been announced, it should be less politically sensitive to make further technical changes to the programme's rules, provided that an end is in sight. •

SEQUENCING: WHY A ONE-OFF DEPOSIT RATE HIKE STILL MAKES SENSE

We have highlighted the merits of a one-off hike in the ECB's deposit rate (see *Flash Note*, 21 March 2017, "ECB: escape the (NIRP) room"), which in our view would help the banking sector while providing a cheap concession to the hawks, if not a trade-off against slower tapering.

The longer QE lasts, the closer the banking sector is likely to move to a 'pain threshold' where negative rates can hurt bank profitability and credit supply. So far, though, consolidated banking data from the ECB have not shown a large drag on banks' net interest income, as other factors have offset the impact of negative rates. We suspect that it will take time before the ECB acknowledges that rising side-effects of negative rates have to be mitigated, which is a necessary step before a formal change in communication can be agreed.

Draghi and ECB Chief Economist Peter Praet have so far been among the fiercest defenders of the current guidance and exit sequencing. This is not only about the distinction between doves and hawks, but more about their vision of what forward guidance is supposed to achieve. In this regard, ECB board member Benoît Coeuré can be put in the 'Delphic' camp, as opposed to an 'Odyssean' approach. The idea is that part of the forward guidance is structural, hence stable and binding, largely relating to the central bank's reaction function and mandate (the 'Odyssean' part). Other elements of the guidance (the 'Delphic' part) merely reflect the central bank's perception of economic conditions. In other words, when facts change, the central bank needs to change its forward guidance.

Our baseline is for the ECB to deliver a 15bp, one-off hike in the deposit rate with risks tilted towards a later move. Either way, the ECB is likely to stress that its main refinancing policy rate, currently at 0%, is still likely to remain low for an extended period of time.

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