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Flash Note

Euro area: 2018 ECB outlook

Mission: possible

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In 2018, we expect the ECB to 'talk the talk', adjusting its communication as the outlook for inflation improves, but not to 'walk the walk', as it sticks with the current exit sequencing, tapering its asset purchases from Q3 2018 before hiking rates by Q3 2019.

While turning more hawkish, we expect the ECB to stick with the guiding principles that have shaped its recent decisions. It will be "accompanying" the economic expansion by "recalibrating" all dimensions of its monetary stance. And, of course, it will remain true to its current mantra of "Confidence, Patience, Persistence, Prudence"

Our baseline scenario remains for the ECB to terminate QE by early 2019 and to deliver a first rate hike in Q3 2019, with risks tilted towards an earlier move

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Our first choice as the title for our 2018 ECB outlook was "*The courage not to act*", but regular readers will know that we used this *hommage* to Ben Bernanke earlier this year. Yet our faith in ECB's courage knows no bounds and this still feels relevant today, with the caveat that the ECB *will* act in 2018, announcing a tapering of its asset purchase programme in the summer, in our view—but **not overreacting to strong economic data**. In this note we answer the ten most frequent questions about our scenario for ECB policy, which we outlined after the 26 October meeting ("Bend it like Draghi").

Q1. What is your baseline scenario for the ECB in 2018? What is the biggest risk relative to market pricing?

Our baseline scenario is that the ECB 'talks the talk' in 2018, adjusting its communication in a more hawkish way as the outlook for inflation improves, **but does not 'walk the walk',** as it sticks with the current exit sequencing, terminating asset purchases by early 2019 before hiking rates by Q3 2019. Specifically, we expect the ECB to prepare markets in June 2018 for a tapering decision which could be made in July and implemented in Q4 2018 (see Q3). As regards policy rates, we expect the ECB's first move to be a 20bp hike in the deposit facility rate (from -0.40% to -0.20%) in tandem with a 5bp hike in the main refinancing rate (from 0% to 0.05%), effectively bringing back a symmetrical 25bp rates corridor that prevailed before QE.

We expect communication to become increasingly hawkish well before the ECB makes new policy decisions (see Q6). Financial market have started to price in a faster QE tapering recently, but the expected pace of monetary tightening remains benign, with a first 25bp rate hike fully priced in by end-2019, and only modest hikes of about 25bp of rate per year beyond that.

Given our constructive outlook for euro area GDP growth and inflation (see "Escape velocity"; 6 December 2017), **the main risk is that markets front-run monetary tightening** if the ECB is perceived as being too far behind the curve, leading to a squeeze in short-term rates. However, too sharp a re-pricing would eventually force the ECB to become more cautious again.

Q2. How will QE composition change in 2018?

As we highlighted a few months ago and was implicitly confirmed during the October press conference, the recalibration of QE, to EUR30bn per month from January 2018, is likely to come at the expense of sovereign bonds while the ECB expects private bonds purchases to remain "sizeable".

Such a vague wording amounts to classic ambiguity on the ECB's side, aimed at keeping sufficient flexibility in terms of QE implementation, depending on liquidity conditions. Moreover, CSPP started 14 months later than public QE, in June 2016, while the related transmission channels are arguably more important to the real economy. We suspect that an additional reason for the greater emphasis on CSPP, notwithstanding liquidity distortions, is that **larger corporate bond purchases will help mitigate sovereign bond scarcity to some extent**.

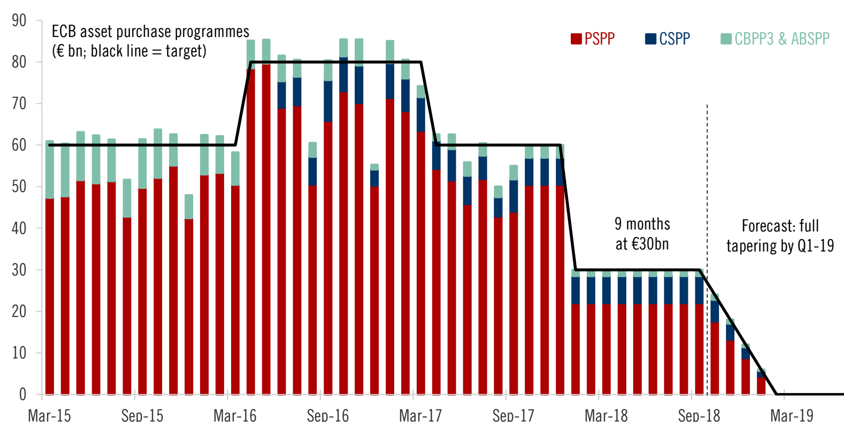
In the end, we expect the bulk of ECB QE rescaling to fall on sovereign bond purchases, implying **a reduction of PSPP from EUR50bn to EUR22bn in 2018**, while **CSPP would decline from EUR7bn to EUR6bn** per month, on average. If inflation disappoints and the ECB needs to buy more, our estimates suggest that **QE could run until June 2019 under this new composition**, using the maximum flexibility embedded in the programme (see "ECB QE composition" for our detailed analysis of bond scarcity).

Q3. How is QE likely to end?

We expect the ECB to prepare markets for the end of QE by discussing tapering in Q2 2018. A decision would then be made a few months ahead of the September 2018 deadline, most likely in June or in July.

Our baseline projection is for tapering to be gradual, with **the ECB reducing monthly purchases from EUR30bn to zero within three to six months**, testing market reaction and keeping its options open in the event of an unwarranted tightening of financial conditions. Either way, residual sovereign bond purchases would be cut to a tiny portion of the EUR30bn in Q4 2018 and Q1 2019.

Chart 1: ECB asset purchases including our projections for QE tapering



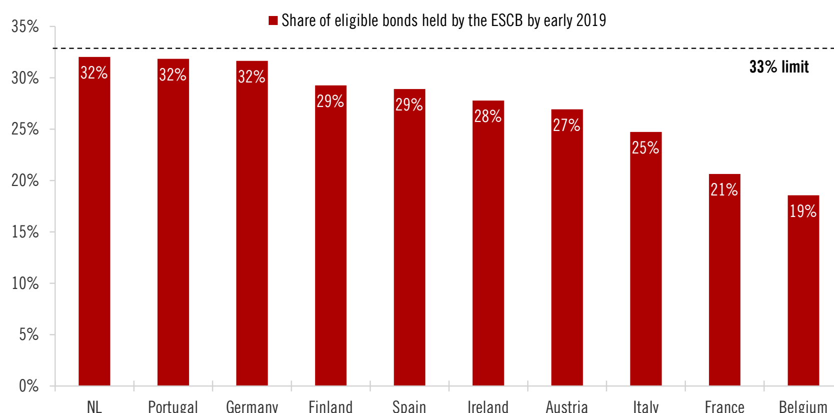
Source: Pictet WM – AA&MR, ECB

Q4. What share of sovereign bonds is the ECB likely to hold when QE ends?

The scarcity of sovereign bonds due to the self-imposed technical constraints on QE has long been overstated, including because the Eurosystem has been buying core bonds at a high price on average while purchasing larger-than-expected amounts of agency and muni debt securities, in our view. Now, slowly but surely, **the ECB will be approaching the 33% limit** on some specific bonds as well as on some issuers (member states) as a whole, as shown in the chart below.

Unless net debt issuance rises in excess of ECB's net asset purchases, there is no escaping the rise in ECB's holdings of sovereign bonds. In some specific cases, additional room for ECB purchases could emerge when legacy ANFA and SMP bond holdings mature, but the amounts will likely remain limited overall.

Chart 2: Estimated share of ECB's sovereign bond holdings by early 2019



Source: Pictet WM – AA&MR, ECB, Bloomberg

Q5. How long will the ECB continue its reinvestment policy?

The ECB has reaffirmed its commitment "to reinvest the principal payments from maturing securities purchased under the APP for an extended period of time after the end of its net asset purchases, and in any case for as long as necessary".

The ECB's reinvestment strategy is both the least controversial part of its arsenal at present, and also the most important one underpinning its future tapering decision. The large stock of assets on the Eurosystem's balance sheet is expected to contribute to maintaining an appropriate monetary stance when the flows of purchases are reduced further and eventually terminated. ECB officials have become more explicitly focused on the stock effect of QE, even though the ECB's official assessment of stock versus flow effects has always remained vague.

We do not expect the ECB to change its guidance on reinvestment in 2018. There would be no obvious reward, only risks, in adjusting the current strategy. Only when the ECB edges closer to the first rate hike will it likely open this debate, in our view. Our best guess is that the ECB could hint at a gradual reduction in its balance sheet – a Fed-like 'runoff' letting the portfolio mature gradually – from late 2020, or even 2021. Meanwhile reinvestments

are expected to increase to around EUR10bn per month on average in 2018, up to EUR15bn in 2019-20.

On a separate note, the ECB's balance sheet will likely shrink modestly in June 2018, when the first window for voluntary repayments opens for the first TLTRO-II (Targeted Longer-Term Refinancing Operations), followed by three others each quarter between September 2018 and March 2019. However, early TLTRO repayments are unlikely to be large enough to fully offset the increase in net asset purchases.

Q6. How will the ECB adjust its forward guidance and its broader communication in 2018?

2017 was the year when the ECB introduced its "Confidence, Patience, Persistence, Prudence" leitmotiv. We expect 2018 to be the year when it implements the strategy described by ECB President Mario Draghi in Sintra in June 2017, which he called "accompanying the recovery".

To be sure, **the ECB will remain prudent and highly dependent on inflation data, including (super) core inflation, wage growth, and (broad) unemployment**. The incremental hawkish changes we expect to the ECB's communication are summarised in the table below, consistent with our view that economic growth peaked in 2017 but will remain robust and of better quality in 2018, while cyclical inflation will rebound in H1 2018.

Table: ECB's communication and potential changes in 2018

ECB guidance	Current (Dec-17)	Expected changes in 2018 (*)
Monetary stance	"An ample degree of monetary stimulus remains necessary."	Towards a more neutral stance, e.g. "The ECB will maintain an appropriate monetary stance throughout the current economic expansion."
Policy rates	"Policy rates to remain at their present levels for an extended period of time, and well past the horizon of our net asset purchases."	Adjustments to "well past" and "extended" by mid-2018, with a growing focus on the pace of rate hikes in 2019, depending on inflation.
QE guidance	QE to continue "in any case until the Governing Council sees a sustained adjustment in the path of inflation".	De-linking with the inflation outlook using a reference to the broader monetary stance, including policy rates.
QE bias	"The Governing Council stands ready to increase the APP in terms of size and/or duration."	Optionality to be dropped by March 2018, although the ECB will stand ready to respond to any unwarranted tightening of financial conditions.
Reinvestment	Reinvestments to continue "for an extended period of time after the end of net asset purchases, and in any case for as long as necessary".	No change in 2018
Balance of risks: growth	"Risks surrounding the euro area growth outlook remain broadly balanced."	"Upside risks to the euro area growth outlook are building."
Balance of risks: inflation	no explicit balance of risks	"Risks to the euro area inflation outlook has started to become more balanced."

Source: Pictet WM – AA&MR, ECB (gradual, incremental communications changes are likely in most cases)*

Source: Pictet WM – AA&MR, ECB

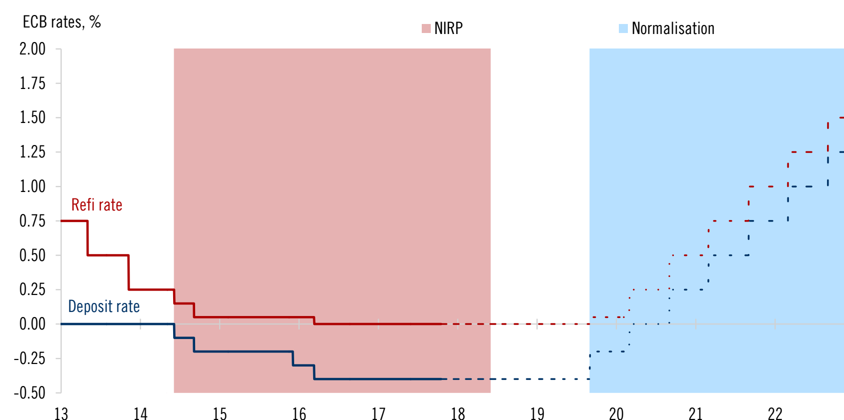
Q7. Once the ECB starts hiking rates, what will the tightening cycle look like?

We have long been forecasting **a first hike in the ECB's main refinancing rate in September 2019** ("refi", currently at 0%) – one month before Draghi leaves office – with risks tilted towards an earlier move. This forecast assumes that "well past" implies a period of at least six months after the end of net asset purchases. However, in 2017 we dropped our call for a one-off increase in the ECB's deposit facility rate (DFR, currently at -0.40%), because the conditions for such a decision did not materialise. In particular, the ECB continues to see the positive effects of its negative rate policy outweighing

the side-effects on bank profitability. This could still change in 2018, although we acknowledge that **a DFR hike will be very difficult to engineer from a communication perspective**, unless the EUR depreciate significantly.

As a first step, we expect the ECB to move back to the symmetrical 25bp rate corridor that prevailed before QE, hiking the deposit facility rate to -0.20% (from -0.40% currently) and the main refinancing rate to 0.05% (from 0%). Thereafter, we envisage a slightly faster pace of tightening relative to market pricing, including *at least* 50bp of cumulative rate hikes each year between 2020 and 2022, up to a terminal rate of slightly below 2%.

Chart 3: ECB policy rates including our projections



Source: Pictet WM – AA&MR, ECB

Ahead of this normalisation process, the ECB's forward guidance will likely be changed by mid-2018, first noting that the Governing Council expects the key ECB interest rates to remain "at their present levels", no longer "for an extended period of time" and possibly no longer "well past" the end of net asset purchases, before rate hikes are first discussed in late 2018, or early 2019.

Q8. When will the next Vice-President and President be named, and who are the likely candidates?

The race for the ECB Presidency has not officially started, but the guessing game has. Germany is likely to deploy a lot of political capital to push for its candidate to succeed Mario Draghi in November 2019. Our understanding is that French President Emmanuel Macron will at least try to push for alternative candidates. Meanwhile Madrid looks set to lobby for a Spanish candidate to join the Executive Board and succeed Vitor Constancio as ECB Vice-President in June 2018. This would further increase the chances of the next President coming from a core country, starting with Germany.

The truth is, there are not so many candidates who could tick all the boxes, and a compromise will have to be found. **Our money is still on Jens Weidmann**, the current Bundesbank President. We think he would make a great ECB President, probably a much more pragmatic one than many fear. However, the race is still wide open and it could be someone else, including one of our favourite candidates, Hélène Rey, Professor of Economics at the London Business School.

Q9. What would be the ECB's response if core inflation fails to pick up? What if there were a recession, or another financial crisis?

Those two questions are among the most frequent ones asked by investors in recent months, and rightly so. **Our short answer: it would be complicated, but initially 'more of the same'.** Specifically, the ECB would likely respond to inflation disappointments or to non-systemic financial shocks by extending QE at an even slower pace of, say, EUR10-20bn, which would be possible under a new composition tilted towards corporate bonds purchases. The main argument would remain that **a longer QE extension would mechanically push the timing of the first rate** hike until "well past" then end of net asset purchases, i.e. with a time lag of six to nine months, supporting a flattening of the yield curve and a further compression of the term premium. There is no guarantee, however, that this would be enough to ease financial conditions to the point where growth and inflation would respond.

In a second step and/or **in the event of a larger adverse shock, the ECB would have to break yet another taboo**. A first option would be to abandon the capital keys driving the allocation of PSPP, or at least to allow for much larger deviations from capital keys in order to avoid hitting the issuer limits in several large jurisdictions including Germany – a legal red line. This would allow for a longer QE extension, or even an increase in the size of asset purchases at the benefit of the most indebted countries including Italy.

A second option would involve the extension of QE to new asset classes, starting with investment-grade bank debt and/or equity ETFs. There again, we are not sure about the cost-benefit analysis given the relatively limited amounts of eligible securities to buy and the questionable transmission channels to inflation.

Last but not least, a systemic crisis would call for new crisis-fighting tools. **Thinking out-of-the-box, our preference has long been for helicopter-like Long-Term Refinancing Operations (LTRO) with a very long maturity and very low (negative) rate**, under the condition that banks pass on favourable lending terms to their clients in the form of new loans. The problem is, if it comes to these extremes, we might well be doomed anyway.

Q10. Will Greece be included in QE before the end of the programme?

The decision on Greece rests with the ECB, which reintroduced the waiver on Greek sovereign bonds in June 2016 while making it clear that a positive conclusion to the third review of Greece's (third) bailout programme was a necessary (but not sufficient) condition for Greek bonds to become eligible for QE. In all likelihood, the ECB will be waiting for soft debt restructuring measures to be implemented in order for public debt to become more sustainable, and for Greece to access debt markets in a more consistent way. Even if those conditions are met at some point in 2018, QE will be close to the end and public debt purchases from the National Bank of Greece are likely to remain very limited at best.

Either way, Greece's eligibility to ECB QE would make less of a different than one or two years ago. True, it could still support lower yields on Greek sovereign bonds especially as the ECB will retain some degree of flexibility as regards the reinvestment of Greek bonds – assuming it does buy some of them before the end of net asset purchases.

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