

Flash Note

Euro area – ECB preview

Guide me if you can!

Pictet Wealth Management - Asset Allocation & Macro Research | 19 January 2018

We expect no policy decision and no major change in the ECB's communication at its 25 January meeting. There is no incentive for the ECB to fuel further hawkish market re-pricing at this stage, especially after core inflation disappointed again and the EUR has strengthened. The only small change we see as possible is the removal of the optionality in terms of QE "size".

Ultimately, the ECB's forward guidance and policy decisions continue to be driven by core inflation. The risk is that more patience is needed before the ECB see a "sustained adjustment" in inflation and wages.

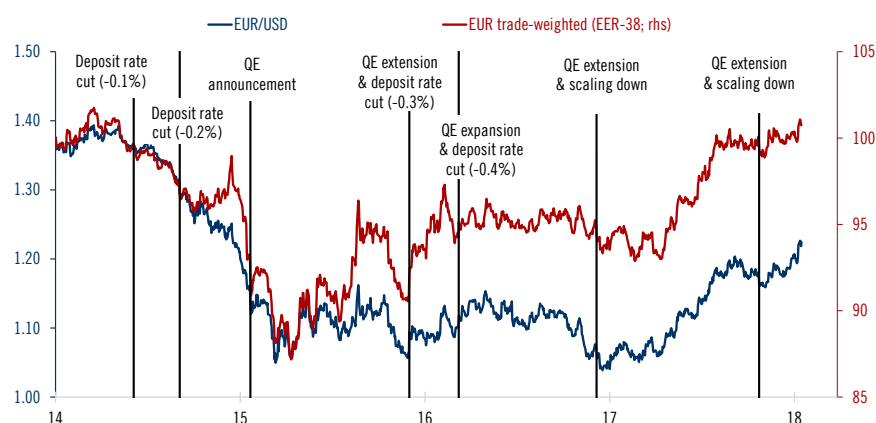
We expect a transition in forward guidance from QE to policy rates in March, followed by a tapering announcement in June or in July. Once Italian elections are out of the way, and assuming limited further EUR appreciation, risks could again shift towards a more hawkish ECB in the spring.

The accounts of the ECB's December meeting have triggered another leg of market re-pricing amid concerns over hawkish communication changes "early this year". Such changes look all but inevitable, as we wrote in our [2018 outlook](#), but we see little incentive for the ECB to precipitate things at the beginning of the year, especially after core inflation disappointed again. Given recent EUR strength, the path of least resistance is for **Mario Draghi to push back against the idea of "early changes"** during the press conference on 25 January, instead hinting at "gradual changes" to the ECB's forward guidance. Crucially, **the exit sequencing should be reinforced**, implying that policy rates will not rise until "well after" the end of net asset purchases.

It would make sense for the ECB to abandon its option to increase asset purchases "in terms of size", but even that change could be postponed until March. Our baseline scenario foresees **a transition in forward guidance from net asset purchases to policy rates in March**, implying a 'de-linking' between QE and the inflation outlook. Looking ahead, we forecast a formal tapering announcement by the summer, and gradual hawkish changes to the ECB's guidance on policy rates in H2 2018.

As regards FX moves, ultimately we expect the ECB to stick with its positive, 'glass half-full' interpretation from 2017 as stronger growth is expected to offset the disinflationary effects of a stronger currency. But, recent EUR strength is "not helping", to quote ECB governor Ewald Nowotny, coming after a 7% appreciation in trade-weighted terms in 2017, adding to the reasons for Draghi to sound cautious at next week's press conference.

Chart 1: ECB decisions and the EUR



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

AUTHOR

Frederik DUCROZET
fducrozet@pictet.com
+41 58 323 4582

Pictet Group
Route des Acacias 60
CH - 1211 Geneva 73
www.pictet.com

Higher volatility could well be the price to pay for gradual changes in communication if markets continue to front-run the ECB. The table below shows a possible timeline for upcoming changes in ECB's forward guidance, including a 'de-linking' between QE and inflation in March and a tapering announcement in June or in July. Draghi is likely to prepare the market next week for such changes to happen in the course of this year.

Table: possible timeline of ECB's communication changes

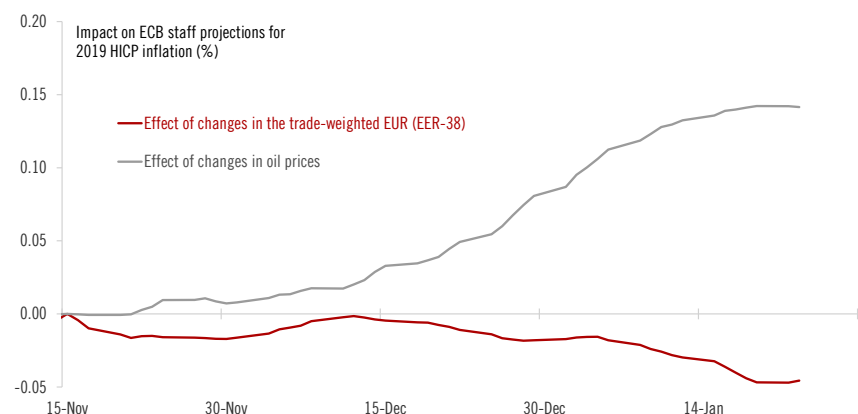
Q1 2018	Q2 2018	Q3 2018	Q4 2018	2019
25 Jan: remove the option to increase QE "in terms of size" (no more optionality by March)	26 Apr: no change	26 Jul: technical details on QE tapering	More guidance on policy rates: - "extended period of time" removed - "well past" adjusted - conditionality (first hike) - modalities (rates corridor)	H1: focus on the pace of rate hikes, liquidity framework and reinvestment policy
8 Mar: transition from forward guidance on QE ('de-linking') to broader policy stance (rates)	14 Jun: taper announcement with the goal to end net asset purchases by Dec-18 or Q1-19	13 Sep: adjust rates guidance but keep exit sequencing		H2: first rate hike no later than Sep-19 +20bp in the deposit rate, to -0.20% +5bp in the refinancing rate, to 0.05%

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

We see risks tilted towards a more cautious ECB in the very near term due to subdued core inflation and the stronger EUR. However, once the Italian elections (4 March) are out of the way, and assuming even a modest rebound in core inflation, the ECB will likely shift more rapidly towards a neutral policy stance. Our impression is that not only are the hawks growing impatient, but a broader group within the Governing Council sees further adjustments to the ECB's forward guidance as warranted.

In our view, **a more hawkish ECB would shift the focus on the pace of rate hikes in 2019** and beyond, once the normalisation process has started. For the record, our scenario remains for the ECB to terminate QE by early 2019 and to deliver a first rate hike no later than in September 2019.

Chart 2: impact on inflation of changes in oil prices and the EUR since December



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

The other talking points ahead of next week's press conference include rising oil prices, political developments and wage negotiations in Germany, Greece's bailout review, or the US tax reform, all of which have the potential to add to the bullish case for euro area inflation later this year. But the ECB will likely start this year like it ended the previous one, sounding confident, but also "patient, persistent and prudent".

Notice: This marketing communication is not intended for persons who are citizens of, domiciled or resident in, or entities registered in a country or a jurisdiction in which its distribution, publication, provision or use would violate current laws and regulations.

The information, data and analysis furnished in this document are disclosed for information purposes only. They do not amount to any type of recommendation, either general or tailored to the personal circumstances of any person. Unless specifically stated otherwise, all price information is indicative only. No entity of the Pictet Group may be held liable for them, nor do they constitute an offer or an invitation to buy, sell or subscribe to securities or other financial instruments. The information contained herein is the result neither of financial analysis within the meaning of the Swiss Bankers Association's Directives on the Independence of Financial Research, nor of investment research for the purposes of the relevant EU MiFID provisions. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness.

Except for any obligations that any entity of the Pictet Group might have towards the addressee, the addressee should consider the suitability of the transaction to individual objectives and independently assess, with a professional advisor, the specific financial risks as well as legal, regulatory, credit, tax and accounting consequences.

Furthermore, the information, opinions and estimates in this document reflect an evaluation as of the date of initial publication and may be changed without notice. The Pictet Group is not under any obligation to update or keep current the information contained herein. In case this document refers to the value and income of one or more securities or financial instruments, it is based on rates from the customary sources of financial information that may fluctuate. The market value of financial instruments may vary on the basis of economic, financial or political changes, currency fluctuations, the remaining term, market conditions, the volatility and solvency of the issuer or the benchmark issuer. Some investments may not be readily realizable since the market in the securities can be illiquid. Moreover, exchange rates may have a positive or negative effect on the value, the price or the income of the securities or the related investments mentioned in this document. When investing in emerging countries, please note that the political and economic situation in those countries is significantly less stable than in industrialized countries. They are much more exposed to the risks of rapid political change and economic setbacks.

Past performance must not be considered an indicator or guarantee of future performance, and the addressees of this document are fully responsible for any investments they make. No express or implied warranty is given as to future performance. Moreover, forecasts are not a reliable indicator of future performance.

The content of this document can only be read and/or used by its addressee. The Pictet Group is not liable for the use, transmission or exploitation of the content of this document. Therefore, any form of reproduction, copying, disclosure, modification and/or publication of the content is under the sole liability of the addressee of this document, and no liability whatsoever will be incurred by the Pictet Group. The addressee of this document agrees to comply with the applicable laws and regulations in the jurisdictions where they use the information reproduced in this document.

This document is issued by Banque Pictet & Cie SA. This publication and its content may be cited provided that the source is indicated. All rights reserved. Copyright 2018.

Banque Pictet & Cie SA is established in Switzerland, exclusively licensed under Swiss Law and therefore subject to the supervision of the Swiss Financial Market Supervisory Authority (FINMA). Distributors: Banque Pictet & Cie SA, Pictet & Cie (Europe) SA