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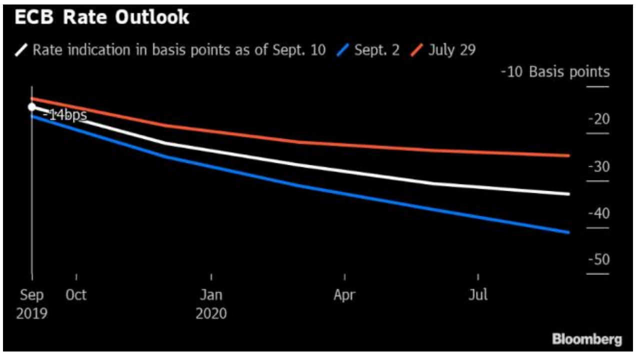
ECB meeting preview – Draghi will not hesitate to fire the last shots of his bazooka

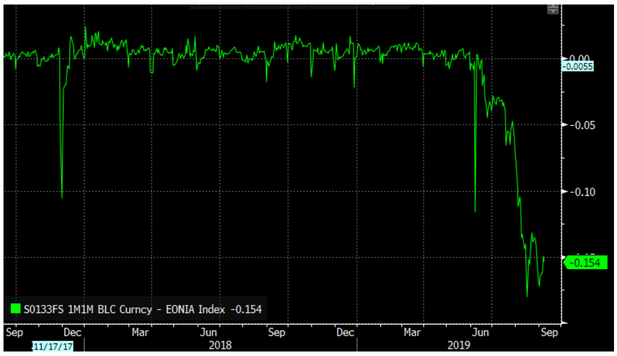
The long-awaited and key pivotal ECB meeting is fast-approaching and the market recently became more hesitant about the prospect of seeing another meaningful round of Draghi`s monetary "bazooka". After a strong rally in the last months European yields are correcting higher in the last one week as **investors intensified the profit taking and squaring of positions ahead of the meeting.**

While the correction itself is still not very impressive – around 20bps in 10y Bund yield from top to bottom, smaller move than the one during the risk relief rally in early July - it could easily get much worse if Draghi indeed disappoints with the announced package. However, **in this Note we outline the strong case for ECB to act quickly and boldly on this meeting.**

Current market expectations

Regarding rates, **the market is currently pricing around 15bps cut from ECB** (50/50 chance for a 10 or 20 bps cut), down from around 17bps last week (right graph). Left graph shows that another around 20bps of cuts are priced-in in the next one year:





Bloomberg survey of 29 economists concluded last week shows the following consensus estimates, which are widely accepted (and priced) by the market at the moment:

- A 10bps cut in the deposit rate to -0.50%
- QE of EUR30bn per month for 12 months of assets purchases, starting from January-2020
- Tiering that excepts 30% of the banks` excess liquidity from the deposit facility

The last tool from the ECB package – the forward guidance – is perceived as less interesting at the moment given the importance of the other three measures.

Possible market reactions

As usual, the devil would be in the details and these would largely define the market reaction to any ECB announcement. Here is a brief review of the most probable reactions:

1) **10 or 20bps?** Given the split market expectations (-15bps pricing), it`s easy to conclude that 10bps would be a slightly hawkish outcome and 20bps a slightly dovish one.

2) **Tiering of excess reserves**: looks as a done deal with little opposition among ECB members. Any negative surprise would be especially harmful for banks which already hold EUR 1.77trl of excess reserves at ECB, **costing them EUR 7bn per year** at the current negative rate of -0.40%. QE of 30bn per month will raise that excess liquidity to 2.13trl in a year, which combined with a further 10bps cut in the deposit rate will penalize the banking sector with **further EUR 3.65bn per year** (+50%). If ECB excepts 30% of the excess liquidity (as expected), then the charge to the banking system remains almost unchanged – EUR 7.5bn per year. **Removing the 10bps margin from TLTRO3 could be an additional positive factor for European banks.**

3) Asset Purchases Program (APP)

➔ <u>positive factors</u>: open-ended program, 40bn size, raising issue limit to 50% from 33% (adding credibility to the program and allowing it to continue to up to three years)
➔ <u>negative</u>: anything less than 30bn per month, no change of limits (some are likely to be reached in one-year time), later starting date than 1-Jan-2020 or announced just as a contingency plan.
➔ <u>mixed</u>: if APP size is tilted to Public Sector Purchase Program (PSPP, positive for sovereigns, negative for credit) or Corporate Sector Purchase Program (CSPP, opposite effects).

4) Yield Curve Control – this Japanese-style measure is likely to be accepted with mixed feelings by bond investors, depending on their duration and curve positioning;

5) Other possible measures - at least for this meeting any of the "more exotic" options like including financial bonds or equities to the APP (largely market positive) are off the table.

<u>The strong case for ECB delivering a generous package and not disappointing the markets</u>

"Inflation expectations now have been at historical lows for some time. We don't like this."
"if the medium-term inflation outlook continues to fall short of our aim, the Governing Council is determined to act."
ECB President Mario Draghi, ECB Press conference, 25 July 2019

1. **Solid commitment to act by both Draghi (above) and Lagarde –** the latter clearly signaled that she`ll follow the steps of her predecessor by pledging to act with "agility" to the monetary policy challenges. (September 4, 2019, European Parliament)

2. **Inflation expectations at historical lows –** 5y/5y EUR inflation swap forward on the graph.

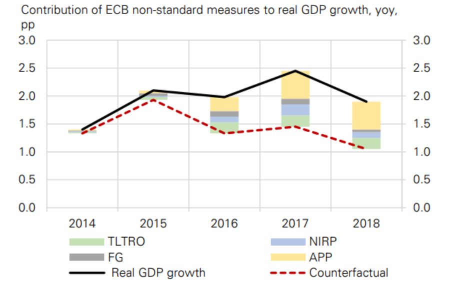
Given the above two factors, if ECB is not convincing enough in its determination to act, it risks losing its credibility and commitment to the inflation target. If QE is not implemented at this moment, it would be perceived as an instrument used for fighting deflationary threats only (as in 2015/16), rather than as a useful tool for achieving the inflation target. This could have a largely negative impact on markets` belief in ECB.

3. **The great dilemma of C-banks with increasingly limited toolbox** – when your arsenal is depleting rapidly, you have only two choices - to act pre-emptively in order to avoid a disaster or keeping your powder dry for the darker days. Gradual adjustment is a luxury that many C-banks cannot afford anymore and history tell us that they usually opt for the "safer" first choice.

4. **The change of guard** – it is understandable if "Super Mario" and the "Saviour of the Euro" wishes to leave the scene on a high note. This could be his last chance to cement his legacy without being accused of setting up the monetary policy for his successor - his last meeting as ECB president is scheduled for 24th of October, or just one week before Lagarde will officially step in.

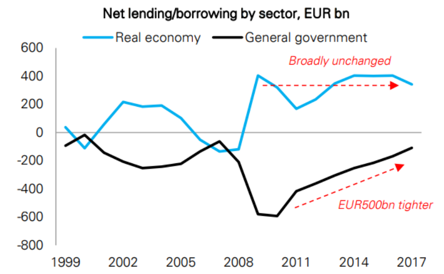
5. **Hawkish comments by ECB "rebels" should be disregarded** – a) Draghi faced even more opposition within ECB when launching the first APP and then CSPP; b) it could be intended communication aiming at tampering down the excessively dovish market expectations; c) they appeared only after the race for next ECB governor was over; d) one of them is a non-voting member on this meeting - François Villeroy de Galhau (Governor, Banque de France).

6. **APP is the most effective tool in the box at the zero/negative bound –** Draghi and ECB have persistently argued that asset purchases are the most effective tool in reviving inflation expectations at the (negative) lower bound and including this tool in previous packages had a significant impact on realized inflation (+0.5pp in 2018, the chart below). According to the ECB's own calculations, meeting the inflation target in the medium term could require another EUR 1.3tn in balance-sheet expansion.



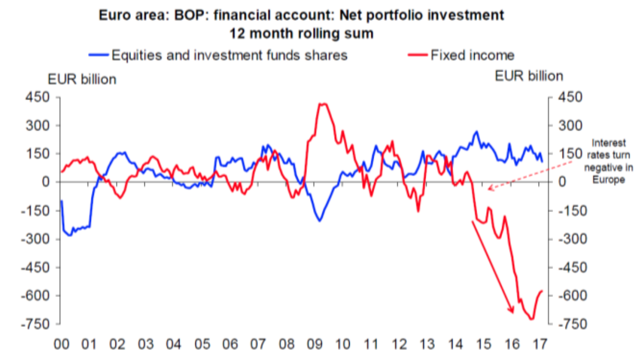
"Monetary Policy and Below-Target Inflation", speech by Philip.R. Lane, ECB Executive Board, 02 July 2019. Source: Deutsche Bank, ECB

7. **"The only game in town" has no choice but to act and create the case for fiscal stimulus –** until European governments agree on loosening their fiscal targets, ECB has no choice but to act against macro headwinds as "the only game left in town". Furthermore, if it wants to change this dire situation, more incentives for fiscal expansions should be created by introducing a new generous round of QE (open-ended, looser limits and PSPP of at least EUR 30bn) and possible Yield Curve Control. This would signal to governments that long-term sovereign rates will stay extremely low for longer and possibly encourage them to reverse the contractionary fiscal policy in Europe that has been in place since the Euro debt crisis erupted in 2011 (chart below). By not counterbalancing the large private sector savings in this period, this contractionary fiscal policy created a huge savings/investment balance in the Eurozone that is largely depressing the interest rate levels:

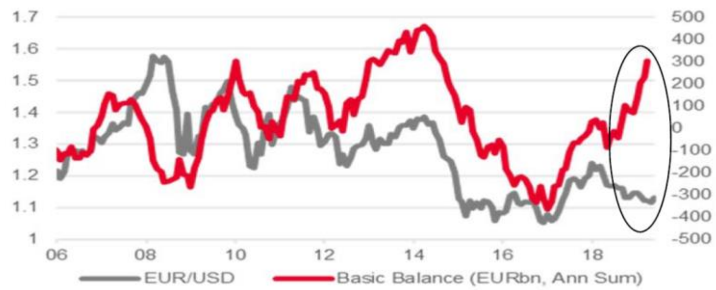


Source : Deutsche Bank, Eurostat

8. **The transmission of ECB monetary policy is largely and increasingly dependent on the FX channel –** the credit channel is basically blocked by already very low/negative rates in place and huge savings/investment imbalance in the Eurozone (see the graph from point 7 above and last graphs on next page) and the wealth channel potential looks quite limited at the already elevated security prices. Hence, the challenge for ECB at this meeting is to introduce a bold enough package that would create a similar to QE1 market reaction in terms of Fixed Income outflows in 2015/16 (left graph). This hugely accommodative policy largely helped the Euro to lose 16% against the USD between Dec-14 and Mar-15 and is still depressing its exchange rate despite the significant growth in its Basic Balance last years (current account + capital account, right graph).



Source: ECB, Haver Analytics, DB Research

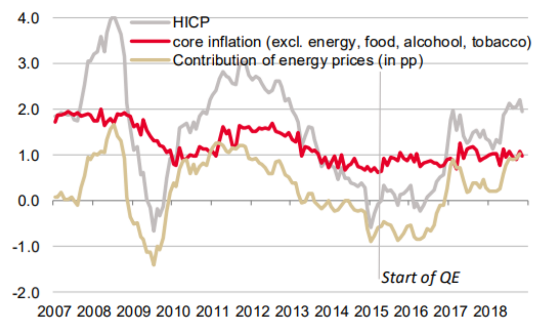


Source: SG FX, Kit Juckes

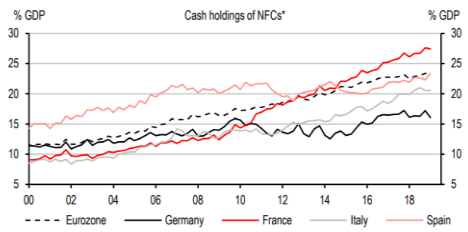
What are the risks?

1. **QE diminishing positive effects** – yield levels and credit spreads are much lower and tighter than before QE1.
2. **QE increasingly negative effects –** flattening yield curve is largely negative for the profitability of banks, despite that having some long-duration assets like long-term fixed-rate sovereign bonds should have a compensating effect.
3. **The dubious effects on inflation from QE –** despite what all the working papers and research by ECB is saying, the market is still questioning the real effect of this policy on achieving the inflation target.

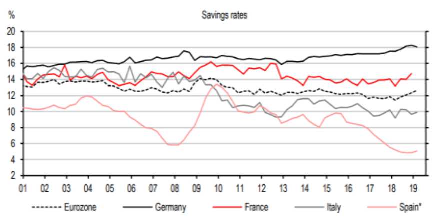
Chart 2. Did QE stop deflation in Europe?



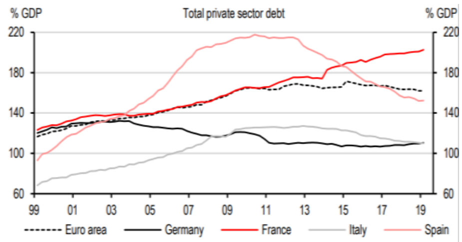
4. **The global easing cycle –** unlike 2015, Fed (and almost every other C-bank in the world) is now in easing cycle, thus making any possible FX and flow effects much more difficult to be accomplished;
5. **The Trump factor –** any substantial easing measures by ECB are surely to face a harsh criticism by Trump and probably renewed threats about countermeasures like Auto tariffs;
6. Any measures towards further facilitating the credit channel in the banking system are likely to have very limited effects as **Europe is having a demand-side problem, not a supply-side one** – as evident by the record-high cash holdings of European corporates left graph), still high (and increasing in Germany) saving rates by households (except in Spain, middle graph) and ongoing deleveraging efforts by the private sector (except in France, right graph):



Source: ECB, HSBC calculations. *Nominal GDP.



Source: Eurostat, HSBC calculations, Note: *Series for Spain is adjusted using a 4QMA



Source: Eurostat, HSBC