ITC - Dec ECB Preview: Ebenezer Draghi vs The Grim Repo-er

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ECB rate announcement: Thursday 8th Dec; 12:45GMT/Press Conference 13:30GMT.

In Brief:

- **consensus for extension of at least 6 months at €80bn/month**
- **risks for longer extension at lower pace (€60bn/month) or a 'tapering signal'**
- **possible increase to the issue limit to address bond scarcity**
- **expect taper discussion but no firm commitment at present**
- **new 2019 inflation forecast expected below 2% target**

While Brexit, Trump, OPEC and the Italian referendum have made for good headlines recently, it has been the all-too-familiar elephant in the room that will likely prompt the ECB to maintain its easing bias this week – that of weak inflation. Since the last meeting, there has been a broadly consistent message from the Governing Council that *"underlying inflation in particular has yet to show clear signs of a more dynamic upward movement"* (Praet, Nov 18), *"we do not yet see a consistent strengthening of underlying price dynamics"* (Draghi, Nov 18) and *"underlying inflation is not showing signs of a durable increase which is a concern"* (Visco, Nov 22). Given that the ECB has repeatedly stated that purchases are "intended to run… until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim", taken at face value this would clearly imply they are not 'done' yet. Indeed, even hawkish Weidmann (24/11) recently said that, while he wants gradual phasing out of ECB bond buying, the asset purchase program will not end suddenly and the ECB will lay the groundwork for any changes to monetary policy.

A recently released Reuters poll said that the ECB is expected to announce a six-month extension to the PSPP on Thursday, whilst keeping the size of monthly purchases unchanged at €80bn per month, a view which is the general consensus of most of the recent bank research on the ECB. A minority expect a nine-month extension at a reduced pace of €60bn per month, or a staggered announcement split with a six-month extension in December and a further three-month extension to be announced at the March meeting next year, or alternatively, a commitment to extend with a decision delayed until the January meeting.

The ECB has repeatedly referenced the flexibility of their easing program and, as such, the 'usual' parameter alterations are once again on the table at the December meeting, however there has been some discussion in recent research implying that technical changes to the program may be more problematic from a legal standpoint that initially thought. Several desks believe that a deviation from the capital key is possible, with the topic featuring in several ECB previews over the last few meetings. This may be a probable option given that the ECB is, at present, not 'strictly' adhering to the capital key with purchases marginally (~+2% vs capital key) higher in Germany, France and Italy over the last few months versus lower in Portugal. However, comments from Weidmann provide some caution when he said that the ECB should continue to follow the capital key "if we don't want to get the Eurosystem into hot water". Another well touted option would be for the ECB to remove the depo-floor, allowing the ECB to purchase bonds with yields below -0.40%. Desks have suggested that such a move would add between 13-16 months-worth of bonds depending on the future purchase rate.

Easy options:

1. Drop the depo floor
2. Extend PSPP purchase maturities below 2y and above 31y
   a. Low chance of legal/political challenge; easy to implement; does not create a huge amount of extra buying room

Plausible but opaque options:

3. Flexible use of the capital key ratio – what can no longer be purchased in Germany could be split across the remaining countries according to the 'remaining' capital key ratios
4. Substitution purchases: buy similar core/semi-core when ECB can no longer by Germany
   a. Might lead to higher volatility in the bond market (but less legally/politically challenging than below)

Politically/Legally tricky options:

5. Drop the capital key ratio in favour of debt ratios
   a. Some analysts have suggested that this action would only add five to eight weeks to the programme's duration if other parameters are left unchanged
6. Raise non-CAC limit to 50% from 33%
   a. Definitely creates more 'purchase room' especially if PSPP is extended but could be legally/politically challenged due to increased chance of market fragmentation
7. Raise limit to 50% on all eligible bonds

<u>**Scarcity:**</u>

Most banks acknowledge that the scarcity debate may be less of a focal point at this meeting given the recent post-election sell off in fixed income, as indicated below:

	07/12/2016		Ahead of last ECB meeting	
Nominal 2y-31y curve	Below 0%	Below depo	Below 0%	Below depo
GE	59.99%	36.16%	72.65%	48.52%
NE	53.43%	25.00%	59.77%	41.45%
FI	39.86%	16.08%	67.83%	32.87%
AS	46.29%	24.69%	59.06%	34.38%
BE	34.53%	16.72%	46.79%	28.41%
FR	43.26%	17.83%	57.55%	29.76%
IR	41.96%	15.21%	47.90%	27.23%
SP	6.54%	0.00%	17.31%	0.00%
IT	0.00%	0.00%	0.00%	0.00%
PO	0.00%	0.00%	0.00%	0.00%

In the press:

Nov 24: Bloomberg – some GC members would like to delay decision to January

Bloomberg cited euro-area officials saying that the ECB may have room to delay some decisions on the future of QE given that some scarcity concerns have abated given the recent rising yields. The sources said that no decision has been taken yet at the GC had not yet tabled a proposal. The same sources said that the GC remains likely to send a dovish signal at the December meeting. However, recent comments from both Draghi and Praet would point to December as the time for change. Indeed, Praet recently said that *"at our policy meeting in early December, we will be in a good position to take a comprehensive perspective on the inflation outlook, our progress made in achieving a sustained adjustment and the monetary policy stance, benefitting from incoming data and survey information, the new staff macroeconomic projections as well as the work of the Eurosystem committees on options to ensure a smooth implementation of our purchase programme until March 2017, or beyond, if needed."*

Nov 30: MNI – ECB is likely to announce an extension of QE at the current level with risks of unexpected outcomes due to unusually wide range of competing views. The piece cited interviews with six "senior Eurosystem sources" delivering a dovish tone overall with little support for a reduction of QE asset purchases post-March 2017.

Dec 1: Reuters – 6m extension at €80bn/month is the base case for discussion

Reuters cited 'senior sources' who said that preparatory work has focused on a six-month extension at a steady pace of €80bn per month although some have indicated that they would favour a longer extension at lower volumes (i.e. nine-months at €60bn/month) as a straight extension could signal an open-ended program. Another option is to not specify monthly purchase volumes but make the volumes dependent on economic developments. The sources said the Governing Council will consider sending a formal signal that the program will eventually end, partly to appease the hawks, however one source said ""We're not talking about tapering. We're talking about a signal." Both Reuters and MNI imply that the hawks may be set to deliver a "signal" that the PSPP is not open-ended but, to be fair, that is nothing we have not heard before. At the October press conference, Draghi himself said, *"… does it mean that [QE] can last forever? The answer is of course no."* However, on Nov 28 ECB's Stournaras said that the ECB's stimulus is likely to continue as that *"tapering is a dangerous word right now… no one is discussing tapering at present, even informally"*.

Matteo Renzi's recent political gamble in Italy clearly did not pay off, however it is clear that the 'No' vote does not really have a direct bearing on the nation's willingness to remain in the Euro. A relatively muted market response to the event would suggest that the recent Reuters sources piece that said the ECB is ready to buy more Italian bonds in the event of post-referendum market turmoil, is unlikely to carry any weight on Thursday. While Italian banks are a cause for concern, and may well feature in the Q&A, it would appear the sources piece is somewhat redundant.

Repo

The universe of German bonds available for use as collateral has notably decreased due to PSPP exacerbated by alongside a drop in new issuance from the Bundesbank. As has been well flagged in recent weeks, the demand for German collateral ahead of year-end remains on the rise, reflected in German repo funding levels reaching new lows. Back on 23 November, Reuters sources said that the ECB is looking for ways to lend out more of its Government bonds to "avert a freeze" in the repo market. The piece said this will be discussed at the December meeting but may not be finalised by then and will depend on what other changes the ECB makes to the asset purchase program.

Possible changes include reducing charges for firms which fail to return the bonds they have borrowed on time, accepting new types of collateral and extending the duration of loans. Several banks believe that addressing this shortage should be a top priority at the ECB and may well feature in the Q&A if not addressed directly.

Peripheral Bonds

Heading into the ECB meeting we have noted a solid rally in short-dated peripheral bonds with 2s & 5s PGBs and BTPs tightening to Germany. There is still a great deal of uncertainty surrounding peripheral Europe with Italy facing bank recapitalisation, snap elections and ratings reviews by DBRS. In terms of policy action on Thursday if the ECB increases issuer limits (CAC/Non-CACs) then it effectively raises the amount of short-dated paper that becomes eligible for the ECB to purchase (as a large part of the short-end curve is already held under SMP which was restricting the amount ECB could buy), which could explain some of the bid.

Projections:

Euro area inflation ticked slightly higher in November with the CPI estimate at +0.6% vs +0.5% in October but only due to 'volatile components' – looking closer at the core CPI, the flash November reading hit +0.77% versus +0.75% in October – such minor increases are unlikely to alter the argument for extending QE as the inflation measures sit so far below the ECB's official target. Since the October meeting Draghi's favoured 5y5y inflation forward rate has risen from 1.4339 to 1.6320 and has been on a fairly convincing uptrend since early September. However, desks see little prospect for core inflation pressure in Europe with subdued growth and weak wage pressures a theme in several banks' 2017 outlook.

	GDP				***HICP***			
	2016	**2017**	**2018**	**New 2019**	**2016**	**2017**	**2018**	**New 2019**
Jun '16 (Eurosystem staff)	1.6	1.7	1.7	-	0.2	1.3	1.6	-
Sep '16 (ECB Staff)	1.7	1.6	1.6	-	0.2	1.2	1.6	-
Forecasts	1.6	1.4-1.6	1.4-1.6	***1.7***	0.2	1.1-1.3	1.1-1.5	***1.6-1.7***

Source: ECB/RBS/Danske/Reuters/GS
https://www.ecb.europa.eu/mopo/strategy/ecana/html/table.en.html

What's Priced In?

Market expectations are very low for this meeting with Dec EONIA ECB pricing a meagre 7% chance of a 10bp cut to the depo rate, slightly higher than the 2% probability going into the October meeting. Focus for this meeting however is not on rate cuts but rather on changes to the asset purchase program.

EUR OIS Run:

Meeting	Mid	Prob of 10bp cut	vs Oct meeting
Dec-16	-0.350	7%	2%
Jan-17	-0.351	1%	6%
Mar-17	-0.346	4%	15%
May-17	-0.348	24%	30%
Jun-17	-0.345	12%	35%
Jul-17	-0.341	15%	45%
Sep-17	-0.338	18%	49%
Nov-17	-0.337	22%	18%

Street Views:

-BAML: expecting 6m extension of €80bn/month via minor tweaks in capital key; addressing repo issues should be at the top of ECB's priority list, solving richness of GC would make a 12m extension feasible without tackling political issues

-Barcs: expect 6m extension at €80bn/month; ECB to take a cautious approach, will not want to overly tighten financial conditions after recent sell off; expect substitution option for Germany, removal of yield floor and relaxation of issue limit for non-CACs as most likely parameters to alter

-BNP: Italy 'No' vote makes it less likely for any talk on tapering; ECB could change fwd guidance to 'signal' that QE cannot continue forever

-Citi: expect 6m QE extension, removal of depo yield floor & taper from €80bn to €60bn/month; little consensus on most matters apart from no hard stop to QE; could also increase issue limits above 33% (perhaps only for AAAs); do not expect the hawks to walk away with nothing; little timely action on repo treatment of bonds

-CS: expect 6m extension at €80bn/month; expects relaxation of depo floor, increase in issue share limit to 50% from 33% for high rated bonds as easiest parameters to alter

-Danske: too early for taper announcement; expect 6m QE extension at current €80bn rate; 2019 inflation f/c likely at 1.7%, others little changed; expect capital key deviation likely when other restrictions are hit but less urgent given recent FI sell off

-DB: expect 6m QE extension at current pace; a tapering that isn't justified by the inflation outlook would risk a more disorderly impact on financial conditions; could remove/soften yield floor to improve supply of eligible bonds or implement a 'soft taper' for core bonds; package could signal that ECB is passed 'peak policy easing'

-GS: expects QE extension at current pace to end-2017 as it would allow ECB to reassess policy after German elections; recent rates sell off has reduced scarcity issue; ECB could eventually relax capital key but not in December;

-MS: instability in Italy makes it difficult for ECB to lay out a time line for tapering

-Nomura: current level of policy accommodation should be maintained as core inflation still weak and significant downside risks to growth outlook; expect 6m QE extension; expect technical changes incl increase in issuer limits for non-CACs from 33% to 45%; depo rate constraint less of an issue at current rate levels; balance of risks skewed toward asset purchase extension but slower pace

-RBS: expect 9m QE extension at €80bn/month; not expecting any discussion of tapering; issue/issuer limits may be relaxed to 50%; staff projections may show new 2019 inflation at 1.6% y/y with 2018 downgraded to 1.5% from1.6% prev

-SocGen: expect ECB to extend QE by 6m-9m; extension may be fwd guidance only and may not mention changes to purchase rate; expect ISSUE limit to be increased to 50% but ISSUER limit left unch at 33%; expect 2019 inflation f/c to be close to tgt; expect 1st reduction in monthly purchases by €10bn in March '17

ECB Voting Rotation:

ECB Meeting Dates	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Monetary Policy Meetings	~~21~~	-	~~10~~	~~21~~	-	~~2~~	**21**	-	~~8~~	~~20~~	-	**8**
Non-Monetary Policy Meetings	~~13~~	~~3 & 17~~	~~16~~	6	~~4 & 18~~	~~22~~	6	3	~~21~~	**5**	~~2 & 16~~	14

ECB Board Members		1	2	3	4	5	6	7	8	9	10	11	12
Name	**Role/Country**	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**
Mario Draghi	President / Italy	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Vítor Constâncio	VP / Portugal	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Sabine Lautenschläger	Exec Board / Germany	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Benoît Cœuré	Exec Board / France	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Yves Mersch	Exec Board / Luxembourg	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Peter Praet	Exec Board / Belgium	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
GC Members - Group 1		**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**
Jens Weidmann	Germany	✓	✓	✗	✓	✓	✓	✓	✗	✓	✓	✓	✓
Luis María Linde	Spain	✓	✓	✓	✗	✓	✓	✓	✓	✗	✓	✓	✓
François Villeroy de Galhau	France	✓	✓	✓	✓	✗	✓	✓	✓	✓	✗	✓	✓
Ignazio Visco	Italy	✗	✓	✓	✓	✓	✗	✓	✓	✓	✓	✗	✓
Klaas Knot	Netherlands	✓	✗	✓	✓	✓	✓	✗	✓	✓	✓	✓	✗
GC Members - Group 2		**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**
Jan Smets	Belgium	✗	✗	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Ardo Hansson	Estonia	✗	✗	✗	✓	✓	✓	✓	✓	✓	✓	✓	✓
Philip Lane	Ireland	✓	✗	✗	✗	✓	✓	✓	✓	✓	✓	✓	✓
Yannis Stournaras	Greece	✓	✓	✗	✗	✗	✓	✓	✓	✓	✓	✓	✓
Chrystalla Georghadji	Cyprus	✓	✓	✓	✗	✗	✗	✓	✓	✓	✓	✓	✓
Vitas Vasiliauskas	Lithuania	✓	✓	✓	✓	✗	✗	✗	✓	✓	✓	✓	✓
Ilmārs Rimšēvičs	Latvia	✓	✓	✓	✓	✓	✗	✗	✗	✓	✓	✓	✓
Gaston Reinesch	Luxembourg	✓	✓	✓	✓	✓	✓	✗	✗	✗	✓	✓	✓
Josef Bonnici	Malta	✓	✓	✓	✓	✓	✓	✓	✗	✗	✗	✓	✓
Ewald Nowotny	Austria	✓	✓	✓	✓	✓	✓	✓	✓	✗	✗	✗	✓
Carlos Costa	Portugal	✓	✓	✓	✓	✓	✓	✓	✓	✓	✗	✗	✗
Boštjan Jazbec	Slovenia	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✗	✗
Jozef Makúch	Slovakia	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✗
Erkki Liikanen	Finland	✗	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓