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# Turning the tables

**ECB special**
**RaboResearch**

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## Summary

- We have changed our ECB view, and we now no longer expect the ECB to hike rates in 2019 or 2020
- Even though we hold some hopes of a moderate (domestic) growth pickup in the Eurozone from Q2 onwards, we believe the ECB has already missed its 'window' to hike rates "through the summer" (even under a flexible interpretation of that guidance)
- As we believe 2020 will bring new challenges the ECB cannot ignore, it increasingly faces a 'Japan/BoE' type of scenario
- This below-consensus and below-market view implies that the risks to our view are now to the upside; but this is just hope that we will be proved wrong

We have long believed that the ECB would start raising rates in September of this year, as it is looking to rid itself of some potentially damaging side-effects of the current negative interest rates policy. However, in our view, significant economic headwinds and unrelenting uncertainties about the outlook have started to outweigh these potential side-effects. Therefore, we now see a rate hike in 2019 as substantially less likely. Crucially, however, amidst our expectations of a US recession in 2020, we believe that a delay beyond 2019 means that the ECB has missed the opportunity to hike. As a result, we have decided to shift our call for a first ECB rate hike out until June 2021.

## Explaining the ECB's (and our) reluctance

We have long held the view that the ECB would start a moderate tightening cycle in September 2019. In fact, we have been forecasting this since 2017Q4. And although economic data steadily worsened over the course of 2018 – following an unexpectedly strong 2017 – we remained reluctant to change. So why this intransigence?

First and foremost we stuck to our view because the ECB Governing Council itself had been so clearly expressing a wish to start a policy normalization at some point in the future, provided of course that the outlook was sufficiently good to allow for such a move. *"Patience, prudence and persistence"* were Mr. Draghi's key words as the ECB gradually phased out QE during 2018, preparing the market for its next move: a rate hike *"through the summer of 2019"*.

We assumed that the underlying motivations behind the ECB's wish to start normalizing rates this year were actually multi-faceted. ECB hawks have often pointed at the potential risks to financial stability from interest rates being so low (or even negative) for such a long time. Elevated asset prices or too low risk premiums could stir excessive risk taking. And for the banking sector, the ECB's policy has been a mixed blessing as well, with asset purchases (including covered bonds) offsetting the impact of negative rates on bank's interest rate margins. But as QE was phased out and bank funding spreads widened, concerns about the latter may have grown. Finally, it appeared as if the ECB genuinely believed that wage growth had finally embarked on a sustainable recovery, one that would ultimately push up core inflation.

Against that backdrop, the ECB had set a relatively low bar for hike rates and as such remained relatively unyielding whilst the data deteriorated over the course of 2018. We also believe that this intransigence was driven by concerns that if it would fail to grab the next available window to 'normalize rates', it would not have sufficient ammunition to respond to the next (inevitable) downturn.

## And explaining our shift in view

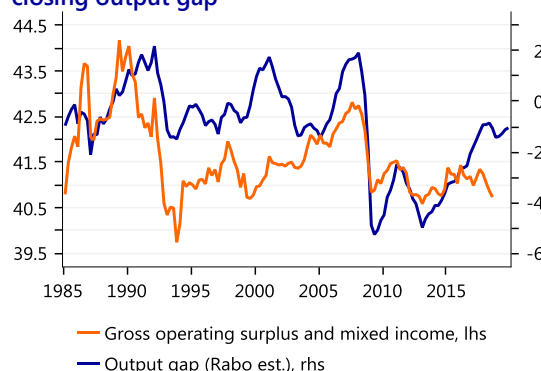
But at the current juncture, looking at recent data and the various risks we see out there, we actually feel that the ECB may have lost that window to hike rates already.

To begin with, it was questionable from the start that (core) inflation would reach the ECB's target ceiling over the relevant policy horizon. This argument was largely ignored on the basis of "patience", but recent developments suggest it will now prove even harder to reach the inflation objective. Although wage growth has clearly accelerated, we feel that there is a significant risk now that this acceleration in wage growth could be stopped in its tracks by a deterioration in labor market conditions. That would mean that last year's wage gains were a one-off affair.

Moreover, the pass-through of higher costs to end-consumers has failed to materialize so far and as companies' profit margins have started to erode since last year, this could be an indication that their pricing power is already deteriorating despite higher capacity utilization (figure 1).

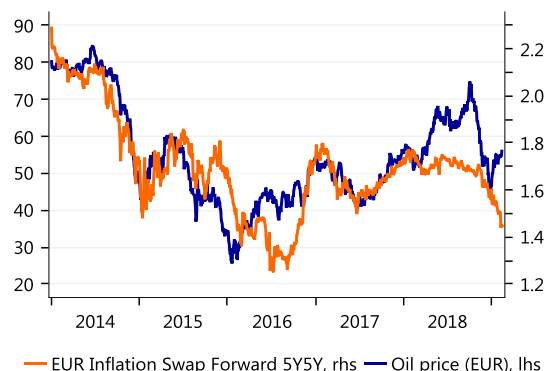
And last but not least, inflation-break-evens have slipped even when oil prices stabilized. This could indicate that the market is once again losing its confidence in a recovery of core inflation in the future. This, in turn, may fuel renewed concerns about de-anchoring of inflation expectations among the Governing Council.

**Figure 1: Profit margins under pressure despite closing output gap**



Source: Macrobond, Rabobank

**Figure 2: Sliding 5y5y inflation forward**



Source: Bloomberg

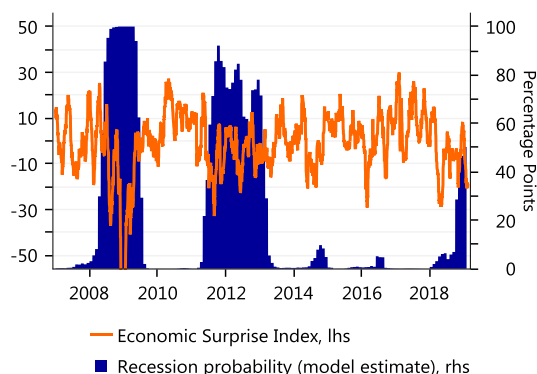
Secondly, the recent string of both hard and soft data has been nothing short from horrible. We only need to mention Eurozone industrial production growth at -4.2% y/y in December and retail sales at a paltry 0.8% y/y to underscore that point. And even most forward looking indicators are not pointing at any significant recovery in growth in Q1. Our (near-term) recession risk indicator rose to 45% in January and economic data have continued to surprise to the downside (figure 3). As such it now seems likely that our economists will further cut their Eurozone growth estimates for 2019 (currently at 1.4%).

This does not necessarily mean that all is lost for the economy. For example, borrowing conditions are still favorable (figure 4) and wage growth has been accelerating, where headline inflation has actually slowed down on the back of lower oil prices. This suggests that there is still some potential for the economy to pick up some speed over the course of this year.

However, the risks that this will *not* happen, or at least not as vigorously as required for the ECB to have the "confidence" to hike rates this year, have now risen sharply. After all, hiking rates without

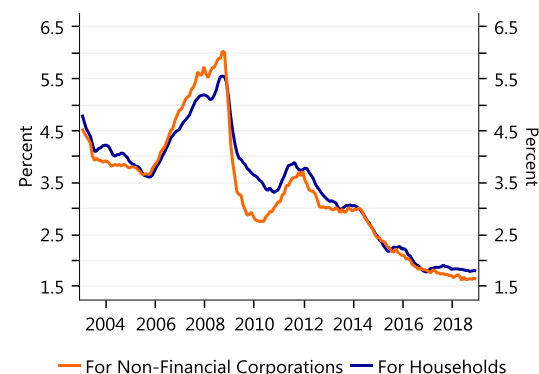
a strong economic backing would expose the Council to 'policy mistake' criticism. A key risk is that the current slowdown in output –which has a clear external component in the form of a slowdown in China– will feed into weaker domestic investment and consumption, especially whilst a number of key downside risks continue to lurk in the background.

**Figure 3: Weak data pointing at elevated recession risk now**



Source: Rabobank

**Figure 4: Borrowing costs still historically low, suggesting there is still room for recovery**



Source: Macrobond

## 2019 tough? 2020 won't be easy either

The most obvious risks are a [hard Brexit](#), a further acceleration in the US-China trade war (or Europe being dragged back into it), a hard landing of the Chinese economy, a sharp widening of Italian sovereign spreads on the back of a cocktail of weak growth, deteriorating fiscal metrics and political uncertainty. And, as highlighted by our own Mike Every in a great [thought experiment](#) this week: a deterioration in political cohesion through rising populism.

Although all these risks on their own aren't in our baseline –except maybe for trade, where we expect US-China tensions to reach an even higher level at some stage–, materialization of any one of these risks would probably already derail the Eurozone economy in its current shape. And although the one-sided probability of a hard Brexit, a hard landing in China, a blow-out of Italian spreads or a further breakdown in political cohesion following the European Parliament elections in May remains below 50%, *the probability of none of these happening at all is clearly below 50%.*

Besides, continued uncertainty amidst all these unknowns has already been weighing on sentiment and thus activity. This "general uncertainty" was also observed by ECB President Draghi in the February press conference in which he announced that the ECB Governing Council had decided to mark the risks to the growth outlook as being tilted to the downside. With even the hawks in the Council, such as Weidmann, Knot and Lautenschläger now sounding dovish, this suggests they have already shifted from "wanting" to "hoping" and that they are effectively going to miss their window for hike rates this year.

Unfortunately, we feel that 2020 won't be any easier. Our US strategist Philip Marey has now pencilled in a shallow [recession in the US](#) starting end-2020. At the very least, would we expect this to cause some spill-over effects to the Eurozone economy preventing it from reaching the growth levels necessary for the ECB to hike. But of course this headwind is likely to be amplified by a much more agile Fed, who is expected to embark on series of rates cuts from June 2020 onwards. Would the ECB dare to 'go against' the Fed and risk a much stronger euro? We would strongly doubt this, especially as the ECB cannot afford any policy mistake.

**Table 1: Money market forecasts for 2019-2021**

	<i>14 Feb</i>	<i>June 19</i>	<i>Dec 19</i>	<i>June 20</i>	<i>Dec 20</i>	<i>June 21</i>	<i>Dec 21</i>
ECB deposit rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.30	-0.10
ECB refinancing rate	0.00	0.00	0.00	0.00	0.00	0.00	0.10
Eonia	-0.37	-0.37	-0.37	-0.36	-0.36	-0.26	-0.07
3m Euribor	-0.31	-0.29	-0.28	-0.27	-0.27	-0.14	0.00
6m Euribor	-0.23	-0.22	-0.22	-0.22	-0.22	-0.03	0.09

Source: Rabobank

## Yes, we are now below consensus

The abovementioned issues persisting through 2019 have caused us to reconsider our rate outlook for this year, and we thus felt that our call for two cautious hikes in September and December cannot be maintained against the current economic outlook. However, that brings us into next year where the risk outlook doesn't appear to be substantially better – considering our US strategists' view of a US slowdown ending in a 2020 recession.

So while our view may be from one extreme (September) to another (no hikes before June 2021), this is purely reflective of the ECB missing its opportunity to embark on a hiking cycle by not moving this year. This change of view now also clearly places our rate forecasts well below the consensus estimate and even below the market's view. The latest poll amongst ECB watchers still put the majority of analysts in the "2019Q4" camp, although the market has already shifted its first rate hike out to mid-2020.

Admittedly, this also means that our call now comes with the potential for upside risks – compared to a purely downside risk to our earlier September forecast. In that sense, we have turned the tables, and it is now up to the economy, the market, and ECB policy makers to prove us wrong.

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