Doubling down on inflation

ECB special

RaboResearch
Global Economics & Markets
mr.rabobank.com

Bas van Geffen, CFA
Quantitative Analyst
+31 712 1046

Elwin de Groot
Head of Macro Strategy
+31 30 712 1322

Contents

Summary

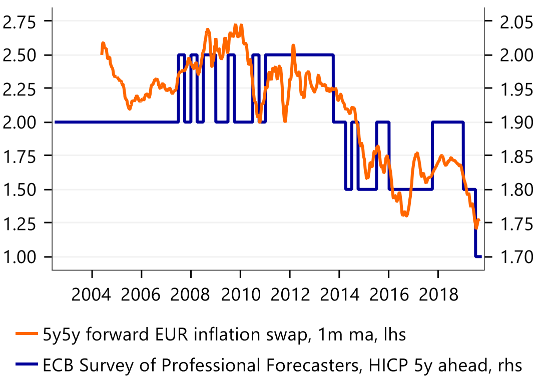
- The ECB does not want to under-deliver with its new stimulus to boost inflation expectations.
- Market's rate expectations have recently shifted to 40bp cuts in the next 12 months, making it difficult for the ECB to outdo these expectations.
- Therefore we now think ECB also has to add QE of about EUR 40bn per month for 12 months.
- A simultaneous announcement in September is likely, with October as potential start date.
- We believe government bonds will make up for the bulk of purchases. To the extent this is needed to allow for these purchases, the issuer limit is more likely to go than the capital key.
- Corporate bonds may be included in the purchases, but bank bonds and equities will not.

Unhappy with inflation

At the July press conference, President Draghi made it very clear that the ECB is not happy with the current inflation backdrop, both in terms of recent realisations as well as the outlook. Market-based measures of inflation expectations remain very muted, with the 5y5y forward inflation swap hovering between 1.2% and 1.3%. And survey data have also weakened, with the ECB's own Survey of Professional Forecasters reporting a long-run inflation expectation of 1.7%. The latter may not sound critical, but this expectation has always been quite stable near the ECB's target. In fact, it is the first time in the survey's history that this long-run estimate has fallen below 1.8%.

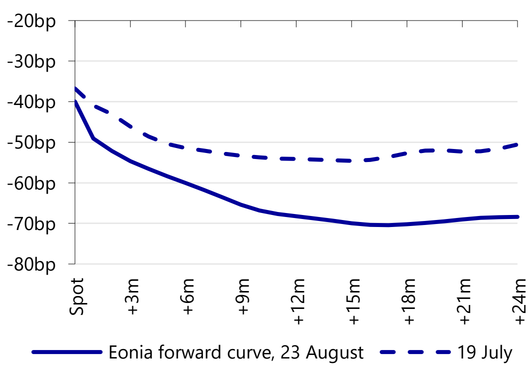
Draghi reassured markets that the Council will not hesitate to address the *"persistently"* low inflation, signalling that the ECB is ready to introduce fresh stimulus in September. But he did not detail which instruments would be used. As we explained in our earlier notes, we still believe that rate cuts are the least contentious of options. However, the market has largely caught up with our once dovish view of 40bp in additional rate cuts. Considering that the ECB probably doesn't want to under-deliver, **we therefore now believe that the ECB will have to restart asset purchases too.**

Figure 1: ECB concerned about de-anchoring?



Source: ECB, Bloomberg

Figure 2: Rate expectations are hard to 'outdove'



Source: Bloomberg, Rabobank

The hawks consent?

The ECB clearly signalled that it includes new asset purchases when weighing its options for further stimulus: the July press statement read that the Council *"has tasked the relevant Eurosystem Committees with examining options, including […] potential new net asset purchases."* This specific phrasing has in the past been used to flag the start of, and various changes to, the asset purchase programme in a subsequent meeting.

And it seems that the hawks have given their consent. Since the July meeting, none of the hawks have really pushed back against the ECB's communication or the markets interpretation – except for one anonymous comment in a Bloomberg article that *"some officials questioned the effectiveness of purchases"*. There wasn't even any hawkish response to Mr. Rehn's recent remarks that the ECB should *"come up with a significant and impactful policy package in September,"* that *"should include 'substantial and sufficient' bond purchases"*.[1] While it is admittedly still the holiday season, the hawks' collective silence seems to suggest that they are on board with new purchases.

Indeed, it is unlikely that archetypal hawks like Mr. Weidmann will have strong objections when the ECB discusses new asset purchases in September. The German economy shrank in the second quarter, and the Bundesbank warned that this may be followed by a negative growth rate in Q3 as well. Furthermore, in its monthly report, the German central bank noted that the ongoing weakness in the German economy is starting to affect the labour market.[2]

Exploiting synergies

That means the discussion should focus on the timing and composition of the new asset purchase programme. Let's first look at the timing. Some in the ECB prefer a simultaneous approach, announcing asset purchases alongside a rate cut. Olli Rehn, for instance, noted that *"it's often better to overshoot than undershoot"* financial market expectations. As we argued above, the recent decline in money market rates suggests that it is increasingly difficult to exceed expectations with rate cuts alone.

Moreover, various Council members see important synergies between the different parts of the ECB's toolkit. Mr. Lane stated that there are *"significant complementarities"* across negative policy rate, forward guidance, asset purchases and TLTROs.[3] Mr. Draghi has made similar observations in past press conferences. This means that easing measures reinforce each other when deployed at the same time. Along the same line, Mr. Rehn concluded that a package of several measures *"has a stronger impact than sequencing various measures over time"*, again indicating that at least some policymakers are pushing for a comprehensive package, combining a rate cut with a new APP.

Such a combined use of stimulus measures is not entirely without precedent. In March 2016, the ECB both cut the deposit rate to -40bp and increased the pace of asset purchases to EUR 80bn per month (from the original 60bn monthly pace).

The main reason not to deploy asset purchases at the same time as rate cuts is that it quickly depletes a large part of the ECB's toolkit, leaving it with empty hands when an even worse downturn materialises[4]. However if the Council believes in the abovementioned synergies, they probably prefer to spend (some of) this ammunition already, since it should go a longer way.

---

[1] "ECB Has Big Bazooka Primed for September, Top Official Says", The Wall Street Journal, 15 August 2019

[2] Monatsbericht August 2019, pp. 8-9 (In German; English translation not yet available)

[3] Monetary Policy and Below-Target Inflation, speech by Philip Lane, 2 July 2019.

[4] Another argument, for which we still share some sympathy, is that a comprehensive package will make it more difficult to assess the individual impact of the measures and whether or not they are really reinforcing each other. But overall, this argument has lost considerable weight as the ECB has already conducted several impact analyses.

Seeing the arguments in favour of a broad easing package and taking into account the lack of pushback from the hawks, we now believe the ECB will announce both a rate cut and asset purchases in September.

With an announcement in early September, asset purchases could commence as soon as the following month. Previous changes to the asset purchases came with a delay between the announcement and the effective date (table 1). However, these lags were either due to the preparation of the necessary infrastructure, or –in case of the extensions– to avoid excessive expectations of policy tightening. We don't expect any new programmes (see below), so nothing needs to be set up in terms of the organisation. The ECB is currently still reinvesting the proceeds of maturing bonds, so all of the infrastructure is still in place.

Table 1: Timing of changes in the Asset Purchase Programme

Change	*Announcement*	*Effective*	*Delay*
Introduction of the APP	January 2015	March 2015	2 months
Extension of end-date	December 2015	September 2016*	9 months
Reinvestment of maturing debt	December 2015	January 2016	-
Increased APP pace to EUR 80bn/month	March 2016	April 2016	-
Introduction of corporate sector purchase programme	March 2016	June 2016	3 months
Extension at EUR 60bn/month	December 2016	April 2017*	4 months
Extension at EUR 30bn/month	October 2017	January 2018*	3 months
Extension and tapering of asset purchases	June 2018	September 2018	3 months

Note: * For these extensions, the effective date was derived from the previously communicated end-date of the APP.
Source: ECB, Rabobank

What's on the shopping list?

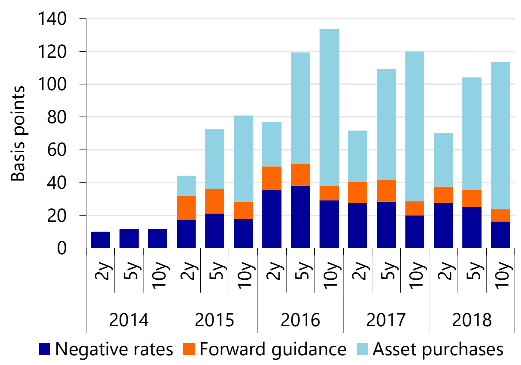
Size

Some Governing Council members have openly indicated they want to overshoot market expectations. While the more hawkish members will probably try to tone this down a bit, the hawks probably also want to avoid the impact of a disappointment on interest rates and the euro. And, as we've noted above, considering the current interest rate expectations, it is difficult for the ECB to surprise on that front. **So we argue that the ECB would seek to deliver an asset purchase programme that is broadly in line with market expectations, while still keeping sufficient leeway to increase the monthly pace if Eurozone growth drops below zero.**

That leaves the question what monthly pace the ECB considers to be roughly market neutral. In the aforementioned speech, Mr. Lane included a chart that shows the estimated impact of the ECB's policy instruments on the term structure of rates (figure 3). From this chart, it follows that the asset purchase programme reduced the 10y term premium by about 50bp in 2015, while dampening it by a bit more than 90bp in the 2016-2018 period.

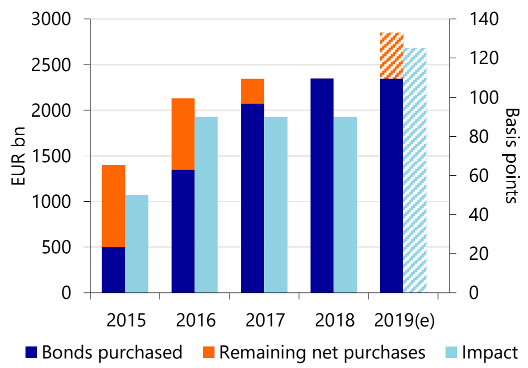
We proceed to compare this estimated impact on the 10y term premium with the actual asset purchases through these years. In the first two years of the APP, a large part of the impact was caused by the expectation of purchases, but through time the stock effect of the ECB's portfolio holdings gained in relative importance (figure 4). We then approximated the decline in the 10y term premium since the start of the year to estimate how much extra impact needs to be generated by new asset purchases for the announcement to be broadly market neutral.

Figure 3: Estimated impact on the term premium



Source: ECB

Figure 4: APP impact on the 10y term premium



Source: ECB, Rabobank

Keeping in mind that other factors have also contributed to the decline of the term premium, we estimate that **current market pricing is consistent with about EUR 500-800bn in asset purchases**, depending on how much of the change in the 10y term premium is presumed to be driven by APP2 expectations. Assuming that the ECB would probably want to commit to a programme duration of about 12 months, that roughly translates to a monthly pace of EUR 40-65bn.

Survey results are roughly in the same ballpark. Bloomberg's July ECB poll showed a median forecast of EUR 40bn/month,[5] while The Wall Street Journal suggested a EUR 50bn consensus.[6] That again, should steer the ECB towards a EUR 40-60bn per month asset purchase programme, depending on whether the ECB sees the need to exceed expectations.

We would argue that the ECB will stick to the lower end of this range, because of the simultaneous easing from a deposit rate cut. As noted above, the ECB believes there is significant synergy between the two instruments, which means that they can probably stay near the lower end of purchases – after all, the rate cut should amplify the impact. That also leaves them with a little more room to scale up the asset purchases if further setbacks materialise in the future. **We therefore expect 12 months of asset purchases at a pace of EUR 40bn per month.**

Composition

As with the first asset purchase programme, government bonds will undoubtedly make up a large part of APP2 purchases. First of all, government bond purchases are the least contested among the Council; while the corporate sector purchase programme has the ECB a bit more divided. Secondly, government bonds are probably the easiest asset class for the ECB to generate substantial monthly volume, even though some self-imposed constraints may need to be relaxed in order for the ECB to do so. Yet, the Council appears to be warming to the idea of lessening (or removing) these constraints; in particular the issuer limit.[7] And even though not all policymakers will particularly like this idea or the implications, it may find less resistance than the inclusion of corporate bonds.

In a previous note, our Rates Strategy team estimated that relaxing the issuer limit to 50% while strictly adhering to the capital key would increase the amount of government bonds that can be

[5] This is the median of survey responses to that question; it therefore excludes the implied EUR 0bn by those who didn't expect asset purchases prior to the July meeting and respondents who did not specify a volume.

[6] "ECB Has Big Bazooka Primed for September, Top Official Says", The Wall Street Journal, 15 August 2019

[7] The terms of the public sector purchase programme stipulate that the ECB is not allowed to hold more than 33% of any specific government bond, nor more than 33% of all bonds issued by a government. This was 1) to preserve market functioning and price discovery, and 2) to avoid the ECB obtains a blocking minority in the event of a debt restructuring. But it is now thought that a blocking minority could be avoided via 'disenfranchisement', though this is not an airtight case. Our Rates Strategy team explored this in more detail here.

bought by about EUR 825bn.[8] This would create sufficient leeway for the implementation of new government bond purchases. By comparison, our scenario would require 'just' EUR 480bn in purchases, and these purchases won't necessarily all be government bonds.

First of all, there are of course the SSA names that can be bought under the public sector programme. And secondly, **despite some Council members not being a fan of corporate bond purchases, we do think that CSPP will be part of APP2.** There are also still proponents of the programme, because the corporate sector purchases have a closer connection to the real economy and immediately affect the financing costs of non-financial companies. So we expect the mix of APP2 to broadly resemble the previous asset purchase programme. **That also means that we don't foresee any completely new asset types being added at this stage.** Although some market participants have speculated about the ECB buying bank bonds or equities as well, we believe that this is still a step too far for the ECB.

---

[8] "QE eligible markets – comparing purchasability and availability", 19 July 2019

RaboResearch
Global Economics & Markets
mr.rabobank.com

Global Head

Jan Lambregts
+44 20 7664 9669
Jan.Lambregts@Rabobank.com

Macro Strategy

Europe

Elwin de Groot
Head of Macro Strategy
Eurozone, ECB
+31 30 712 1322
Elwin.de.Groot@Rabobank.com

Stefan Koopman
Senior Market Economist
UK, Eurozone
+31 30 712 1328
Stefan.Koopman@Rabobank.com

Teeuwe Mevissen
Senior Market Economist
Eurozone
+31 30 712 1509
Teeuwe.Mevissen@Rabobank.com

Bas van Geffen
Quantitative Analyst
ECB
+31 30 712 1046
Bas.van.Geffen@Rabobank.com

Maartje Wijffelaars
Senior Economist
Italy, Spain, Portugal, Greece
+31 30 216 8740
Maartje.Wijffelaars@Rabobank.nl

Michiel van der Veen
Economist
Eurozone
+31 6 831 34 616
Michiel.van.der.Veen@Rabobank.nl

Wim Boonstra
Senior Advisor

+31 30 216 2666
Wim.Boonstra@Rabobank.nl

Americas

Philip Marey
Senior Market Strategist
United States, Fed
+31 30 712 1437
Philip.Marey@Rabobank.com

Hugo Erken
Head of International Economics
United States
+31 30 215 2308
Hugo.Erken@Rabobank.nl

Christian Lawrence
Senior Market Strategist
Canada, Mexico
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Mauricio Oreng
Senior Market Strategist
Brazil
+55 11 5503 7315
Mauricio.Oreng@Rabobank.com

Gabriel Santos
Strategist
Brazil
+55 11 5503 7288
Gabriel.Santos@Rabobank.com

Asia-Pacific

Michael Every
Senior Market Strategist
Asia, Australia, New Zealand
+852 2103 2612
Michael.Every@Rabobank.com

Björn Giesbergen
Senior Economist
China, Japan
+31 30 216 2562
Bjorn.Giesbergen@Rabobank.nl

Hugo Erken
Head of International Economics
India
+31 30 215 2308
Hugo.Erken@Rabobank.nl

Raphie Hayat
Senior Economist

+31 30 216 2666
Raphie.Hayat@Rabobank.nl

FX Strategy

Jane Foley
Head of FX Strategy
G10 FX
+44 20 7809 4776
Jane.Foley@Rabobank.com

Piotr Matys
FX Strategist
Central & Eastern Europe FX
+44 20 7664 9774
Piotr.Matys@Rabobank.com

Christian Lawrence
Senior Market Strategist
LatAm FX
+1 212 808 6923
Christian.Lawrence@Rabobank.com

Rates Strategy

Richard McGuire
Head of Rates Strategy
+44 20 7664 9730
Richard.McGuire@Rabobank.com

Lyn Graham-Taylor
Senior Rates Strategist
+44 20 7664 9732
Lyn.Graham-Taylor@Rabobank.com

Matt Cairns
Senior SSA Strategist
+44 20 7664 9502
Matt.Cairns@Rabobank.com

Credit Strategy & Regulation

Ruben van Leeuwen
Head of Credit Strategy
ABS, Covered Bonds
+31 30 712 1391
Ruben.van.Leeuwen@Rabobank.com

Vaclav Vacikar
Analyst
Financials
+31 30 712 1519
Vaclav.Vacikar@Rabobank.com

Hyung-Ja de Zeeuw
Senior Strategist
Corporates
+31 30 712 1555
Hyung-Ja.de.Zeeuw@Rabobank.com

Bas van Zanden
Senior Analyst
Pension funds, Regulation
+31 30 712 1869
Bas.van.Zanden@Rabobank.com

Cas Bonsema
Analyst
ABS
+31 30 712 1849
Cas.Bonsema@Rabobank.com

Energy & Metals

Ryan Fitzmaurice
Commodity Strategist
+1 212 916 7874
Ryan.Fitzmaurice@Rabobank.com

Agri Commodity Markets

Stefan Vogel
Head of ACMR
+44 20 7664 9523
Stefan.Vogel@Rabobank.com

Carlos Mera
Senior Commodity Analyst
+44 20 7664 9512
Carlos.Mera@Rabobank.nl

Michael Magdovitz
Commodity Analyst
+44 20 7664 9969
Michael.Magdovitz@Rabobank.com

Client coverage

Wholesale Corporate Clients

Martijn Sorber	Global Head	+31 30 712 3578	Martijn.Sorber@Rabobank.com
Hans Deusing	Netherlands	+31 30 216 9045	Hans.Deusing@Rabobank.com
David Kane	Europe	+44 20 7664 9744	David.Kane@Rabobank.com
Neil Williamson	North America	+1 212 808 6966	Neil.Williamson@Rabobank.com
David Teakle	Australia, New Zealand	+61 2 8115 3101	David.Teakle@Rabobank.com
Ethan Sheng	Asia	+852 2103 2688	Ethan.Sheng@Rabobank.com
Ricardo Rosa	Brazil	+55 11 5503 7150	Ricardo.Rosa@Rabobank.com

Financial Institutions

Eddie Villiers	Global Head	+44 20 7664 9834	Eddie.Villiers@Rabobank.com
Roeland Bronsveld	Benelux	+31 30 216 9030	Roeland.Bronsveld@Rabobank.com
Krishna Nayak	Germany, Austria, CEE	+44 20 7664 9883	Krishna.Nayak@Rabobank.com
Mauro Giachero	Italy	+44 20 7664 9892	Mauro.Giachero@Rabobank.com
Martin Best	UK, Scandinavia, Middle East	+44 20 7809 4639	Martin.Best@Rabobank.com
Paul Duddy	USA	+1 212 916 3799	Paul.Duddy@Rabobank.com
Wouter Eijsvogel	Treasury Sales Europe	+31 30 216 9723	Wouter.Eijsvogel@Rabobank.com
David Pye	Central Banks	+44 20 7664 9865	David.Pye@Rabobank.com

Capital Markets

Herald Top	Global Head of Capital Markets	+31 30 216 9501	Herald.Top@Rabobank.com
Nader Pasdar	Capital Markets USA	+1 212 808 6861	Nader.Pasdar@Rabobank.com
Ian Baggott	Capital Markets Asia	+852 2103 2629	Ian.Baggott@Rabobank.com
Willem Kröner	Global Head of Equity Capital Markets	+31 30 712 4783	Willem.Kroner@Rabobank.com
Crispijn Kooijmans	DCM FIs & SSAs	+31 30 216 9028	Crispijn.Kooijmans@Rabobank.com
Bjorn Alink	DCM Securitisation & Covered Bonds	+31 30 216 9393	Bjorn.Alink@Rabobank.com
Othmar ter Waarbeek	DCM Corporate Bonds	+31 30 216 9022	Othmar.ter.Waarbeek@Rabobank.com
Joris Reijnders	DCM Corporate Loans	+31 30 216 9510	Joris.Reijnders@Rabobank.com
Brian Percival	DCM Leveraged Finance	+44 20 7809 3156	Brian.Percival@Rabobank.com

Disclaimer

Non Independent Research