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Dragging feet

ECB post-meeting comment

RaboResearch

Global Economics &
Markets
mr.rabobank.com

Elwin de Groot

Head of Macro Strategy
+31 30 712 1322

Bas van Geffen, CFA

Quantitative Analyst
+31 30 712 1046

Summary

- Risks to the growth outlook were assessed as being tilted to the downside – mostly because of persisting uncertainties, which may ultimately weigh on confidence.
- Despite this downgrade of the balance of risks, no policy response was considered.
- Draghi appeared reluctant to steer towards new policy measures, but the Council may need to act if the economic weakness persists.
- TLTROs were now raised by “several” members, suggesting that this may be the preferred first policy response if data remains weak.

Policy decisions

- The ECB kept its key rates on hold, with the deposit rate at -0.40% and the refi rate at 0.00%.
- Forward guidance on rates was left unchanged at “*at least through the summer of 2019*”.
- Forward guidance on reinvestments was confirmed as “*an extended period of time past the date when it starts raising the key ECB interest rates, and in any case for as long as necessary*”.
- No other new policy initiatives were introduced.

Downside risks

Amidst ongoing weakness in economic data, the Governing Council shifted its assessment of risks to the growth outlook to the downside. These risks were seen as mainly stemming from external sources –e.g. the recent growth slowdown in China, protectionism and Brexit– as well as some country or sector-specific factors, such as the ongoing troubles in the German auto industry.

However, even though the Council unanimously agreed that growth risks were tilted to the downside, there appears to be a division amongst the members over the odds that these risks will actually materialise. Several members are still not convinced that the slowdown is more than merely a temporary phenomenon. Specifically, Mr. Draghi cited confidence that measures taken by the Chinese authorities will support the Chinese economy, which means that much of the weakness in the export sector should “wash out”. The Council also expects some of the idiosyncratic factors in the domestic economy –such as the car industry– to fade.

Additionally, the ECB appears to be quite pleased with the labour market developments as well as their current monetary policy stance – which they consider to be accommodative still– and the resulting favourable financing conditions. Moreover, the banking sector is much more resilient now. As a result, Mr. Draghi noted that a potential realisation of (some of) these risks would mainly cause longer weakness in economic momentum, leading to a slower convergence of inflation towards the ECB’s goal. Risks of a recession, however, are still perceived to be low, a sentiment that was shared unanimously according to Mr. Draghi.

Remaining calm

In other words, the ECB currently doesn’t quite see the need to intervene – not urgently anyway. President Draghi’s attitude in the press conference clearly reflected this view. Apart from the announcement that the balance of risks was changed, the ECB president did not push

a substantially dovish message to the markets, even if he easily could have done so. Quite the contrary, even. Mr. Draghi seemed to advocate patience and calm.

Part of this may have been driven by the fact that the Council has only just ended the asset purchases, meaning that a stronger response could have been interpreted as a signal that the Eurozone economy is not on the right track – making it counterproductive. But Mr. Draghi may also have been mindful that part of the Council still expects these headwinds to fade. President Draghi's neutral stance certainly allows the Council to shift their risk assessment back to neutral if risk factors like the Chinese economy and the German car sector wane, whilst at the same time they now have the option of making changes in the policy stance as early as March if necessary.

First assessment then response

As the ECB is waiting to see how the economic developments pan out, no thoughts were put into a potential policy response to the current prevailing risks. What stood out from today's press conference were 1) that the ECB president emphasised the broad toolkit of the ECB rather than just its rates policy – even though the latter was supposed to have grown in importance; and 2) that the current policy settings are already seen as accommodative. Liquidity is abundant and the market's interpretation of the ECB's reaction function almost automatically provides more (sufficient?) easing in case the slowdown is just a soft patch. In this regard, the ECB president explicitly cited things like lower term premiums and a flatter yield curve.

Unless it is absolutely necessary, the Governing Council may not see compelling reasons to change its current stance. Obviously this view cannot be maintained forever, but it does leave additional time to assess the situation. Another implication of the two points mentioned above is that the interest rate instrument (i.e. guidance) may in fact not be the first to be deployed. Rather, we feel that –also given the frequent mentions of the instrument– a new VLTRO could be used by Draghi in the course of this year as a “fresh” response to combat any signs of protracted weakness, especially if this weakness is concentrated in certain parts of the euro area where the state of the banking sector could impede the transmission of the current accommodative stance. That still does not rule out a delay in the hiking cycle, but it may buy the ECB some extra time before it would need to change tack.

Our take: still September (2019)

Considering today's comments in the press conference, which –in our view– were not yet convincingly pointing towards an imminent change in policy stance, we are holding on to our view that the first rate hike could still take place this September. This view is clearly not shared by the market, but we believe the market is underestimating the ECB's resolve to get rid of its negative deposit rate as soon as they find a suitable window for that.

Because of this, we think a new VLTRO is still very much on the cards – potentially as soon as March if the economic data remain soft. However, we would caution against assuming that such a VLTRO announcement also by default signals a postponement of the first hike. It could equally well create the necessary room for the ECB to push through its rate normalisation plan.

That being said, if the data weaken substantially further in the coming weeks, the ECB may see no other option but to rephrase their forward guidance and delay the hiking cycle.

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

Market Economist
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

Wim Boonstra

Senior Advisor
Germany
+31 30 216 2666
Wim.Boonstra@Rabobank.nl

Ester Barendregt

Senior Economist
France
+31 30 215 2312
Ester.Barendregt@Rabobank.nl

Alexandra Dumitru

Economist
UK, Ireland
+31 30 216 0441
Alexandra.Dumitru@Rabobank.nl

Maartje Wijffelaars

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

Koen Verbruggen

Economist
Eurozone
+31 6 129 73 956
Koen.Verbruggen@Rabobank.nl

Americas

Philip Marey

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

Hugo Erken

Senior Economist
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

Asia-Pacific

Michael Every

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

Björn Giesbergen

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

Hugo Erken

Senior Economist
India
+31 30 215 2308
Hugo.Erken@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 Markets

Ryan Fitzmaurice

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

Agri Commodity Markets

Stefan Vogel

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

Carlos Mera

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

Charles Clack

Commodity Analyst
+44 20 7664 9756
Charles.Clack@Rabobank.com

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
Philippe Macart	France	+44 20 7664 9893	Philippe.Macart@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
Adam Wotton	Capital Markets Asia	+852 2103 2629	Adam.Wotton@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

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