ECB preview: ECB speak vs Euro area data

Bank of America Merrill Lynch

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Rates and Currencies Research
Global

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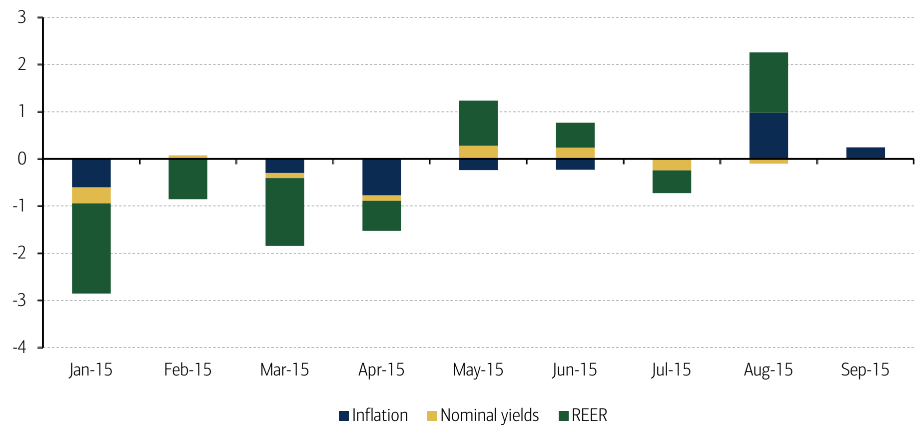
Chart of the day: Euro area monetary conditions have tightened (positive means tightening)

Contributions to changes in MCI Index with 1Y10Y inflation swaps



Source: BofA Merrill Lynch Global Research

QE2 announcement now seems more likely in December

We push our central case for an announcement of QE2 from October – although still a "live" meeting, in our view – to December. We believe the dataflow is more and more consistent with an additional layer of monetary stimulus, but the ECB-speak – in particular Benoît Coeuré on Monday – suggests that a consensus may yet take some time to form at the Council. We are not ruling out that ECB President Mario Draghi manages to "force" a decision next week, but the bar on an immediate response seems to be high.

We would not be surprised by "compromise solutions" next week, with for instance strong hints at a "thorough review of the programme by year-end." Still, we believe that the more the ECB waits, the more it will have to do to convince the market it can deliver on its price stability objective. Further, the lack of a quick response could cost the Euro area's GDP growth 0.2/0.3ppt in 2016, still leaving a decent pace (above potential) but with no acceleration relative to this year.

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"Wait and see" mode seems to have spread beyond the hawks

Since July we have been saying that the ECB would have to roll out QE2 – in the form of an extension beyond September 2016 – by the end of this year. In our view, the Fed's non-decision and the data flow, at a global level and now increasingly at the Euro area specifically, favor a quick response by the Governing Council. This made us think that, although a close call, an announcement would be made on 22 October.

Until Monday, ECB rhetoric, skewed more toward "wait and see," did not sway us as it was coming from the hawks. However, it seems to be spreading beyond the ranks of those who were already even against the principle of QE in January. Benoît Coeuré in a CNBC interview was notably dismissive, stating that while the ECB had to be "ready", a "discussion" on more QE would be "premature."

This was a key message from last month's press conference, but over the last month, we thought that the Council's level of concern – already quite elevated according to our reading of the minutes last week – had significantly increased. Unlike Peter Praet in his latest speeches, Coeuré chose to "accentuate the positives" about the Euro area. This may signal that there is not sufficient consensus within the Council for a decision to be made this month. Coeuré said in Lima that the ECB was in a "fact-finding" mode. This could be one of those episodes where the ECB, though sensing that "something is not quite right," does not want to jump the gun. We have been there before.

Although the impending Council meeting remains "live," in our view, we believe 3 December is now a likelier occasion for a QE2 announcement. Formation of a consensus could well require further signs of transmission of low EM demand to European exports (after the disappointing series of German data last week), as well as more signals of a relapse in observed and expected inflation.

The more the ECB waits, the more it will need to give

Still, we believe that the more the ECB waits, the more it will have to do to convince the market it can deliver on its price stability objective. QE2 is increasingly consensual among commentators, and market expectations for a decisive further step are building – with expansion, on top of extension, being discussed more and more, in addition to some pricing in of a deposit rate cut. In this configuration, the ECB could surprise on the upside on the "when" by accelerating the timing (thus delivering next week), while it is increasingly difficult to surprise on the "what" (the content).

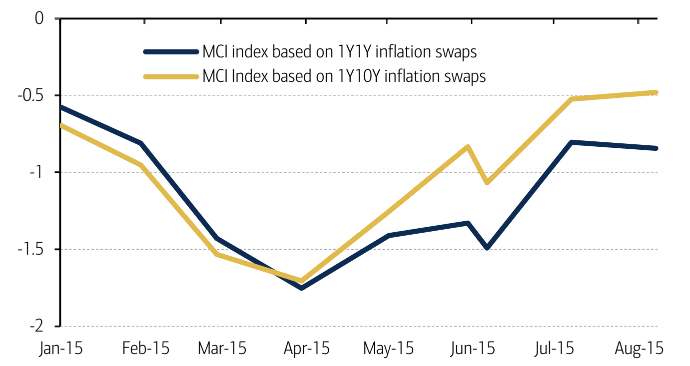
If the ECB waits to announce in December, we believe it risks merely confirming what the market and other macroeconomic agents already seem to be anticipating: in other words, better than nothing, but hardly decisive. In a nutshell, while mere extension could suffice for a move in October, by December we believe the ECB would need to deliver extension and expansion – with the "delta" in purchases possibly being directed toward corporate bonds – to fully re-assure the market and compensate for any further deterioration in the economic outlook that could come with that delay (see below for a discussion on how an insufficient or late reaction could hamper some of the delta in terms of growth we are forecasting for 2016).

Table 2: BofAML forecasts - Euro area

	GDP	Private Consump.	Gov. Consump.	Investment	Net Exports
2015	1.58	1.85	1.22	2.05	0.15
2016	1.88	1.80	0.66	2.67	0.23

Note: yoy growth rate.
*Contribution to GDP growth.
Source: BofA Merrill Lynch Global Research

Chart 1: MCI



Source: BofA Merrill Lynch Global Research

Communication could be complicated for Draghi next week. In September he was already remarkably dovish. He has little space at this stage to "up the ante" and keep the central bank on the right side of the curve without making actual announcements. A compromise solution would be (1) to acknowledge explicitly that a discussion on QE2 is already taking place at the Governing Council and (2) to provide some indicative timing – for instance by stating that the ECB intends to "review" the program at the end of the year as the new forecasts are coming out. This would constitute the kind of "near announcement" that would support market confidence.

As an example, and unsurprisingly in this environment, the euro pushed towards 1.15 on the back of poor US data. Just as unsurprisingly, as this has been a recurrent pattern since April, a Governing Council member broke the purdah period to come out very dovish, explicitly mentioning the ECB's "failure on core inflation," to help bring back the euro toward safer territory.

Tighter conditions until December could harm growth

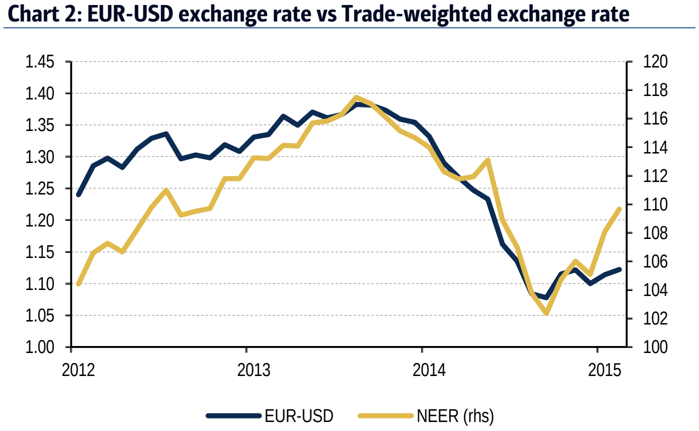
While Draghi usually displays an impressive mastery of the press conference, he has had "communication mishaps" in the past. If he comes out too hawkish next week, ie, too dismissive of the risks, the euro exchange rate could undergo a knee-jerk leap, which would make waiting until 3 December quite taxing for the Euro area. Without a quick response from the ECB, we believe the new configuration for world demand combined with tightened financial conditions (real interest rates are up and the euro's trade-weighted exchange rate is up 6.2% from trough in April) could cost the Euro area's GDP growth 0.2/0.3ppt, still leaving a decent pace (above potential) but with no acceleration relative to this year.

The acceleration of our forecasts from 1.6% GDP growth in 2015 to 1.9% in 2016 was mainly driven by a pick-up in capex from 2.0% to 2.7% (Table 2). This was expected to be fuelled by re-emergence of the lending cycle with abundant liquidity, expectations of decent growth for a couple of years, and real rates at their lowest levels for a while. This would certainly at least be questioned if the ECB response was not fast and/or strong enough.

We have discussed before (see report: Europe Economic Weekly: Deconstructing Depo) the tightening of monetary conditions since the end of April this year (Chart 1). And we have argued that, in contrast to May, the recent move has a lot to do with the evolution of real rates, which in turn have been driven by falling inflation expectations (Chart of the day), together with the evolution of the currency (Chart 2). This generalized tightening of monetary conditions was the main driver of our QE2 call for this year.

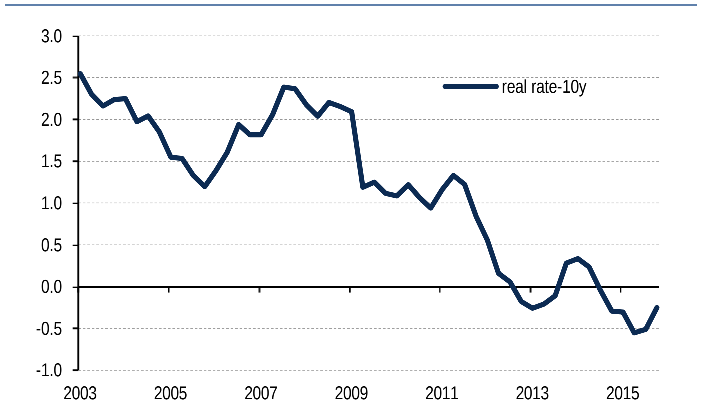
If we look in particular at the long end of real rates, the important ones for the evolution of investment, since the lows in Q2 10Y real rates are up 30bp (Chart 3). If the ECB disappoints and real rates do not move much from where they are in the short run, that would cost the 20-30bp in terms of GDP for 2016 suggested above, since it would impact the evolution of investment in the next few quarters.

Chart 2: EUR-USD exchange rate vs Trade-weighted exchange rate



Source: ECB, BofA Merrill Lynch Global Research

Chart 3: Real rates



Source: BofA Merrill Lynch Global Research

Rates: Spanish trades closed, inflation trade opened on ECB inaction

Back in late July, and more recently at the end of September, we recommended going long Spanish 2y1y and 4y3y rates, based on an analysis of the forward gaps. With QE2 now unlikely in October, and the trades' strong performance since initiation, we close both positions. Nowotny's comments last week, including a frank assessment of how the ECB are "clearly missing" their inflation target, have made next week's delicate balancing act even more difficult. Draghi may struggle to sound more dovish than he did at the September meeting, appeasing increasingly long peripheral positioning, while also defending no further action in the face of such a "clear miss". Given the uncertainty surrounding the meeting, we prefer to lighten our positions.

Despite scaling back on peripheral forward trades, we remain constructive overall, and see the wider carry-trade narrative holding into the year end – particularly should the range-bound nature of core rates continue. We look to re-enter at more attractive levels on the back of any ECB disappointment next week.

US-EZ 5y5y wideners - nominal good, b/e better

Back in August, we recommended receiving 5y5y EUR versus USD in nominal space, based on the expected policy divergence in the two economies. In late September, we concluded it was the US-EZ forward inflation rate that looked very attractive, with both central banks priced to undershoot their respective mandates by the same amount. However, at the time we were concerned that an October QE extension announcement might cause a brief bounce in EZ 5y5y inflation, offering improved entry levels.

Given that it seems much less likely now, we recommend entering the trade at current levels of 47bp, targeting 75bp with a stop-loss of 32bp. At 47bp, the spread appears low relative to both recent and pre-crisis norms, while it is also historically low as a proportion of the nominal 5y5y spread.

FX: Bar is high for sustained EUR downside

Since the last ECB meeting in early September, EUR is over 1.5% higher on a trade-weighted basis. Indeed, the close on 3 September marked the most recent low in the TWI following a dovish message by Draghi at the press conference. The bulk of those EUR gains have been against USD, which is down over 2% as EUR/USD maintained a handle above 1.10. Much of this resilience can be attributed to the recalibration of Fed rate hike expectations following the 17 September meeting.

ECB officials have shown little tolerance for a stronger EUR and we note with interest that the move towards 1.15 in EUR/USD has triggered a flurry of dovish comments from ECB officials. Tangible action from the ECB could provide the catalyst for a lower EUR/USD but the flip side is that US economic data need to start delivering positive traction on the policy divergence theme for such a move to be sustained; but so far Q3 releases have been disappointing.

Our base-case scenario is that the ECB and the Fed will ultimately deliver by the year end and push EUR/USD lower. We do concede, however, that there are growing risks to our year-end FX forecasts and headed into next week's meeting the recent resilience of EUR suggests that merely dovish rhetoric will not be enough to meaningfully or sustainably weaken the currency outside of a firm commitment to policy action in December.

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