10 October 2019

Flash: ECB Research

Muddy ECB minutes amid questioned commitment

- The ECB minutes from the September meeting released earlier today showed all Governing Council members (GC) wanted to act, but disagreements on how to act. Markets still question the ECB's ability and willingness to do whatever it takes.
- We do acknowledge the need for action by the ECB given the low inflationary outlook, but troubles lie ahead, with subdued economic and inflationary momentum, geopolitical risks and no sizeable fiscal support in sight. Inflation is expected to stay stubbornly low at least until the end of next year.
- We expect the ECB to stay side-lined at the 24 October meeting, but the recent fall in inflation expectations increases the probability of further action in the December meeting (or early next year) by the ECB – although it is still unclear what such measures would entail, and the minutes didn't give any new indication.

ECB minutes

The ECB minutes released today from the 12 September meeting carried the tone of an ECB unanimously agreeing to act, but uncertainty about how to act. Some arguments were put forward regarding substituting the effect of the measures, rather than the usual complementarity of the policy tools, where particularly some argued for a larger rate cut and no QE. The minutes also carried a tone of the ECB needing to act because of markets having already taken into account further easing, in particular given the weak economic outlook. On the economic outlook, '*Several members were arguing that, despite the revisions, the baseline scenario in the latest ECB staff projections was still too optimistic*', which clearly is a concern as the already optimistic projection takes for granted easier financial conditions. The staff projections do not reflect a no-deal Brexit or a US-China trade collapse, which do increase the risk of further policy responses should they happen (not our baseline). That said, the tone of the minutes does not indicate an ECB about to act imminently.

On the restart of QE, the minutes show that the ECB launched it in order to complement the other policy measures and also due to market expectations that had already built up. It was further noted that its purpose was also to avoid the loss in duration of the ~~already~~ existing portfolio holdings. On the much debated potential break of the ISIN limits, they also assume easier fiscal policies, which means the ECB assumes an increasing stock of purchasable assets. This is not a view we share, see also our Government Bond Weekly *here*. Finally, a '*number of members… not sufficient strong to restart QE*'. Reservations were also expressed about QE, for if the open-ended EUR20bn did not lift inflation, then more would be demanded by markets.

The outlook for policy changes remains blurred, with starkly opposing views and limited scope within the original toolbox. The *FT* reported earlier today that the governing councils decided to overturn the recommendation by the monetary policy committee on restart of QE, but the minutes did not indicate that. With growth risks still elevated, the ECB saw the inflation outlook as subdued at the 12 September meeting and they are getting more and more challenged by the expectations for low inflation.

Senior ECB / Euro area Analyst
Piet P. H. Christiansen
+45 45 13 20 21
phai@danskebank.dk

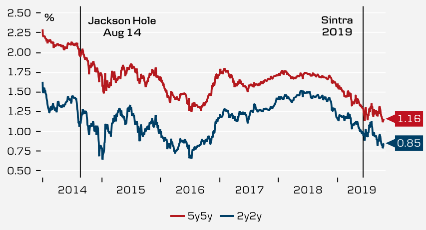
Senior Analyst
Aila Mihr
+45 45 12 85 35
amih@danskebank.dk

Far from target – challenged ECB

The ECB is getting gradually more challenged and has been since the 12 September meeting, as the growth outlook has been weakening slightly and inflation expectations have declined markedly: they currently hover around record low levels (5y5y inflation swap at 1.16% currently). The ECB's at first bold, but non-committable package according to markets, has failed to lift market expectations as public disagreement has questioned the ECB's commitment, and potentially also its ability, to lift inflation back to target. The ECB GC unanimously also acknowledged that fiscal policies were the main tool via growth friendly fiscal initiatives, but Germany remains reluctant to *loosen the brake of fiscal policies*.

To our surprise, the ECB is still not worried about de-anchoring inflation expectations, although they carefully reiterate 're-anchoring' of inflation expectations at levels not compatible with the mandate. We believe that the limited policy response within the current framework partly reflects that view.

Inflation swaps at all-time lows



Sources: Bloomberg, Macrobond and Danske Bank

Public cacophony limits stimulus impact

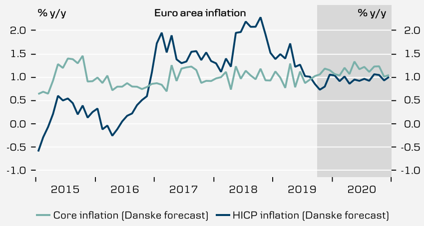
The public cacophony and discord with the official policy line dents the ECB's ability to convincingly lift inflation, illustrated by the doves' (Draghi, Lane, Rehn) continuous repetition of this package being adequate to lift inflation which is being counterweighted by the hawks' (Knot, Weidmann, Coeuré) opposition against it. We believe the ECB was right in launching a package due it its mandate, but we were left disappointed with the details. With the ECB's conventional toolbox looking increasingly empty, the ECB's commitment to think even more unconventionally should eventually also include measures that stimulate the demand side of the economy. More supply side measures have little effect as financing conditions are already very loose in the euro area

Looking back on the previous weeks, the disagreement with the package has been quite clear. In the aftermath of the September ECB meeting, media stories suggested wide disagreement with the policy actions, where at least seven governing council members have been opposing the package, but up to 12 have had reservations with the package. We have also seen, an to our knowledge, unprecedented move by the Dutch Klaas Knot opposing the package with a statement on the Dutch central bank website where he coins the package 'disproportionate' to the current economic conditions. Also following the decision to stimulate the economy, ECB board member Sabine Lautenschläger resigned, in what can only be interpreted as disagreement with the package as she has been in long-standing opposition to the bond purchases.

Inflation outlook

The details of the recent inflation dynamics have shown that the ECB's hope continues to rest on service prices. While it might see a slight lift in the coming months as the drag from package tours abates, it alone cannot trigger a sustained rebound in realised or projected market expectations for inflation. This remains a key reason why we still do not expect core inflation of more than a mere 1.1% on average next year. Service price inflation is still too low to compensate for the drag from the goods side – making the ECB's 2% inflation target seem as elusive as ever.

Inflation outlook still subdued



Source: Danske Bank

Assumptions: Brent oil at 64USD/bbl in 2019 and 60USD/bbl in 2020; EUR/USD at 1.12 in 2019 and 1.13 in 2020

Further monetary policy accommodation will be challenged

The relatively widespread disagreement with the latest package limits the room for manoeuvre in the near term. This is clearly illustrated by the ECB's vice-president Luis de Guindos' interview yesterday, when he said that a package should only be used once a year and should not be changed often as that undermines its effectiveness. **We see the ECB being side-lined at the October meeting, but the recent fall in inflation expectations raises the probability of further action in the December (or early next year) by the ECB – although it is still unclear what such measures would entail**. Fiscal policies would be welcomed, however at current stance and judging from the 2020 budgets released so far, we do not expect fiscal policies to play any meaningful role in lifting inflation.

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Michael Grahn and Marcus Söderberg.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

Danske Bank's research reports are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from and do not report to other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including as sensitivity analysis of relevant assumptions, are stated throughout the text.

Date of first publication

See the front page of this research report for the date of first publication.

Disclaimer

This [research has been prepared by Danske Bank A/S. It is provided for informational purposes only and should not be considered investment advice. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.

Report completed: 10 October 2019, 14:28 CEST

Report first disseminated: 10 October 2019, 15:45 CEST