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## Focal Point

# ECB: Further easing steps ahead

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- The ECB will have to reassess its monetary policy stance on March 10 because of record-low financial market inflation expectations, a downward adjustment in the macro outlook and worsening financial conditions.
- We see the ECB to lower the deposit rate (by 10 – 20 bps), to likely switch to a multi-tier deposit rate scheme, to possibly increase the volume of monthly purchases (by € 10 – 20 bn) and maybe to even start buying corporate bonds.
- However, the expected new measures will be implemented at a time when the effectiveness of monetary policy is questioned. In fact, the experience after one year of QE in the euro area is at best mixed.
- While the short-term impact on risky assets can be positive, a lasting turnaround and a more sustainable improvement, however, will require progress on various risks currently burdening financial markets (e.g. growth concerns).

Following the latest round of ECB easing measures in December, the period of monetary policy expansion has not come to an end. In January, ECB President Draghi announced that the ECB will “*review and possibly reassess its monetary policy stance in March*”. We think that the Governing Council will announce a new package of policy measure on March 10 that will not disappoint markets.

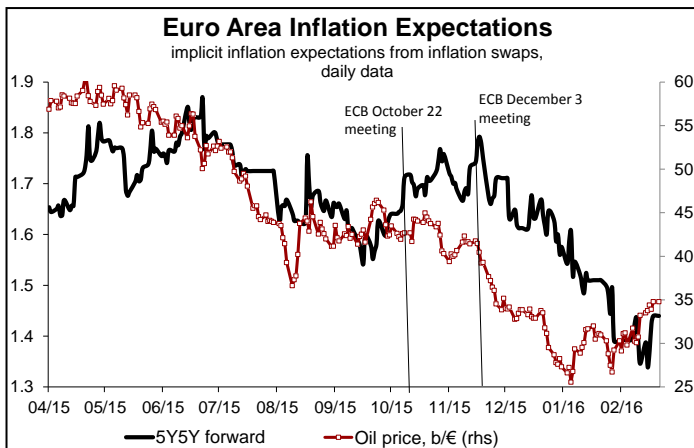
### Reasons for the ECB to reassess its policy

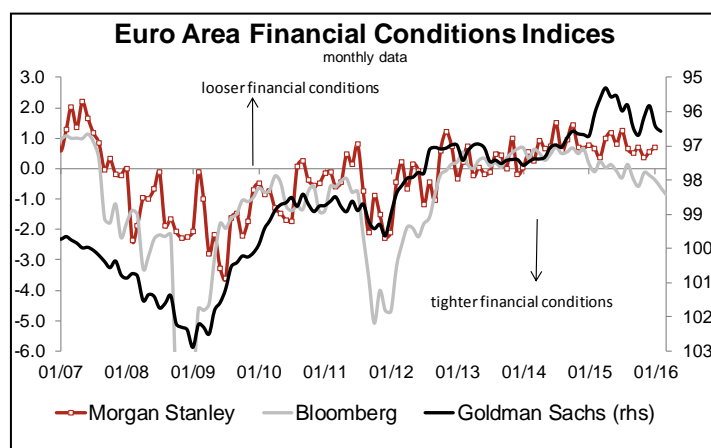
There are many reasons for the ECB to act. First, financial market inflation expectations have come down to an all-time low. Even worse, as of late they temporarily kept on falling even when the oil price started to stabilize. Other indicators of inflation expectations (Survey of Professional Forecasters, EC Survey) look less gloomy but given the

prominent role of the 5y5y implicit inflation expectation there is clearly a reason to be seriously concerned. This indicator is more than two standard deviations below normal flagging that the risk of second-round effects rises.

Second, in March the ECB will have to update its growth and inflation projections. Given the latest slump in oil prices the 2016 inflation forecast of 1.0% will have to be revised substantially, to 0.5% in our view. Moreover, there is mounting indication that economic activity loses speed. The composite PMI receded to 53.0 in February (high: 54.3 in December) and also forward-looking expectations were deteriorating on a broad-base as of late. Risks related to the global economy, the refugee crisis, the Brexit scenario and various country-specific factors also argue for a clear downward revision of the ECB’s 2016 growth forecast of currently 1.7% closer to 1%.

Third, on top of that there is some indication that the current turmoil in financial markets has started to affect also the real economy. The stress in the banking sector will in an extreme low yield environment also harm the bank’s willingness and ability to provide credit the longer it persists. Financial condition indices (FCIs) that are a comprehensive measure of financing conditions firms are facing have deteriorated (see chart, next page). While the FCIs are not back to crisis levels yet, it tends to dampen activity additionally at a time of weakening loan growth. In January, private loan growth was at 0.8% yoy (November high: 1.2% yoy) as loans to non-financial corporations lost momentum (from November high of 0.7% yoy to 0.4% yoy in January).





### More QE and a deposit rate cut in March

While latest comments from ECB officials also hinted at further action in March, there were almost no concrete remarks about the measures likely to be adopted. We think that the new measures will aim at primarily shielding the real economy from financial market woes and the global growth slowdown. However, given that the ECB has already taken bold measures in the past, the design of new measures becomes more challenging. A large scale extension of the asset purchase program (APP) likely leads to scarcity problems, especially in the case of Bunds. These effects could be mitigated for instance by increasing the issuer limit (from 33% at present) or departure from the public sector bond buying according to ECB capital keys. However, doing this would bring the ECB closer to the allegation of state financing and reduce the incentive of governments to lastingly improve public finances. From this perspective, an extension of the APP to other more risky asset classes (e.g. corporates, and ultimately even equities) or an extension of ABS purchases could be considered. However, the ECB then takes higher risks that could easily result in losses, something the ECB wants to avoid. A lower deposit rate would widen the ECB's universe of eligible assets (given its self-imposed restriction not to buy assets with a yield below the deposit rate) and also work towards a weaker euro. But it would also penalize banks additionally thereby contributing to the financial sector woes the ECB would rather like to tame.

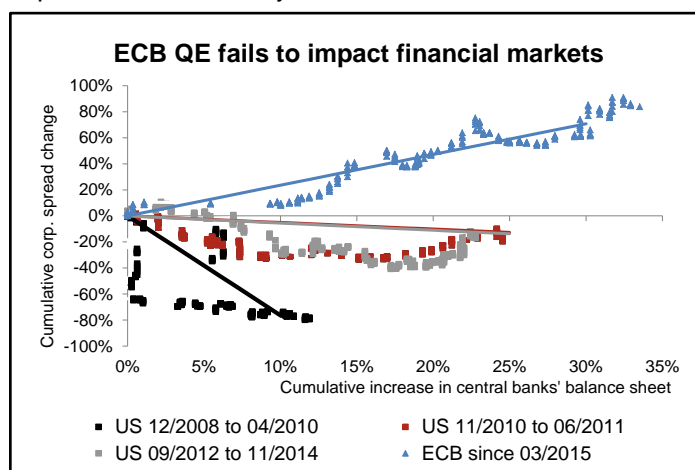
Given these considerations we think that the ECB will rather adopt a variety of tailored measures than focusing on one single issue only. We deem it most likely that the ECB lowers the deposit rate from the current level -0.3% further to -0.4% to -0.5%. But as it is a two-edged sword we find it equally likely that a multi-tiered deposit rate scheme in the spirit of the Bank of Japan (BoJ) will be adopted. Given the current market pressure, higher bank profits will likely more than outweigh the reduced incentive to create new loans in case a part of the deposits is no longer subject to negative interest.

In order to be able to extend the volume of monthly APP purchases from € 60 bn to € 70 bn to 80 bn an extension of the universe of eligible assets towards more agencies is also likely. An outright move to corporate bond buying is something we would rather expect for further rounds of QE. To give a clear signal about its commitment we also find it likely that the period of asset purchases will be extended further into 2017.

### Inconclusive market results after one year of QE

Detached from regulatory considerations, at least there was a broad-based consensus that QE is able to support financial markets. It is generally recognized that the aggressive monetary easing by the Fed between 2008 and 2014 contributed to rising equities and a significant tightening of credit spreads.

However, the ECB will act at a time when financial markets have started to question the effectiveness of central bank actions. The surprise move by the BoJ at the end of January did neither trigger a weakening of the yen nor boosted equities. In fact, the results after one year of QE by the ECB are at best inconclusive. While euro area core yields are slightly lower, the effects on more risky assets are mixed. European equities are around 15% lower, corporate spreads have nearly doubled and even the spread of peripheral bonds which are included in the QE program have widened by around 40 bps. In addition, inflation expectations are at or close to historical lows. With 10-year inflation swaps around 1.1% and the closely watched 5-year 5-year inflation forwards below 1.5%, current inflation expectations can hardly be described as anchored.



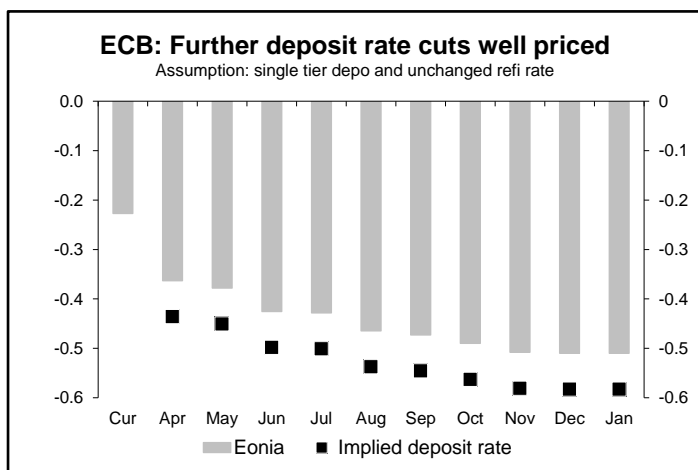
However, the conclusion that QE is generally ineffective appears premature. Indeed, financial markets have got accustomed to central banks' interventions and the impact has faded somewhat. What is more, the side effect of e.g. negative rates on banks' profitability is seen more critical than before. However, this analysis does not account for external factors and disentangling the pure effect of QE is hardly possible. Certainly, increased growth concerns and the heightened risk aversion have had a great impact on the poor performance of risky assets in recent weeks. Overall, several studies show that the scarcity of assets and the signaling effect of QE in combination with the central bank's forward guidance are important factors. Therefore, a well-designed QE program still has the potential to impact financial markets.

### Further ECB measures likely well received

For assessing the effect of the additional monetary measures outlined above, it is necessary to evaluate what markets have already priced. Most straightforward, this can be done for money markets. Assuming a single tier deposit rate scheme, a cut of around 15 bps is priced (followed by another 15 bps until the end of the year). As this is roughly in line with our expectations for this week, it is fair to say that the forthcoming ECB actions are fully priced

by money markets. Hence, the immediate impact is expected to be rather small.

With respect to bond markets, it is more difficult to derive markets' expectations as the recent strong moves are mainly driven by the risk off sentiment and not by the forthcoming additional ECB measures. While the trend towards wider public and private spreads indicates that not much is priced, the strong flattening of the 2-year/10-year curve signals that some adjustments have already taken place. On balance, we think that shorter-dated yields have to a large extent prepared for substantial ECB measures (in case they will be announced largely as outlined above), but inflation expectations at record lows indicate that market participants doubt their lasting success.



Nevertheless, assuming the complete ECB package comes in line with our expectations outlined above, the initial market reaction to a renewed ECB commitment may still be positive. Particularly, peripheral spreads have leeway to tighten and inflation expectations are expected to increase. If Investment Grade corporates become eligible for the APP, corporate spreads will tighten considerably as this is not a consensus view yet. Even if not, taking into account the trickle-down effect and the low yield environment spreads have some leeway to fall.

The case is less clear for euro area core yields. Given the too strong downward movement – from a fundamental perspective – in recent weeks, higher breakevens and slightly improving economic perspectives induced by the ECB measures, work against a further drop in core yields. If the ECB tackles the scarcity problem of German Bunds successfully (e.g. by removing the deposit rate floor), even an increase of long-dated Bund yields is possible.

### Longer-term market impact more uncertain

The durability of the impact on financial markets, however, is dependent on other factors. To achieve a lasting effect and to trigger a turnaround in risk sentiment, progress on the various risks currently depressing markets and/or a more coordinated approach of various central banks appears necessary. Particularly, Chinese macroeconomic data have to improve sustainably reducing concerns about a spillover to the developed world. In addition, political risks in the euro area (e.g. reform fatigue, refugee crisis, Brexit) need to recede considerably. This applies all the more as lowering the term premium and reducing rates further into negative territory can turn out to be counterproductive. Hence, the expected further easing of monetary policy by the ECB will in and of itself not be sufficient to

induce a sustainable rally in equities and a strong and lasting tightening in private and public spreads.

Merely, the current level of long-dated inflation expectations does not appear sustainable. 10-year euro area inflation swaps slightly above 1% and 30-year inflation swaps around 1.6% ought to rise in line with bottoming out of euro area headline inflation rates. The ECB commitment to push up inflation rates will sooner or later leave its mark in higher inflation expectations.

# Imprint

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