

Focal Point

ECB tapering to support upward trend in yields

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- At its meeting on October 26, the ECB announced to cut its QE purchases to €30 bn from January 2018 onwards until at least September 2018, to reinvest QE-related redemptions, to leave the forward guidance in place and to extend the fixed rate tender procedures with full allotment in monetary operations to at least end-2019.
- Thereby, the ECB delivered the expected dovish tapering in order to avoid a tantrum-like market behavior. While QE likely ends in September 2018, we look for first key rate hikes in 2019.
- Regarding policy implementation, the PSPP's issuer limit of 33% is likely to become binding in Q2 2018. Hence, the actual purchases will deviate further from the capital key implied share.
- In a knee-jerk reaction, financial markets have reacted with a drop in yields and the euro while equities soared. Looking ahead, however, the reduced ECB support will still leave European yields trending upwards.

At the October meeting the ECB revealed how it will proceed in reducing its asset purchases. As we will explain in the following, this will help to pave the way for higher yields. However, the ECB also made clear that it seeks to avoid any sort of taper tantrum and stands ready to act with renewed monetary policy support, if needed.

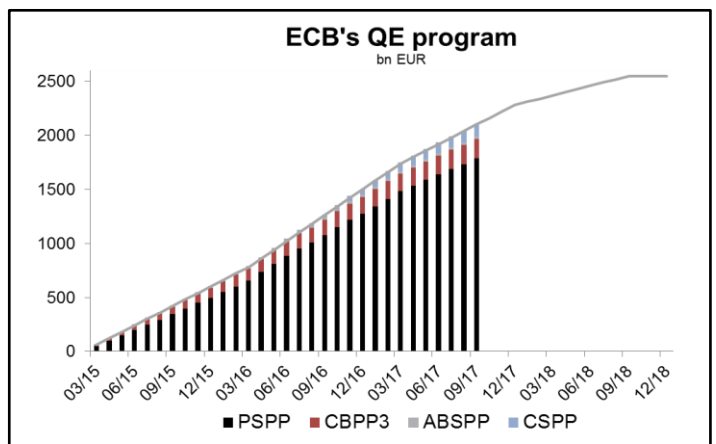
ECB goes for a dovish tapering in 2018

After having confirmed in summer that QE will have to be adjusted, at the October 26 meeting the ECB communicated the long awaited details. It announced that from January 2018 onwards monthly Asset Purchase Programme (APP) purchases will be reduced to €30 bn per month, from €60 bn. Purchases will last until at least September 2018 as the ECB did not pre-commit itself to a definite end, while maintaining the APP easing bias. Without any further extension of QE, the total amount of QE purchases will fall from €780 bn in 2017 to €270 bn in 2018.

Moreover, the ECB committed itself to “reinvest the principal payments from maturing securities purchased under the APP for an extended period of time after the end of its net asset purchases...”. By confirming market expectations of such kind of passive QE, the ECB aims at dampening the effect from reduced net asset purchases on bond demand. According to our calculations, in 2018 there will be reinvestments of about €110 bn under the Public Sector Purchase Programme (PSPP) alone.

The forward guidance, stating that interest rates will remain at their present levels for an extended period of

time, and well past the horizon of QE, was maintained. Regarding refinancing operations, the ECB announced that the fixed rate tender procedures with full allotment for the main refinancing operations and the three-month longer-term refinancing operations will be maintained at least until the end of 2019.



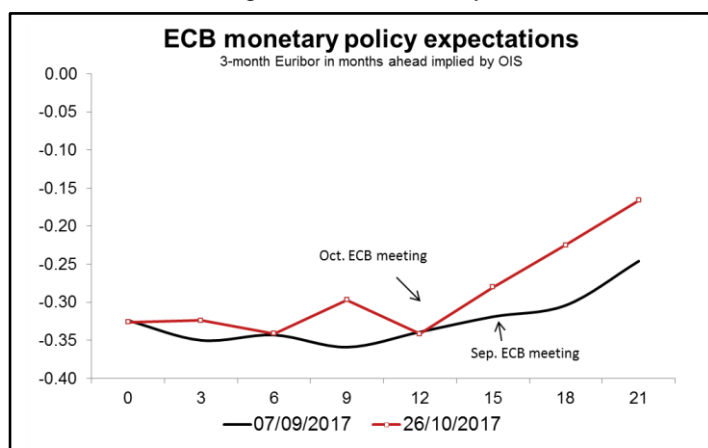
These two money market measures are a clear signal that the monetary policy adjustment in 2018 will focus on the long end of the curve only and that the favorable financing conditions at the short-end of the curve will stay in place for quite some time after QE will be finished. Draghi, not surprisingly, refused to comment on what this means in terms of months.

All in all, the October ECB policy meeting was in line with expectations. The ECB maintained a dovish tone and

accordingly rather talked of recalibration and downsizing than of tapering.

What a dovish tapering path means

Looking ahead, the key question is what a dovish tapering path means. The expected macro setting will likely remain favorable: The ECB growth expectation of 2.2%/1.8% and the inflation forecast of 1.5%/1.2% for 2017/18 are backed by the latest data flow. On top, with growth above potential the output gap will likely close already in 2018, supporting the uptrend in underlying inflation, which according to the ECB yet has to “show more convincing signs of a sustained upward trend”. We see the ingredients for an upward trend in place and expect underlying inflation to further inch up from the current reading of 1.3% yoy. But, Draghi referred to the response of nominal wages to the closing output gap as a key factor. We also think that a sustained rise in wages is still some way off.



However, only slowly rising underlying inflation does not automatically imply an extension of QE beyond September 2018. The ECB explicitly stated that monetary support is not only provided by QE but also by the stock of purchased assets, the reinvestment of maturing bonds and the forward guidance. Given the all in all favorable macro environment we think that net QE purchases will no longer be needed after September 2018. In order to mitigate the negative effects from below zero policy rates, we furthermore continue to expect a deposit rate increase by 15 bps to follow then. This is consistent with market expectations (see graph). Next, we foresee a first repo rate hike. While we envisage these key rate hikes for 2019, the ECB in any case made clear that it wants to engineer a dovish tapering in order to avoid any kind of taper tantrum. According to Draghi, the reinvestment of redemptions under the APP is not related to key rates and we expect the ECB to follow the Fed and to maintain reinvestments also well past the first repo rate hike.

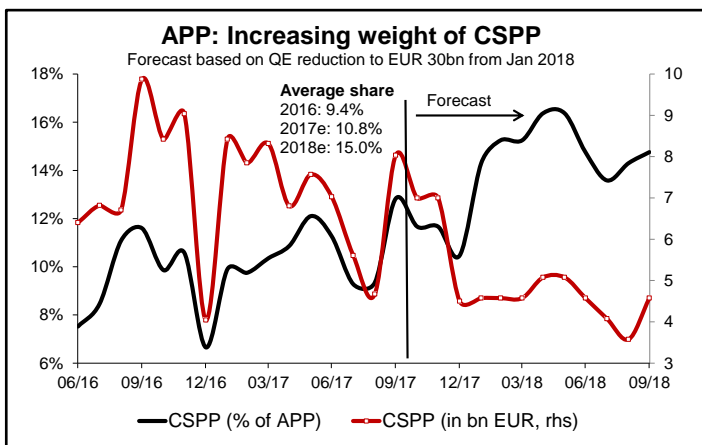
QE beyond September 2018 remains a risk

We see the major risk related to the above described tapering trajectory due to disappointing core inflation. Here, the exchange rate development is also a potential factor but its importance has been scaled back at the October meeting. Also, a marked deterioration in financial conditions because of political woes (e.g. Catalonia, Italian elections) has the potential to trigger a further extension of QE. However, we think that the hurdles for doing so are high

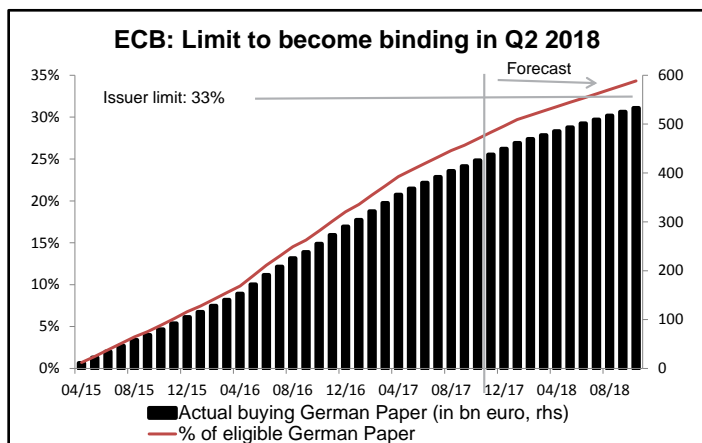
and that the main purpose of the easing bias with regard to the APP is to contribute to a smooth and dovish tapering.

Scarcity to become a pressing issue in Q2 2018

ECB President Draghi did not give any hints regarding the composition of future purchases. While in the past the PSPP's share amounted to more than 80% on average, the central bank showed some flexibility as the Asset-Backed Securities Purchase Programme's (ABSPP) and the third Covered Bond Purchase Programme's (CBPP) volume fell over time. In contrast, the CSPP gained in importance. In September, the CSPP's share in the overall programme even reached a historical high of 12.8%. This helped to ease the scarcity burden as the 33% issuer limit got closer for some countries.

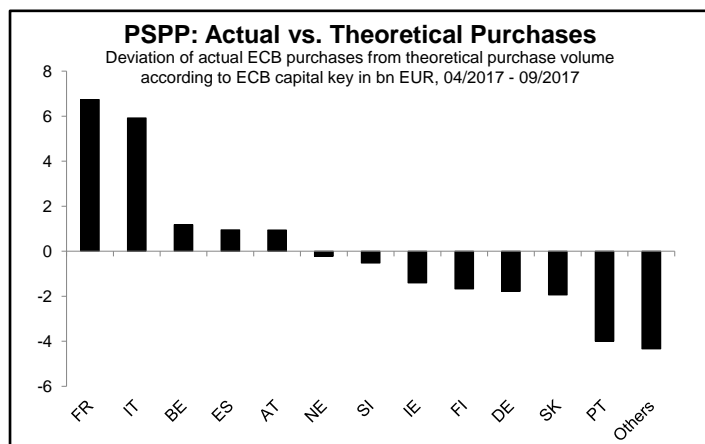


Going forward, we expect the ECB to focus even more on the CSPP. While the average share was slightly above 9% in 2016, it is assumed that it will increase to around 15% next year. This implies that the ECB will purchase on average €4.5 bn per month (compared to €6.5 bn for the period from April 2017).



Still, the majority of ECB purchases will be targeted at the sovereign bond market, bringing the scarcity issue back on the table. For our calculations, we assume that from January onwards the ECB will purchase less than €24 bn for the PSPP (excluding supnationals: around €21 bn). The most pressing case are German bonds. At the end of September the ECB already held more than €425 bn of German bonds (27% of outstanding eligible). Based on the assumptions above, the ECB's theoretical purchase volume of German bonds will be around €5.5 bn per month. Taking into account reinvestment flows, this sums up to €8.5 bn. This implies that at the end of Q2 2018 the issuer limit for German bonds will be reached.

As ECB President Draghi stressed that the hurdle to depart from the issuer limit is extremely high and other modifications do not ease the problem lastingly (like e.g. the increase of the 30-yr maturity restriction), the most probable way to overcome the problem is to deviate from the ECB capital key buying. Although Draghi always denied a substantial deviation, the actual purchases have differed from the theoretical purchases for a long time. Not only small countries are underrepresented, but since spring also German bonds are bought at a reduced amount compared to the theoretically implied volume.



Since April, the accumulated actual purchase volume for German bonds is nearly €2 bn below the theoretical level. However, as the central bank bought more German paper than implied by the ECB capital key at the start of the QE programme, there is still a buffer of more than €6 bn. This cushion will likely be reduced gradually and will probably even become negative until the end of the QE programme. The same applies to other countries, especially to Slovakia and Portugal. By contrast, the relative support particularly for French, Italian and Spanish bonds will even intensify going forward to balance this target shortfall.

Limited financial market impact in the near term

The perceived dovish QE tapering announcement triggered a friendly reaction on financial markets. In a knee-jerk reaction, sovereign yields fell, public and private spreads tightened, equities rose and the euro depreciated. As the reduction of the purchase volume is still some way off and considering that the announcement was broadly in line with expectations, there is little reason to assume that yesterday's press conference will impact financial markets strongly near term.

Looking into 2018, however, euro area core yields are likely to trend upwards. The economic outlook remains benign and financial market's pricing of a first repo rate hike appears too cautious. In addition, the term premium is unlikely to remain close to zero in light of reduced QE support and rising inflation expectations. Accordingly, 10-year Bund yields are seen to rise to 0.80% on a 12-month horizon. As the ECB forward guidance will to some extent anchor the short end of the curve, the core yield curve is likely to bear steeper.

Although the central bank will purchase more BTPs and Bonos than implied by the ECB capital key in 2018, the absolute volume will still come down strongly compared to 2017. As the core yield level is expected to rise, this reduces the incentive to search for a pick-up. What is more,

in Italy (general elections) and in Spain (unresolved Catalan issue) political hurdles are in the way and will likely trigger higher sovereign spreads in H1 2018.

Although it is assumed that the CSPP as a percentage of the overall QE programme will increase, the absolute volume will come down next year. What is more, the trickle-down effect euro area corporate bonds have enjoyed since 2015 will abate going forward. Moreover, the net supply is expected to increase next year which – in combination with the already ambitious valuation – should pave the way for moderately higher corporate spreads over the course of 2018.

Imprint

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