Focal Point

ECB: Action postponed towards year-end

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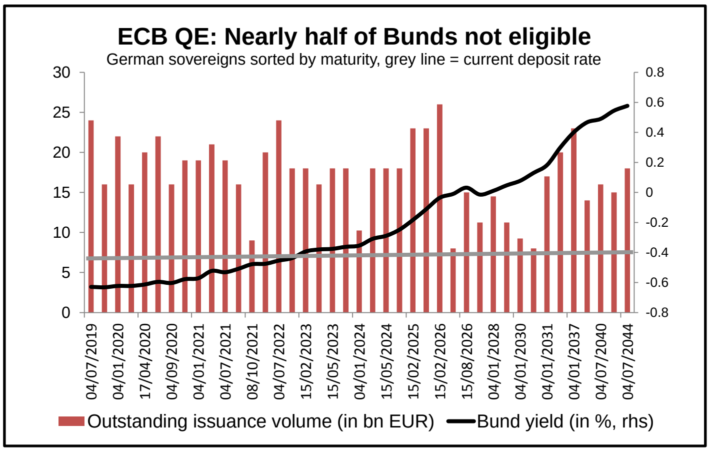
- At the September meeting, the ECB neither gave an indication about the needed adjustment of the APP nor hinted at the extension of its QE program, thereby disappointing markets.
- Looking ahead, we still think that under the current eligibility criteria the ECB is hardly able to complete its QE program so that an adjustment (e.g. an increase of the issuer limit to 50%) seems inevitable.
- Moreover, we think that the ECB is too optimistic on growth as well as inflation and inflation expectations remain stubbornly low. We expect that the ECB will have to announce an extension of its QE program, probably in December.
- As a result, despite the recent yield pick-up, ECB intervention will ultimately draw on government bond yields and keep a lid on private and public spreads.

At the September Governing Council meeting, the ECB decided to leave its key rates unchanged. It also decided to keep the size of its monthly asset purchases at € 80bn and the horizon until which it at least pursues them at March 2017. This disappointed market expectations that the ECB might hint at further action. So, is the ECB now done with its measures? We do not think so. Instead, in what follows we argue that the ECB will need to adjust its Asset Purchase Program (APP) in order to get around strong bond market dislocations. Moreover, we continue to see good reasons why the ECB will extend its QE program again, most likely in December.

Adjustment of APP inevitable

While the ECB has adjusted the APP already several times since its start in March 2015, under the current program parameters the QE program is running into constraints at latest by the end of the year. The most pressing matter is the scarcity of German Bunds. While the outstanding amount of German Bunds was already a point of concern at the start of the program, the drop in yields has aggravated the matter significantly. Despite the recent moderate back-up in yields, nearly half of the outstanding amount of German sovereign paper is not eligible for the Public Sector Purchase Program (PSPP). As the ECB has imposed a lower yield floor at the deposit rate (currently -0.4%), all German Bunds up to a maturity of around 6 years cannot be purchased currently. It is noteworthy that since the start of the year, the Bundesbank has lengthened the duration of its purchases already. According to ECB data, the weighted average remaining maturity of German Bunds is now 7.6 years (up from 7.0 years at the start of the year).

At the current yield level, a nominal value of around € 430bn (market value around € 580bn) still qualifies for the PSPP. Applying the 33% issuance limit leaves around € 140bn (market value € 190bn) of German Bunds eligible for the PSPP. Since the start of the QE program, the central bank has already purchased a portion of these bonds. We estimate that the ECB already holds at least a nominal value of € 100bn of the currently eligible German Bunds.



This implies that the central bank can purchase a nominal value of less than € 40bn before the issuance limit is reached. Although there is some flexibility for the Bundesbank to choose between purchases of Bunds and securities of German agencies (outstanding nominal amount satisfying ECB criteria around € 75bn), the ECB will reach its limit regarding Bunds at latest by the end of the year assuming yields remain around current levels.

ECB's options to adjust APP

Therefore, the ECB has to take measures in order to enlarge the universe of eligible assets. It did not come as a surprise that the Governing Council "*tasked the relevant committees to work … on the smooth implementation, and the changes that are needed to ensure a smooth implementation of our programme*", as stated by President Draghi in the September press conference. Moreover, "*The committees have full mandate. They will look at all options to redesign the programme…"*. The key question is what to expect from the overhaul of the program? In what follows we discuss key options in the order of falling probability.

In our view it is highly likely that the ECB will adjust the issuer limit for bonds without a collective action clause (CAC) – such a clause allows a supermajority of bondholders to agree to a debt restructuring that is legally binding on all holders of the bond - from 33% to 50%. Another straightforward way is an extension towards regional government bonds. These measures are easy to conduct within the current framework, face no major political hurdles and would give the ECB leeway to smoothly implement the current APP.

At a later stage, removing the yield floor would increase the universe of eligible assets even more strongly. However, it would also induce lower short-term yields and might be interpreted as a signal that the ECB is willing to cut the depo rate further. This would be negative for banks' profitability. Buying bonds below the deposit rate floor might intensify discussions about undue monetary financing. But we think that the ECB would argue that losses on its balance sheet are acceptable as the transmission of the monetary policy stance to the real economy is key. All in, such a measure also seems feasible.

Presently, the ECB buys government bonds according to the share the euro area states hold at the ECB capital. A departure from capital key buying towards a market capital key buying is a potentially very powerful instrument. But it is very much disputed within the Governing Council and faces huge political hurdles. However, from the June accounts we learned that it had been discussed that NCBs, which run into constraints, could be allowed to purchase "*close substitutes across markets*". This might be interpreted as government bonds of a similar rating. Still, we deem such a step less likely.

An extension of the maturities bought under the APP beyond 30-years would also be an option. However, the additional buying volume at the very long end of the curve is relatively low, close to zero in case of Bunds, and we also think that the ECB wants to avoid a flat yield curve in order not to discourage long-term investments. Therefore, we also consider this option less likely.

In our view, an expansion of the universe of eligible APP assets towards equities or the option of helicopter money is unlikely to be adopted. When asked about it at the press conference, Draghi merely said that these measures had not been discussed. Also, purchasing of senior unsecured bank bonds is highly unlikely, too, given supervisory concerns.

All in all, we deem it most likely that the ECB announces an increase in the issuer limit in October or at latest in December. Depending on the market development, some of the other measures might also be needed.

ECB too optimistic on growth

Looking further ahead, we continue to think that the ECB will extend its QE policy beyond March 2017. It maintained a dovish policy stance by confirming "*the need to preserve a very substantial amount of monetary policy support*" in order to reach the inflation target. While the growth and inflation projections were broadly kept stable (see table below), the risks to activity are still tilted to the downside in the ECB's view. We even deem the ECB 2017 euro area growth forecast of 1.6% too optimistic. Given the fallout from the Brexit, a high degree of policy induced uncertainty in the euro area and a weak external environment, we look for a growth rate of 1.1%; even slightly below the consensus forecast of 1.2%. Therefore, the ECB will in our view have to revise its projections to the downside. This revision then also comprises the outlook for underlying price pressures which according to Draghi "*continue to lack a convincing upward trend, and remain an ongoing source of concern*". According to the latest macro projections, underlying inflation is set to average 1.5% in 2018; the August reading is 0.8% yoy. Moreover, the current staff projection is based on the full implementation of the current program and, according to ECB calculations, over the forecast horizon, cumulatively 0.6% of growth and 0.4% of inflation are due to the ECB policy measures decided in December 2015 and March 2016. This underlines that with growth likely to disappoint even stronger monetary policy support will be needed.

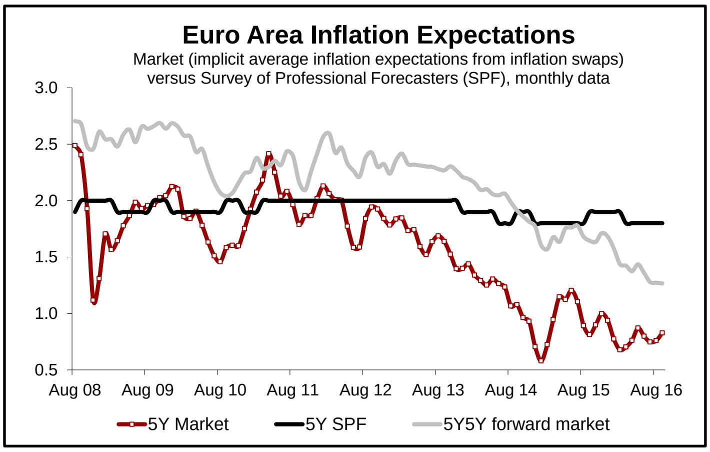
Key ECB vs GIE Macro Forecasts

% yoy

	2016	2017	2018
GDP			
ECB Sep-16	1.7	1.6	1.6
GIE	1.5	1.1	1.2
Inflation			
ECB Sep-16	0.2	1.2	1.6
GIE	0.3	1.3	1.4

Furthermore, the ECB is also concerned about stubbornly low inflation expectations. In a recent ECB working paper (No 1945, August 2016) it was even stated that "*in recent years inflation expectations in the euro area have shown some signs of de-anchoring*." Hence, there are well founded concerns about negative second-round effects so that the ECB is monitoring these developments very closely and stands ready to act, if needed.

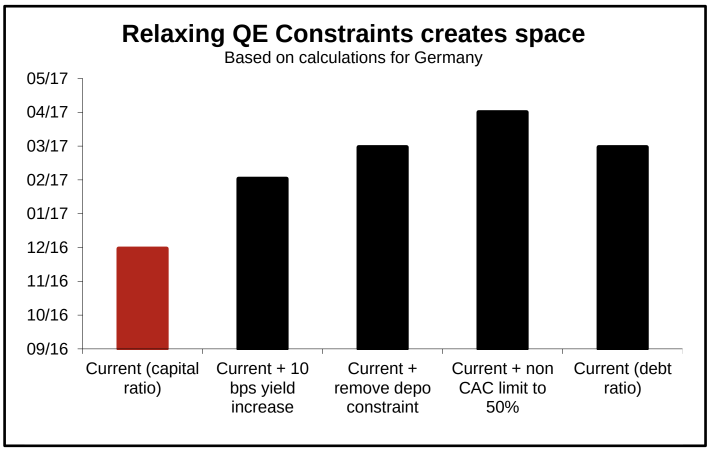
All in all, we deem it most likely that the ECB extends its QE program beyond March 2017. In our view, this announcement will come in December, when the update of the macro projections will likely be revised down and the extension of the forecast horizon to 2019 sees inflation still considerably below target at that time.



Impact on bond markets

The ongoing interventions by the ECB will continue to affect euro area government bond markets. The additional demand will support the entire range of fixed income assets. While the impact on bonds which are on the ECB's purchase list is most straightforward, we see the trickle-down effect as increasingly important as well.

Assuming that the ECB will adjust the issuer limit for non-CAC bonds to 50% and extend the APP in Q4, the scarcity issue of German Bunds will remain a dominant driver. According to our calculations, an increased issuer limit of 50% will give the central bank space to continue until April 2017. While this is sufficient to complete the program as scheduled, it does not allow a considerable extension of the program. Therefore, the lack of eligible German bonds will remain on market participants' radar screens and will stand in the way of any sustainable upward trend in euro area core yields. In contrast, until the end of the year a moderate decrease in yields is likely. By the end of December, we expect 10-year Bund yields to fall to -0.05%.



Further down the road, additional changes in eligibility criteria are necessary. Depending on the exact adjustment, the fallout will vary. While removing the deposit rate constraint is expected to trigger a bullish curve steepening, in the unlikely event of a shift towards market capital key purchases euro area core yields can even rise – supported by rising headline inflation and a continuation of the economic upswing.

While the change in the technical parameters is unlikely to be a major driver for Southern European bond spreads (exception: shift towards market capital key purchases would be supportive), the forecast extension of the QE program would be good news. The continued ECB support is an important technical factor and the additional demand will keep a lid on government bond spreads going forward.

Private spread products will benefit from an extension of the QE program, too. Particularly euro area IG corporate bonds are main beneficiaries. Until the scheduled end of the program, the ECB will have bought already close to € 70bn of euro area IG corporate bonds. Given that the outstanding amount of corporates eligible for the program is below € 600bn, an extension beyond March 2017 – taking into account monthly purchases of around € 8bn – would constitute a strong technical support. While the bulk of the spread tightening has already been taken place, the technical backstop in combination with all in all still sound fundamentals has the potential to trigger somewhat tighter euro area IG corporate bond spreads further down the road.

Imprint

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