EVERCORE ISI

Global Policy & Central Banking Strategy

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ECB SEPT PREVIEW — NOTHING ON “TWIST”, NO MORE QE FOR ITALY, BUT OPEN TO LTROS

If financial conditions tighten preference would likely be to lean against pressure on bank funding costs

Summary. We expect no new policy initiatives from the ECB at the September meeting in spite of the turmoil in emerging markets, US-China trade conflict and stress around Italy. Specifically we do not expect any announcement on an “operation twist” to reinvest maturing QE bonds into long dated paper or any QE extension / other initiative to help Italy. However, we anticipate that Draghi will strike a cautious tone, talking up the stabilization in domestic activity data ex-Italy but noting that while risks overall remain roughly balanced, uncertainties relating to trade, EM and geopolitical developments (Italy, Brexit) have become still more prominent in recent weeks.

We think the ECB president will assert that the ECB has sufficient policy instruments to respond if needed to any severe and persistent tightening of financial market conditions or deterioration in the outlook inconsistent with progress towards its inflation objectives. In our view the tool of first resort would be another round of long term refinancing operations to shield bank funding costs against upward pressure from trade, EM, Italy and Brexit. It is probably too soon for the ECB to make or even pre-signal a decision on LTROs but Draghi could hint at an openness to consider this if needed — for instance by citing term liquidity operations as one of the instruments available to the ECB to foster financial conditions consistent with its inflation aim.

Meanwhile we reiterate our view that Italy will probably avoid a full blown collision with the EU over its budget (FLASH NOTE — ITALY'S BUDGET: AVOIDING A FULL BLOWN SHOWDOWN?), though the costs associated with a bad outcome there are potentially so large that the ECB will remain very cautious ahead of the formal budget submission. We also remind clients that we assess that the likelihood of a No Deal Brexit is materially lower than consensus thinks (FLASH NOTE — NO DEAL BREXIT RISK FALLING FURTHER WITH HINTS OF NARROWING ON IRISH BORDER). Consequently, while we remain concerned regarding the global implications of US-China trade conflict we see potential upside for the euro / eurozone assets as these Europe-specific risks moderate even if the underlying issues around both Italy and Brexit remain unresolved.

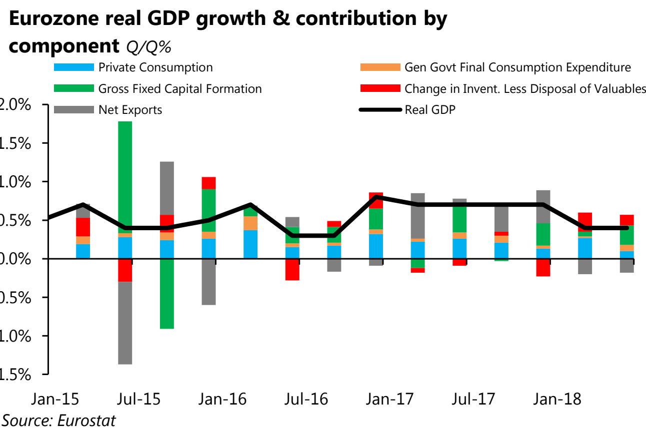
Our full note discusses the ECB outlook in detail. In brief:

- Eurozone data ex-Italy has continued to stabilize at levels consistent with above trend growth though the pace of expansion remains much less vigorous than in 2H 2017
- Domestic financial conditions have tightened notably more than in the US, reflecting greater vulnerability to EM turmoil, US-China trade conflict and Italy stress with only a partial offset from a weaker euro on the dollar cross
- Market-based indicators of inflation expectations have held up reasonably well during this period (though they remain below levels we view as fully consistent with the ECB’s inflation goal) giving the ECB some breathing room

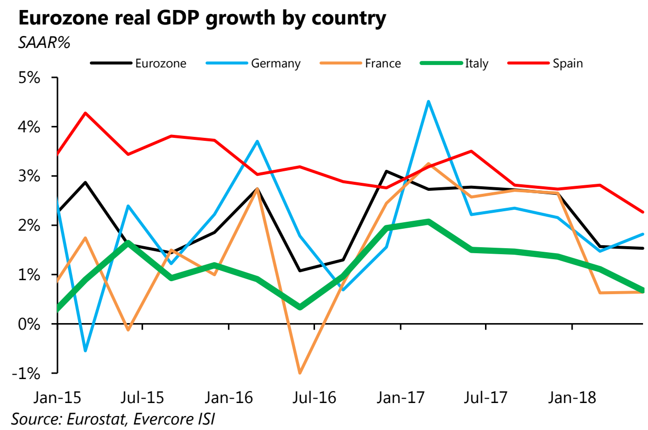
- Against this backdrop Draghi will stick to the June policy plan that involves retiring QE in December and handing off to forward guidance on interest rates and reinvestment of maturing bonds
- We expect no clarification of the language that rates will remain at present levels “through the summer of 2019” though we confidently interpret this as no hike before September 2019
- At the same time we expect that Draghi will insist that the ECB has sufficient tools to respond if there is a sufficiently material deterioration in financial conditions and / or the economic outlook that threatens progress towards its inflation goal
- We think that in truth the ECB’s policy space is limited and it has a “missing instruments problem” with no tool to deal with intermediate spread contagion short of the nuclear option OMT program once regular QE is retired
- We strongly believe that the ECB will not consider extending QE or taking more targeted measures to shield Italy from market pressures invited by populist policies
- In our view the ECB will be the bad cop in a good cop-bad cop act with the European Commission — sticking to its rules while the Commission shows some flexibility on the fiscal rules over Italy’s budget
- There has been market speculation that the ECB could boost the impact of its reinvestments by initiating an “operation twist” and reinvesting the proceeds of maturing QE bonds exclusively into long dated bonds
- We think this speculation is premature at best and expect no definitive announcement on reinvestment strategy at the September meeting: the Council will keep its options open while continuing in the base case with a fuzzy market-neutral approach in each national debt market under capital key allocation
- We think the ECB’s focus will be on bank funding costs that have come under some pressure in recent weeks
- There was already a good case for the ECB to consider rolling over at least some of the long term refinancing operations (LTROs / TLTROs) that are set to mature over the next couple of years to avoid too sharp a decline in this financing and in its balance sheet size
- We believe the ECB is likely starting to think about the potential desirability of putting in place more LTROs next year
- It is too soon to make the decision now, and we doubt the ECB is even ready to presignal such a move, but Draghi could indicate an openness to this
- Another round of LTROs would provide some indirect support for national sovereign debt, however less than in the past, as ECB supervisors would likely limit the extent to which banks could engage in carry trades in their national sovereign debt

DOMESTIC ACTIVITY DATA HAS STABILIZED EX-ITALY BUT DOWNSIDE RISKS HAVE TAKEN ON FURTHER PROMINENCE

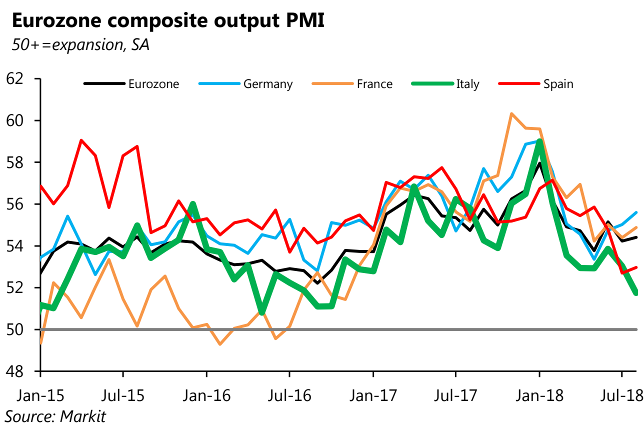
Outside Italy — where growth is slowing and the latest PMIs show a worrying deterioration — activity data in the eurozone has continued to stabilize at levels consistent with above trend growth, with the eurozone surprise indicator recovering from depressed territory and second quarter growth at 0.4 per cent quarter-on-quarter. This will give the ECB confidence that employment — already at record levels in absolute terms — will continue to increase, unemployment will decline further from today's near-decade low of 8.2 per cent, and tighter labor markets / output gaps will eventually deliver progress on underlying inflation. However, while we expect that Draghi will highlight the better eurozone data, we think he will emphasize the prominence of geopolitical / international risks, including trade, EM stress, Brexit and Italy — without formally shifting to a downside risk skew that would implicitly call for consideration of further policy stimulus.



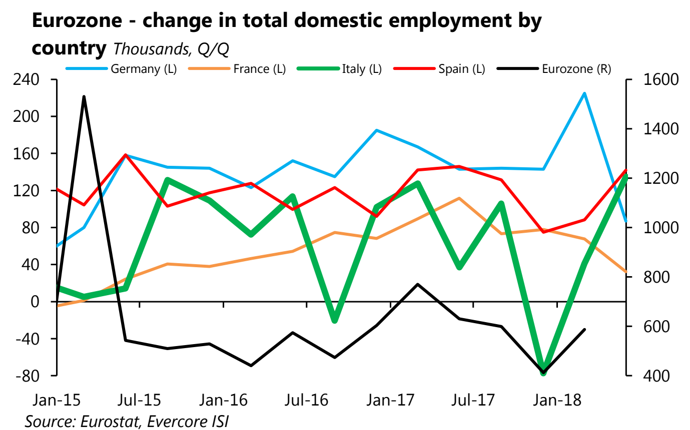
Source: Eurostat



Source: Eurostat, Evercore ISI

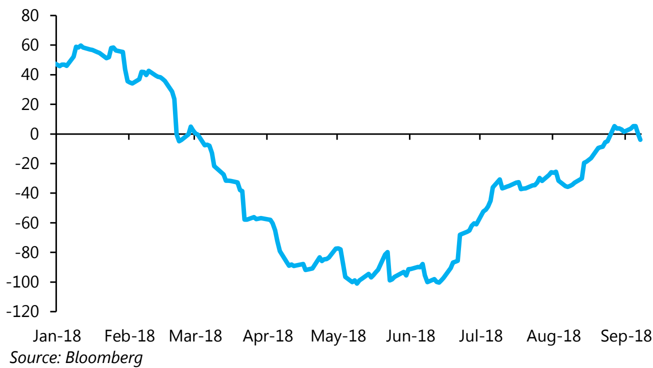


Source: Markit



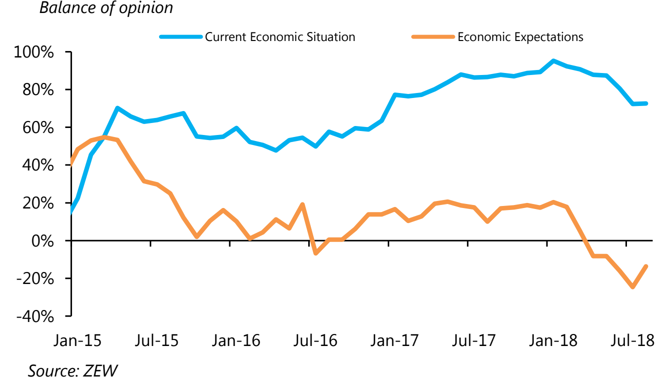
Source: Eurostat, Evercore ISI

Eurozone Citi surprise index



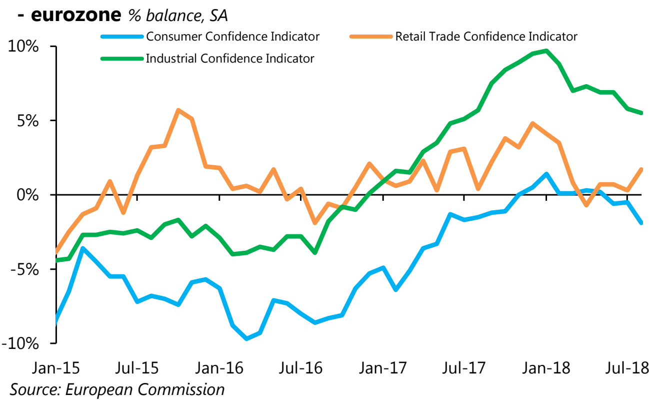
Source: Bloomberg

Germany ZEW financial market survey
Balance of opinion



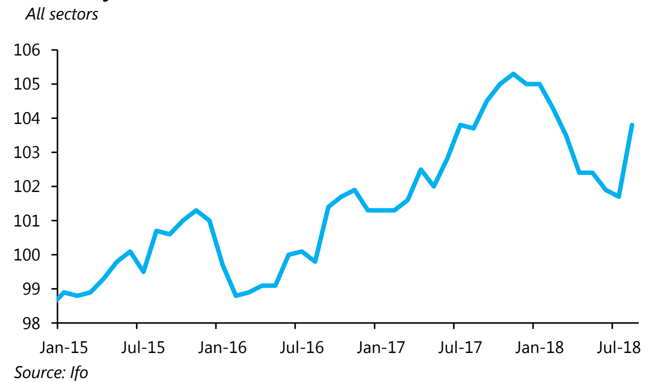
Source: ZEW

European Commission Business and Consumer Survey - eurozone *% balance, SA*



Source: European Commission

Germany Ifo business climate index
All sectors

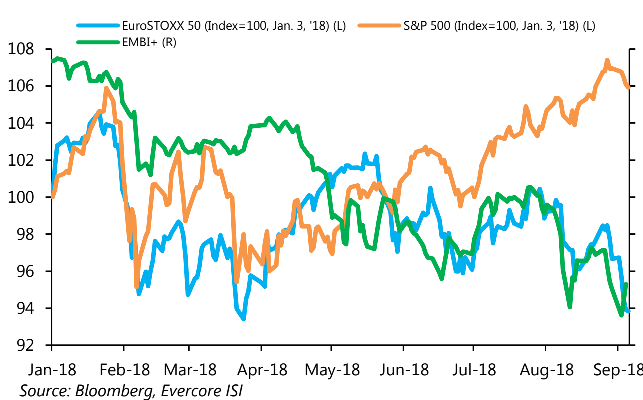


Source: Ifo

FINANCIAL CONDITIONS HAVE TIGHTENED REFLECTING GREATER VULNERABILITY TO EM, TRADE, ITALY V US — EURO / DOLLAR ONLY PARTIAL OFFSET

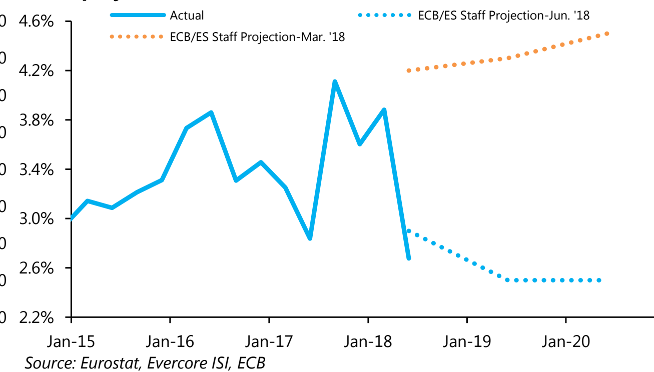
Domestic eurozone financial market conditions have tightened materially — not just in Italy and not only due to Italy, reflecting the eurozone's greater perceived vulnerability to the state of the global economy (EM / US-China trade / China supply chain) and absence of domestic stimulus relative to the US. The weakness of the euro relative to the dollar invited — perhaps not accidentally — by Draghi's comments at the last press conference, has served as a partial offset, but the euro has strengthened appreciably on a trade weighted basis, reflecting EM FX weakness. Bank lending conditions — ex-Italy — remain supportive but bank funding costs have increased, which if persistent, would generally with a lag lead to less favorable credit conditions.

EuroSTOXX 50 / S&P 500 v EMBI+



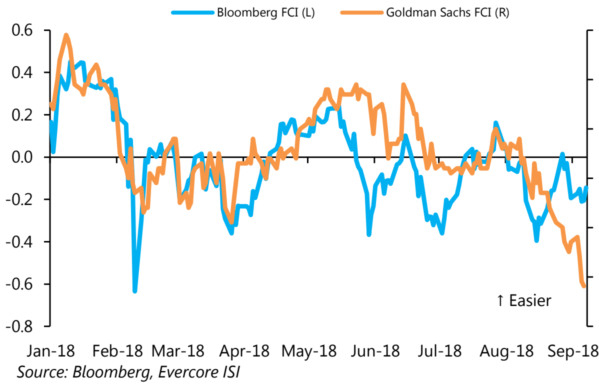
Source: Bloomberg, Evercore ISI

Eurozone current account balance & ECB/Eurosystem staff projection *% of GDP*



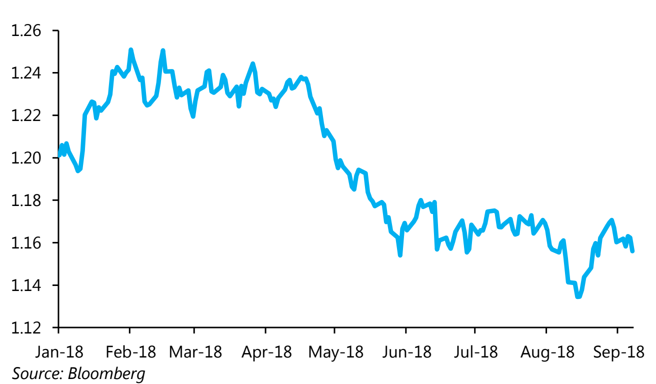
Source: Eurostat, Evercore ISI, ECB

Eurozone financial conditions indices



Source: Bloomberg, Evercore ISI

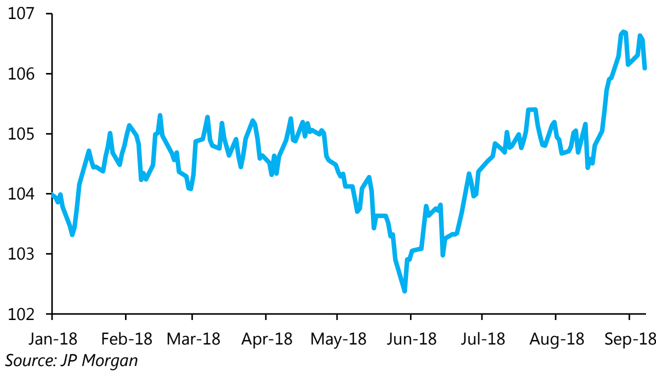
EUR/USD cross



Source: Bloomberg

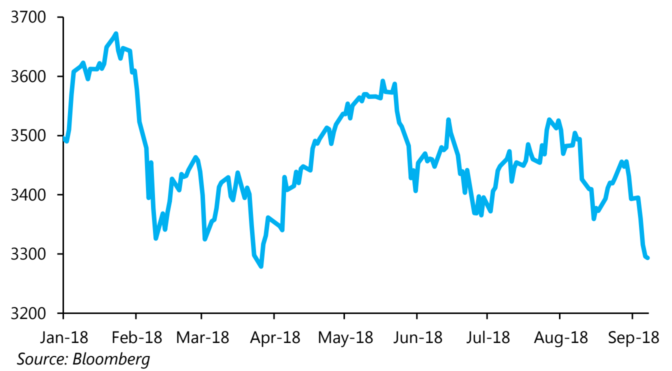
JP Morgan broad nominal effective TW euro

Index=100, 2010



Source: JP Morgan

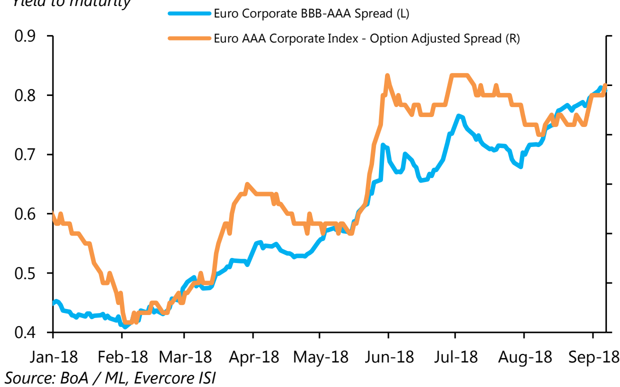
EuroSTOXX 50



Source: Bloomberg

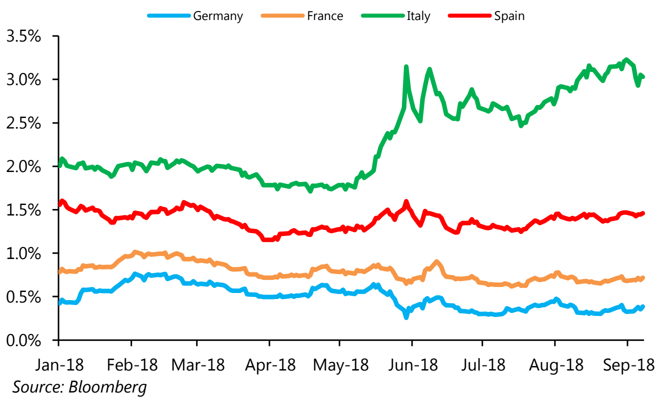
Eurozone coporate bond yield spreads

Yield to maturity



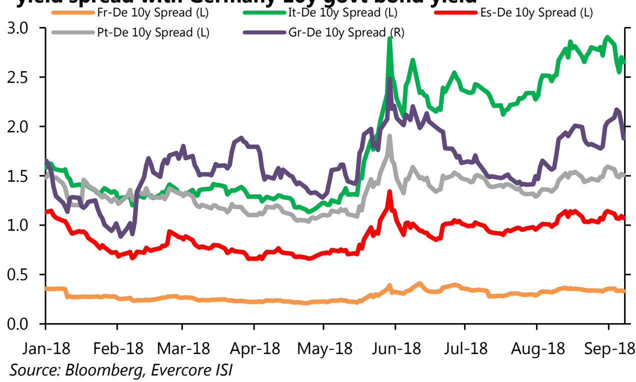
Source: BoA / ML, Evercore ISI

Eurozone 10y government bond yields



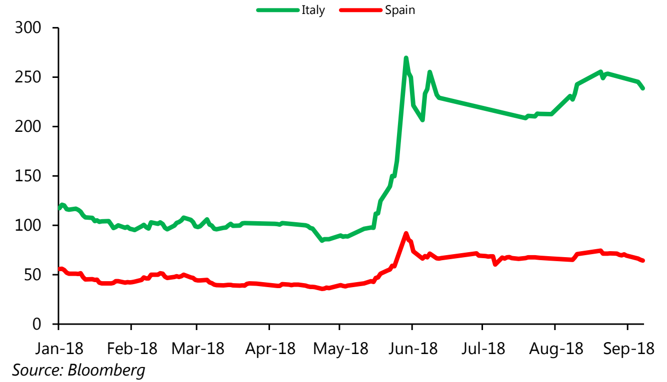
Source: Bloomberg

France/Italy/Spain/Portugal/Greece 10y govt bond yield spread with Germany 10y govt bond yield



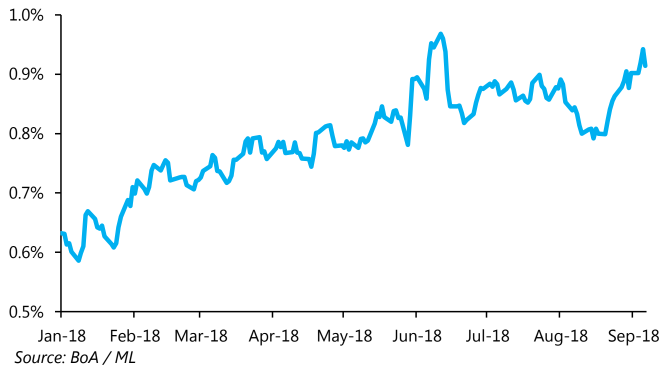
Source: Bloomberg, Evercore ISI

Spain & Portugal senior 5y USD CDS



Source: Bloomberg

Bank of America / Merrill Lynch euro banking bond index - yield to maturity

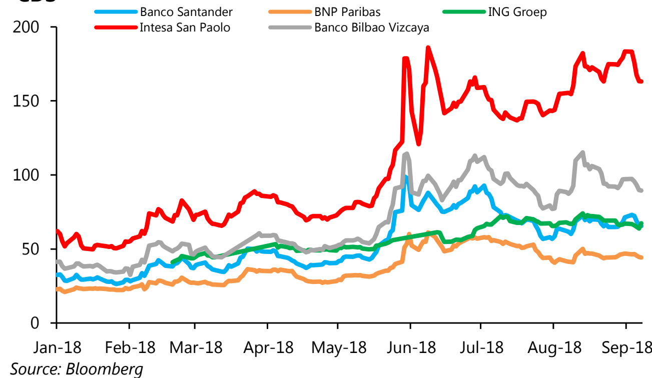


Source: BoA / ML

EuroSTOXX banks

Source: Bloomberg

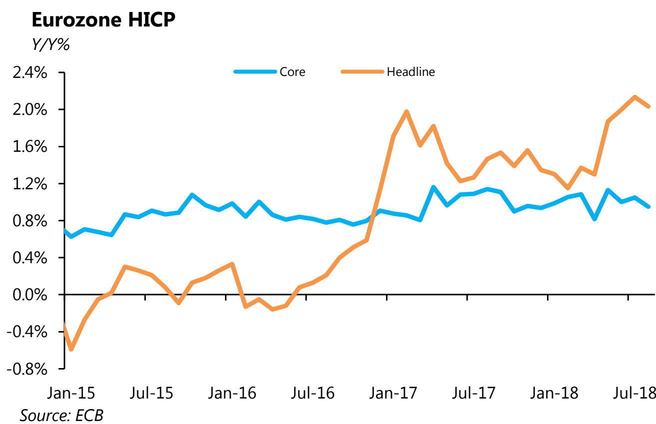
Eurozone banks (top 5 by market cap) senior 5y euro CDS

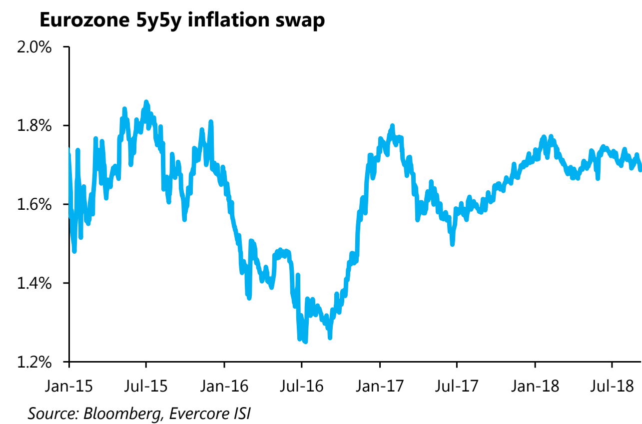


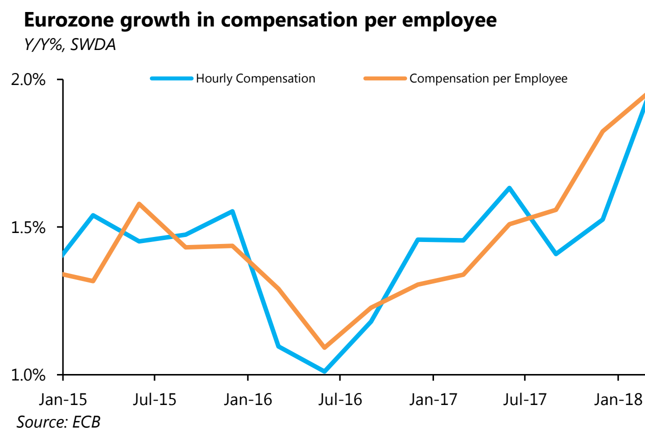
Source: Bloomberg

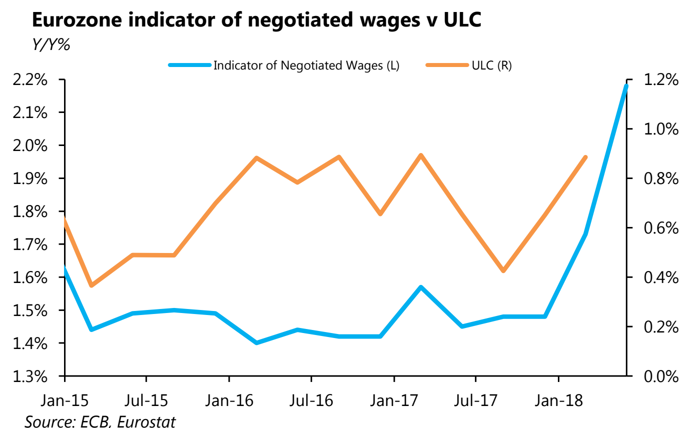
MARKET-BASED INDICATORS OF INFLATION EXPECTATIONS HAVE HELD UP REASONABLY WELL — GIVING THE ECB SOME BREATHING ROOM

Underlying inflation readings in the eurozone remain muted even though headline inflation is around 2 per cent largely due to past increases in the price of oil denominated in euros. However, the Governing Council's increased confidence that firming wage / negotiation data will support firmer inflation dynamics over time[1] almost certainly remains intact. Importantly, market-based indicators of inflation expectations have only softened a little over the period since June in spite of increased global / geopolitical risks and tighter financial conditions. This gives the ECB some breathing room and suggests market participants remain for now willing to accept the hand-off from QE to rates guidance / reinvestment and Draghi's claim that the central bank retains sufficient policy space[2] in the event of a deeper deterioration in the outlook.



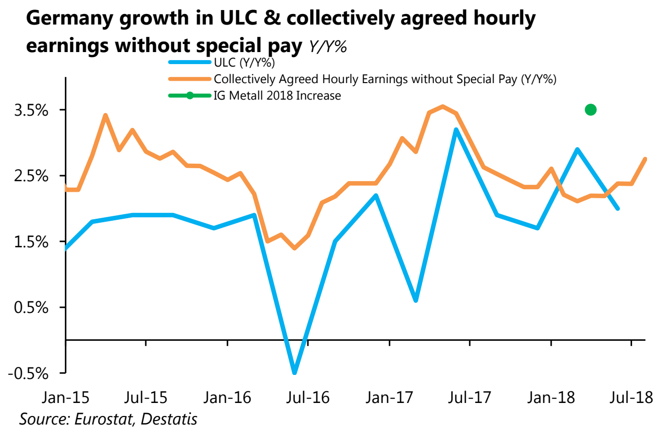






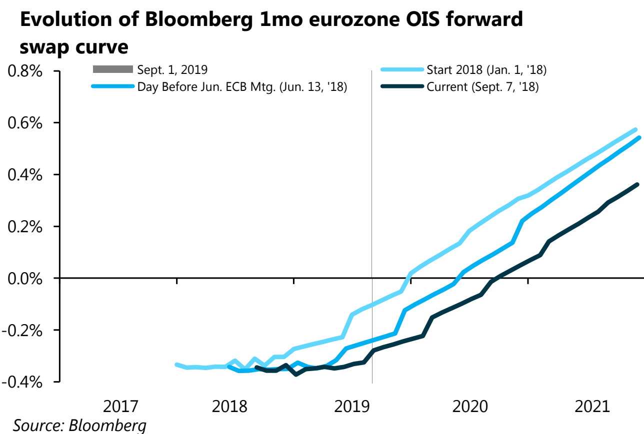
[1] "In the first quarter of 2018, the impetus for this upward trend had come from stronger negotiated wage growth, rather than wage drift, as had previously been the case. This shift to negotiated wage growth as the main driver bolstered confidence that the pick-up in wage growth would be sustained…The strength of the euro area economy supported confidence that the convergence of inflation to levels below, but close to, 2% over the medium term would continue in the period ahead. This confidence was further bolstered by rising wages and increasing price pressures at the early stages of the pricing chain." — Account of the July 25-26, 2018 Monetary Policy Meeting of the ECB Governing Council.

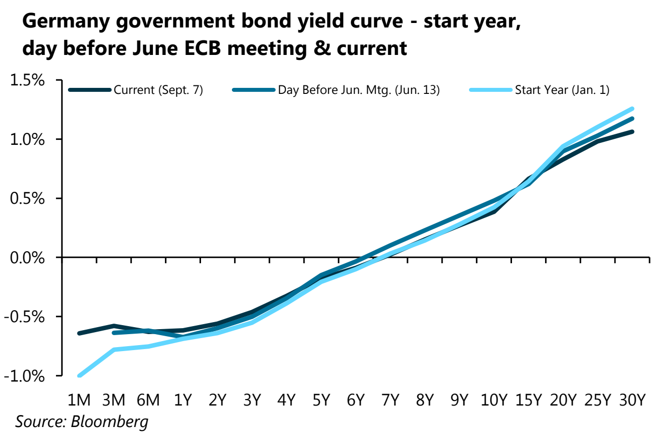
[2] "as you've seen, as I've stressed in the last Riga monetary policy council, all the statements, the Introductory Statement and all the formulation of all the monetary policy tools, contain a repeated optionality and flexibility, putting the Governing Council in an ideal position to react to events. Some of these events are part of a foreseeable future based on the current set of information. Some other events may well not be foreseeable at the present time. We don't want to exclude the possibility that they may happen. That's why we retain a high degree of optionality." — Mario Draghi (July 26, 2018), press conference following the monetary policy meeting of the ECB Governing Council.



DRAGHI HAPPY WITH MARKET INTERPRETATION OF FORWARD GUIDANCE, NO NEED TO CLARIFY "THROUGH THE SUMMER"

We think Draghi is comfortable that the market correctly interprets the ECB's forward guidance as meaning no rate hike before September 2019 at the earliest and the Governing Council continues to see no need to clarify the phrase "through the summer of 2019."[3] In our view this guidance is asymmetrically sticky: it would take a very big upside surprise for the central bank to move the calendar date earlier in the time, while in principle the date could be pushed back more easily. However we think the guidance is somewhat sticky in the latter direction too, as the Council would be uncomfortable guiding much more than a year ahead, and Draghi will want to preserve the option (and the base case expectation) that he will announce the start of rate normalization before he steps down as ECB president at the end of October 2019, allowing him to shape guidance around the subsequent slope / pace of that normalization process.





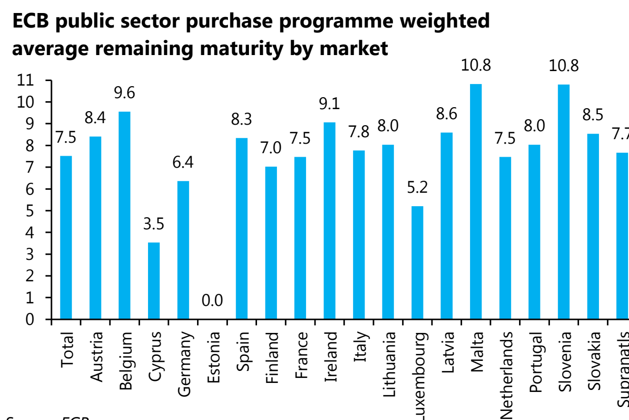
[3] "The Governing Council's enhanced forward guidance on the future path of policy rates had been effective in aligning market views about the future evolution of policy rates with the Governing Council's expectation that the key ECB interest rates would remain at their current levels "at least through the summer of 2019". This formulation was considered to have struck an appropriate balance between being sufficiently precise to provide effective forward guidance and maintaining a suitable degree of flexibility. In this regard, it was remarked that the Governing Council's expectation was probabilistic in nature." — Account of the July 25-26, 2018 Monetary Policy Meeting of the ECB Governing Council.

NO EXTENSION OF QE OR SPECIAL ACTIONS TO HELP ITALY DEAL WITH MARKET STRESS

We also believe that the Governing Council — which was mightily relieved to get through the announcement of the planned retirement of QE at year end without a severely adverse market reaction — is nowhere near considering an extension of QE in response to recent developments around EM, trade and Italy. In particular, while we think the ECB would extend / expand QE in response to a full-blown global trade war that dragged in the EU — this would be an exogenous shock and would hit Germany worst of all — we think the central bank cannot and will not extend QE in response to market stress associated with populist policies in Italy. Nor will the ECB respond to calls from Italian politicians to intervene with some form of spread cap or other targeted intervention. In our view the ECB is playing the bad cop in a good-cop / bad-cop act with the European Commission, indicating no flexibility beyond equal treatment under its rules, while the Commission will offer some flexibility around the fiscal rules.

SPECULATION THAT THE ECB WILL SEEK TO AMP UP THE IMPACT OF ITS REINVESTMENT PROGRAM VIA AN "OPERATION TWIST" IS PREMATURE — STILL NOT BASE CASE

As the ECB prepares to hand off from (net) QE to reinvestment (as well as forward guidance) the central bank will at some point provide more detail on substantial upcoming reinvestment flows. This could come as early as September, though more likely in October or December. Reinvestment to date has taken place within the capital key geographic allocation based on a hazy market-neutral principle that purchases should be minimally distortive to market price formation. Capital key reinvestment is not a legal requirement but there would be a very high hurdle to change this. By contrast, there has been speculation that the Council could amplify the impact of a given euro amount of reinvestment flows by adopting a Fed "operation twist" exercise in which the Eurosystem would invest exclusively into long dated securities in order to maximize duration extraction. However we think this speculation is premature at best and that the Council will not announce an "operation twist" or any other radical new departure in reinvestment strategy in September. In our view the Council remains oriented towards some version of market-neutral reinvestment but can sensibly keep its options open — including the option of an "operation twist" — over the months ahead.

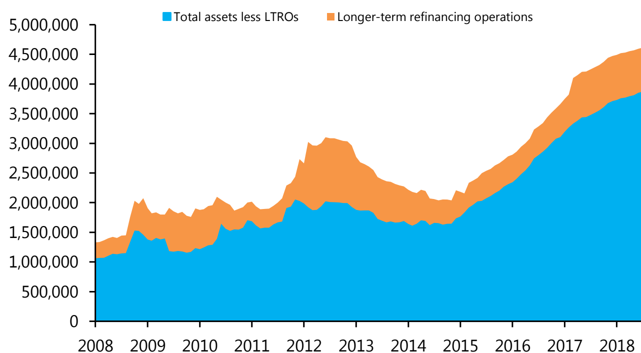


Source: ECB

ECB MORE LIKELY TO TURN TO LTROS — AND DRAGHI MIGHT INDICATE AT LEAST SOME OPENNESS TO THIS IN SEPTEMBER

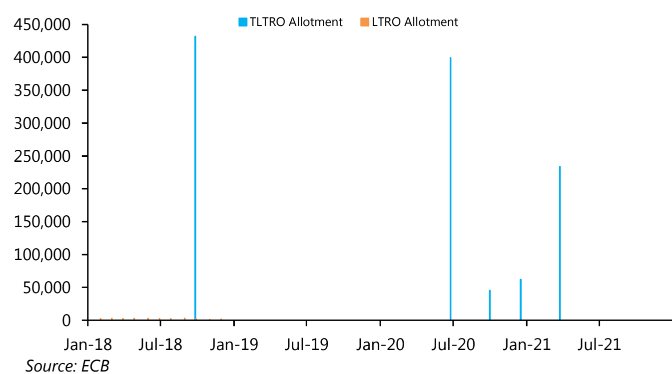
In our view the ECB is more likely to turn to a new series of long term refinancing operations to ensure supportive financial conditions. In particular, we think the Council will be focused on the increase in bank funding costs in recent weeks associated with spillovers from Italy but also Turkey and other EM / trade risks. Short lived fluctuations in bank funding costs tend not to have large impacts on credit provision but a large and persistent increase would be macro-significant as well as potentially indicate some increase in risk of financial instability. If funding costs stay elevated, we think the ECB will turn to new LTROs. The case for doing so at least to some degree was already quite good, given that the current repayment schedule is quite abrupt and would involve a relatively rapid reduction in its long term bank funding and balance sheet size over the next two years. We think Draghi may indicate openness to this in September but it is too soon to lock in the decision. In the current context of higher funding costs the primary purpose would be to prevent any tightening of credit conditions for the real economy. There would be an additional financial stability benefit as market providers of term funding are less likely to run if they are confident a bank has access to term funding from the central bank to replace private sources of funding as needed — the insurance function of LTROs.

ECB balance sheet - total assets ex LTROs and LTROs
Million euros



Source: ECB

ECB TLTRO & LTRO allotment by maturity date
Million euros, note does not account for prepayment

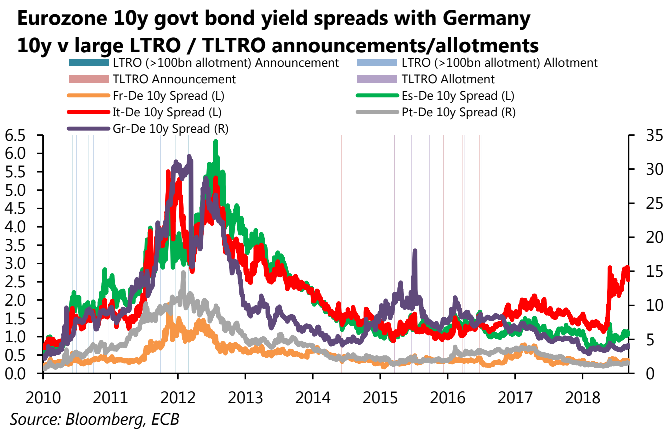


Source: ECB

LTROS WOULD PROVIDE SOME DEGREE OF SUPPORT FOR SOVEREIGN DEBT — EVEN IN ITALY — THOUGH ECB SUPERVISORS WOULD LIKELY PUSH AGAINST A RESUMPTION OF THE OLD CARRY TRADE

Additional LTRO funding would directly help banks and would to some degree indirectly help periphery sovereigns — including Italy itself. Indeed the original LTRO program back in 2012 served a dual purpose: allowing banks to rebuild capital via a carry trade into high yielding sovereign debt, and, through their purchases providing support for sovereign debt in an indirect poor man's version of QE. Today the situation is quite different. In level terms yields even in Italy and certainly in the rest of the periphery ex-Greece are much lower than they were at the peak of the eurozone crisis, providing less scope for carry. Moreover, eurozone banks are now subject to the single supervisory mechanism (SSM) operated by the ECB on a pan-eurozone basis. The SSM in principle is there in part to break the nexus between banks and their national sovereign debt markets that in the past was aided and abetted by national regulators. And, while the SSM appears to have acquiesced in Italian banks picking up bonds sold by foreign investors in the last couple of months, we think there are likely to be limits to this tolerance, and it is quite likely that the SSM would operate at cross-purposes to any effort by the ECB's monetary policy arm to ease financial conditions in sovereign markets.

Eurozone 10y govt bond yield spreads with Germany 10y v large LTRO / TLTRO announcements/allotments



Source: Bloomberg, ECB

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