

# Inflated expectations

## Economist Insights

Managing expectations can be an exercise fraught with difficulty, as last week's announcement by the ECB demonstrated all too clearly. The market regarded the outcome of December's meeting as the most disappointing for years. Could it be that Mario Draghi, who has so successfully managed the market's expectations in the past, has become a victim of his own success?



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When everyone is trying to get one step ahead of everyone else, expectations are crucial. Financial markets are all about buying an asset before everyone else buys it, or selling it before everyone else sells it: in other words, expectations. Central bankers know this as well as anyone else, so they try to manage expectations. But expectations can also be mismanaged.

The European Central Bank (ECB) seems to have done just that. Ever since the October ECB meeting the expectations of a significant further easing began to build. ECB President Mario Draghi started the management exercise by announcing that even though they had not done it, the ECB had considered cutting the deposit rate further into negative territory. This was quite a surprise given that the ECB had previously insisted the rate could not go lower. Expectations were then inflated further still by press leakages of additional quantitative easing (QE) backed up by more dovish comments from various ECB members. There was even speculation the ECB could buy high risk bank loans.

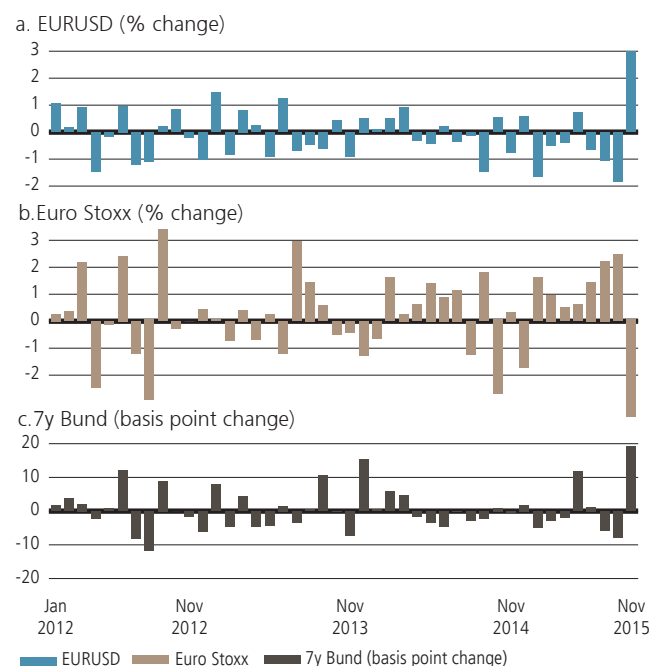
Given the ECB's track record of surprising to the dovish side, expectations of further easing measures rapidly got out of control. So when the announcement of a bit more easing came through, it ended up being a disappointment. In fact, the December ECB meeting was the most disappointing for years, at least compared to what the market wanted to see. The EUR posted a big rally against the USD when the statement turned out to be more hawkish than the price reflected (chart 1). Equities also posted their largest decline on an ECB announcement, and bund yields spiked up.

To be fair, at least compared to the October meeting (and ignoring all the speculation in between), the ECB was dovish. Not only did it cut the deposit rate by a further

10 basis points, but they also extended QE by a further six months (something not explicitly mentioned in October). But conspicuous by its absence was an increase in the monthly pace of QE. Rumours about a two-tiered deposit rate that would penalise banks for holding too many reserves also proved unfounded.

**Chart 1: Disappointing**

One-day change around ECB meetings (close of day)



Source: Bloomberg Finance LP, UBS Asset Management

As if all this disappointment was not enough, the other announcements upset markets even more. The inclusion of local and regional government bonds among the assets that the ECB can buy under QE was not welcomed by sovereign bond markets: without an increase in the pace of QE that means that purchases will be diverted away from government bonds.

Similarly, the announcement that the ECB will be re-investing the principal payments on the bonds that expire left markets quite unimpressed. Firstly, this will not really have any impact before March 2017 (when the first government bonds will start to expire). Secondly, this will take place for "as long as necessary", which for markets does not really sound like a time commitment. After all, that could be sooner as well as later. Finally, re-investment was hardly news given that this is deemed normal practice since the Federal Reserve, Bank of England and Bank of Japan all do it.

### Expecting the expected

The ECB can hardly complain that it was unaware of how over-excited the market was getting. After all, the market anticipation was obvious in the price action (see chart 2). One wonders then why they stoked expectations up so high only to pour cold water on them. A few careful speeches could easily have cooled things down a bit earlier.

One explanation is simply that the ECB Governing Council is made up of many people, not just Mr Draghi. So perhaps Mr Draghi and the more dovish members wanted to do more, but the more hawkish members prevented them. Mr Draghi's position is complicated by the rotating voting rights of the Governing Council, so that this time round some of the typically more dovish members (such as Belgium and France) did not have the vote in December.

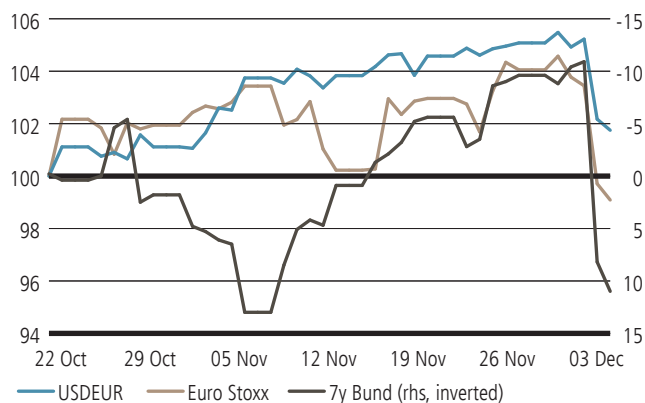
In the past Mr Draghi has effectively cornered the hawkish members into going along with the dovish members. His trick was, in effect, to pre-announce a dovish move and watch the positive market reaction follow. It would then be the fault of the hawkish members if markets sold off, and they would take the blame for 'spoiling things'. If so, it may be that this time round the hawks decided enough was enough and refused to play along.

Or perhaps none of these more conspiratorial theories are true, and in fact Mr Draghi was simply a victim of his own strategy. By shifting market expectations, he pushed the EUR down significantly ahead of the December meeting. This lower EUR (together with much lower interest rates) fed into the ECB staff forecasts, effectively pushing up the forecasts for inflation and (to a lesser extent) GDP. But if this was too successful, then the forecasts end up being too positive and, paradoxically, the easing becomes less necessary. In truth,

the new ECB forecasts show that the positive impact from the lower exchange rate and interest rates were just enough to offset the drag from a weaker external demand. However, because the new forecast for GDP and inflation ended up being broadly unrevised compared to September, this would have made it harder for Draghi to convince the rest of the Governing Council that more easing was necessary.

**Chart 2: Getting excited**

Change in the USDEUR (22 Oct = 100), Euro Stoxx index (22 Oct = 100) and the 7-year German Bund rate (bp, 22 Oct = 0) since the October ECB meeting



Source: Bloomberg Finance LP, UBS Asset Management

The peril of expectations management is that those expectations are not really under your control. Perhaps the term itself is misleading: 'management' implies more control than anyone can really have over the market. Maybe the term 'expectations nudging' would be more appropriate. All the time, central bankers are being second guessed by the market. As John Maynard Keynes might have said, it is not just market expectations, but the market's expectations of the market's expectations.

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