Macro-Strategy Key Issue
ECB: What should we expect this week?

Economics

Europe including UK

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ECB: What should we expect this week?

Following the ECB's big decision, on 8 December, to extend QE from April to December 2017, with monthly asset purchases of €60bn, we do not expect new policy initiatives or major new guidance from the ECB in its upcoming meeting on 19 January. Despite upbeat data recently, ECB President Draghi will likely argue that the focus is now on the implementation of the previously announced measures. The release of the accounts of the December meeting indicated that the discussion in the Governing Council about an extension of QE was more controversial than perhaps previously thought.

Expect discussion on growth and inflation outlook

We expect the ECB press conference to focus on: a) the surprisingly firm Eurozone PMIs and the pick-up in inflation in December and their likely implications for the monetary policy outlook; b) ongoing efforts to address the challenges in the Italian banking sector; c) the outcome of the ECB's new Bank Lending Survey, which will be released on 17 January, as well as; d) the implications of potential changes in US economic policy on Europe and the ECB monetary policy.

We project the ECB to run down QE purchases during 2018

Our base case scenario remains that the ECB will run its QE programme until December 2017, as pre-announced on 8 December, but start tapering as of January 2018, to wind down its asset purchases over the course of perhaps 12 months. Under this scenario, the ECB's tapering decision could come as early as 7 September, or 14 December at the latest. Our call is based on inflation rising to an average 1.8% in 2018E, not least driven by an ongoing recovery in oil prices. We reiterate, however, that deviations in oil prices from our central scenario would imply potentially significant two-way risk to our inflation projections and hence to our monetary policy forecasts (Eurozone inflation under different oil prices, 13 December 2016).

Rates Strategy: Focus on "hawkish" nuances and QE implementation

As we do not expect tangible action from the ECB this week, the focus is likely to be on nuances in the communication. Market pricing implies an ideal scenario for the ECB with inflation expectations rising and real rates falling (having decoupled from the US) which is supporting financial conditions for the real economy and therefore equities. However, the decoupling of US real rates from EGB peers seems to have reached its limits, while the rise in euro area inflation expectations looks stretched against rates. The PSPP Legal Act clears sub deposit rate purchases and the German front-end should find support from an outright as well as an ASW (curve) perspective over the near-term. In general, ultra-long Bund should remain the weakest link on the curve (we stick to steepeners), German ASW should remain structurally wide and we recommend using tightening to scale into wideners. Opposition to PSPP issue and issuer limit changes should continue to weigh in particular on PGBs.

Corporate credit: Spreads to drift wider on the back of continued volatility

We are not expecting any changes around the Corporate Sector purchase programme for the January meeting given that the technical changes around the PSPP have given the ECB some breathing room for available bonds. In conjunction with the slowdown in the overall QE programme, we see corporate purchases slowing to €6bn per month, from historically €8bn per month. We expect continued market volatility across the asset class on the back of uncertainty, not necessarily a downturn and therefore expect spreads to drift wider with our 6 month forward looking model for Eur HY iBoxx at 443bps spread (43bps wider than current levels).

Good data to make ECB discussions more lively

Rising Eurozone PMIs and a pick-up in inflation

On the economic front, the most meaningful development since the last ECB meeting on 8 December was the rise in Eurozone PMIs to a 67 month high in December and the jump in headline inflation to 1.1% y/y from 0.6% in November. However, as we argued last week, we do not think this has immediate implications for ECB monetary policy, given that the Bank laid out the road map for monetary policy in 2017 only a few weeks ago. Having said that, the latest data will make the discussion on the ECB Governing Council more lively and strengthen the arguments of the hawks (with the particular strength of the German inflation data playing into the hands of Bundesbank President Weidmann).

A controversial discussion at last December meeting

The accounts of the December ECB meeting note that the discussions in the Governing Council had focussed on two options for extending QE beyond March 2017: (1) continue purchases at the €80bn pace for an additional six months; or (2) an extension by nine months at €60bn (the decision eventually taken). While there was "broad agreement that an extension of asset purchases beyond March 2017 was warranted", the accounts indicate that the discussion in the Council was more controversial than perhaps previously thought. Specifically, it is stated that "arguments were put forward in support of a shorter purchase horizon, namely six months, at a rescaled pace of purchases of €60 billion". Also, "a few members could not support either of the two options that had been proposed, while welcoming the scaling-down of purchases and other elements of the proposals, in view of their well-known general scepticism regarding the APP and public debt purchases in particular." Overall, it seems unlikely to us that the hawks will soften their stance if growth and inflation continue as expected during the year, raising the bar for a further extension of QE, rather than tapering, after December 2017.

Noteworthy remarks by Benoît Cœuré

In terms of public remarks by ECB policy makers, a newspaper interview with ECB Executive Board member Benoît Cœuré (published on 31 December) was most noteworthy:

- Mr Cœuré acknowledged that "a discussion will be needed about normalisation of monetary policy but it needs to be initiated carefully".
- He indicated (surprisingly explicitly) that amid signs of rising headline inflation the ECB is "still waiting for signs that core inflation is on the rise & will clearly exceed 1%".
- He acknowledged the risk of rising bond yields, above all for governments ("...all actors must prepare themselves for the time when extremely favourable interest rate conditions gradually come to an end. In particular, governments should be aware that their budgets are subject to interest rate risks")
- However, regarding the risk of European bond yields being pushed up by higher US Treasury yields, he reportedly said "We can't accept that long-term euro area interest rates would be entirely driven by US interest rates. We need a certain amount of decoupling, as the recovery in the euro area is not yet as robust as in the United States. Our asset purchase program helps ensure this".
- Last but not least, referring to the technical parameters of the QE programme, Mr Cœuré said that, compared with the maturity restrictions and yield floors of asset purchases, which were softened in December, the current issue and issuer

limits "are more binding and important". He is reported to have concluded that the Governing Council would be "very reluctant" to change issue/issuer limits.

Rates Strategy: Focus on any "hawkish" nuances in the ECB's communication and QE implementation

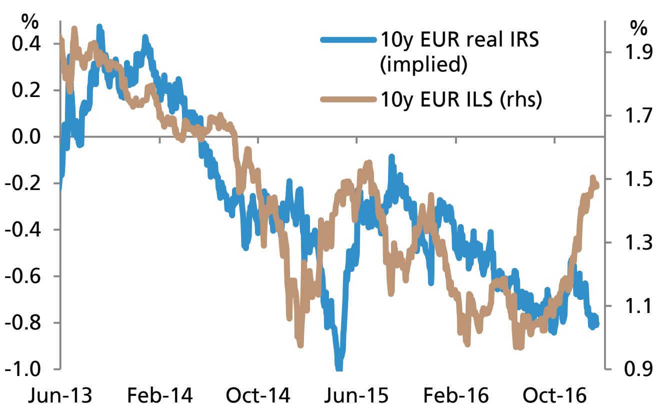
Tangible action from the ECB is unlikely with the focus on nuances in the communication

As mentioned, after the changes the ECB made to the APP at its last meeting alongside the dovish forward guidance, tangible action from the ECB is considered unlikely at the 19 January meeting. Thus, the key focus will most likely be on nuances of the ECB's communication, but we do not expect the ECB's official stance to change meaningfully at the next meeting.

Market pricing implies an ideal scenario for the ECB

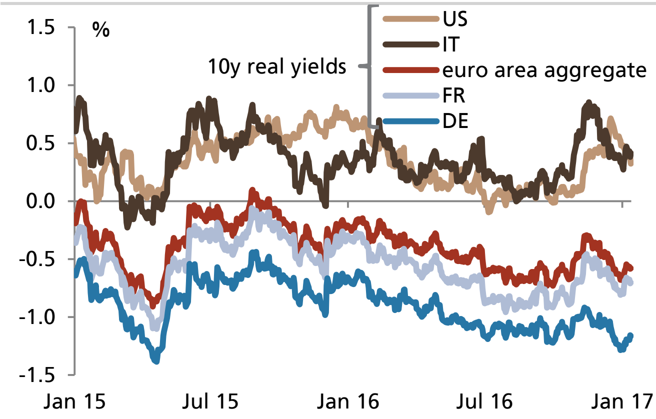
Supported by the ECB's dovish forward guidance, the market pricing, in particular since last December, implies an ideal scenario for the ECB. Market based inflation expectations are on the rise to a large degree driven by lower real rates (Figure 1) which is supporting financial conditions for the real economy and therefore equities. Thus, monetary policy has so far been successful in preventing euro area real rates from rising alongside the US. Figure 2 shows that aggregate EGB real yields had already started to fall since mid-November while US real rates were still on the rise until mid-December. This is clearly in line with Mr. Cœuré's thoughts, which we highlight above.

Figure 1: Euro area inflation expectations diverging from (real) rates



Source: UBS, Bloomberg

Figure 2: Euro area real yields broadly decoupled from the US



Source: UBS, Bloomberg
Using HICPxt inflation swaps (ILS) as a proxy for EGBs breakevens and a GDP weighting for euro area aggregate sovereign real yields

However, we outline in our latest Global Rates Landscape that the decoupling of US real rates from EGB peers seems to have reached its limits, while the rise in euro area inflation expectations look stretched against nominal rates.

Euro area inflation expectations look stretched against rates and…

We recommend regression-weighted 10y Bund breakeven (EUR ILS) tighteners

Within the euro area we approach the divergence of inflation expectations and nominal/real rates (Figure 1) from both ends and recommend regression-weighted 10y Bund breakeven (EUR ILS) tighteners. i.e. being short inflation versus selling (paying) 10y Bunds (EUR IRS) in a risk weighting of 35% (44%), in bond terms this implies selling DBRei Apr26 vs. 65% DBR Feb26.

… euro area real rates too low vs the US

On cross-market, euro area inflation expectations already look quite rich against US peers. However, with US growth overpriced in our view, we prefer to focus on real rate compression trades in USTs vs. Bunds (long 10y US TIPS vs Bundei). US vs German real rate spread tightening can work from both legs. If the reflation dynamics abate TIPS should outperform in the spread, while sustained global reflation should also push (currently very low) Bund real yields and implied EUR IRS real rates higher. In the latter case the risk is that the hawkish wing of the ECB's Governing Council gains traction in favour of tapering ECB QE sooner rather than later. The strong data (see above) provides additional ammunition for the GC's hawks, while the Dec-16 meeting accounts already showed no unanimity on the ECB's policy decision. Nonetheless, amidst the ECB's favoured "steady-hand" approach that keeps financial conditions easy and supports the recovery, we think it is unlikely that the official monetary policy stance will change meaningfully anytime soon.

We like real rate compression trades in USTs vs. Bunds (long 10y US TIPS vs Bundei)

QE implementation important for the Bund (ASW) curve

The QE design changes from last December (allowing purchases in the new 1y-31y maturity band and below the depo rate) had a pivoting impact on the curve. The German front-end received a firm bid additionally supported by the collateral squeeze into year-end. Ultra-long Bunds remained the weakest link on the curve which we outlined already in our 2017 Market Outlook and we stick to our 5s30s Bund curve steepening recommendation.

Ultra-long Bunds remain the weakest link on the curve, stick to steepeners

Since the start of the year 2y Schatz yields rose some 9bp implying that Bundesbank's PSPP bid had not ventured to the very front-end yet. However, last Thursday's Legal Act for the PSPP provided the legal basis for technical PSPP parameter changes providing a green light for the Bundesbank to move purchases below the deposit rate. The Schatz should find support by on aggregate shorter PSPP purchases (or expectations thereof), but we doubt that Bundesbank purchases will be very drastically skewed to the front-end of the German curve.

Legal Act clears sub deposit rate purchases. The Schatz should find support from an outright as well as…

In swaps spread, the extreme steepness of 2y-5y German Eonia ASW box (ahead of the Dec-16 ECB meeting) corrected (Figure 3) and our respective recommendation reached its target. After the PSPP legal act, renewed market expectations of a very pronounced front-end skew of Bundesbank purchases could re-steepen the 2y-5y ASW curve and put widening pressure on Schatz swap spreads. However, we prefer to wait for more clarity from the ECB's PSPP reporting before re-engaging in swap spread curve positions. In general, we think that the German swaps spreads are bound to stay structurally wide given that the QE induced supply-demand imbalance in Bunds prevails. We think further tightening should be used to enter swap spread wideners.

… ASW (curve) perspective

German ASW to remain structurally wide, use tightening to scale into wideners

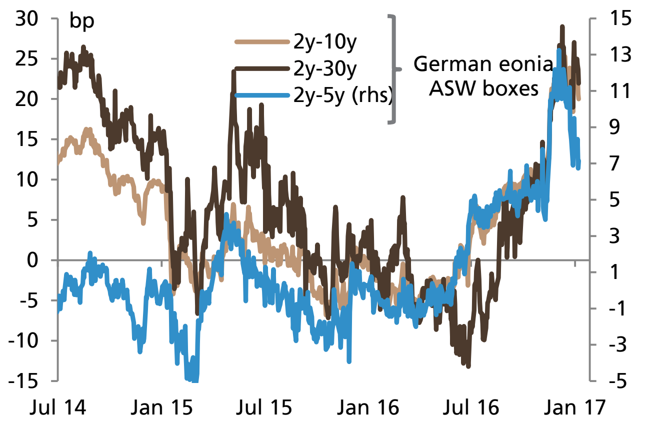
Opposition to issuer/issue limit changes structurally weighs on PGBs

As several ECB speakers outlined over the past few weeks it was also highlighted in the latest ECB accounts that "legal implications, communication challenges and reputational risks" made an increase in issue and issuer limits unsuitable options for QE design changes. This is negative mainly for Portuguese (and to a lesser extent Irish paper), as these limits impair QE purchases below the share implied by the ECB's capital key. Purchases of Portuguese debt have been below the monthly target for eight consecutive months and as of end-2016 15ppt below the amount implied by the capital key since QE started. Consequently PGBs have been on the

Binding PSPP issue and issuer limits will continue to weigh on PGBs in particular

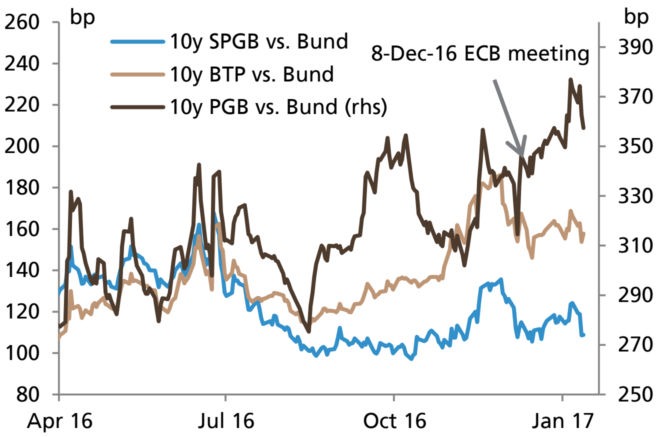
back foot against peripheral peers which intensified after the ECB QE design changes were announced in last December (Figure 4).

Figure 3: 2y-5y ASW box correction



Source: UBS, Bloomberg, using generic futures swap spreads

Figure 4: Limited QE support for PGBs



Source: UBS, Bloomberg

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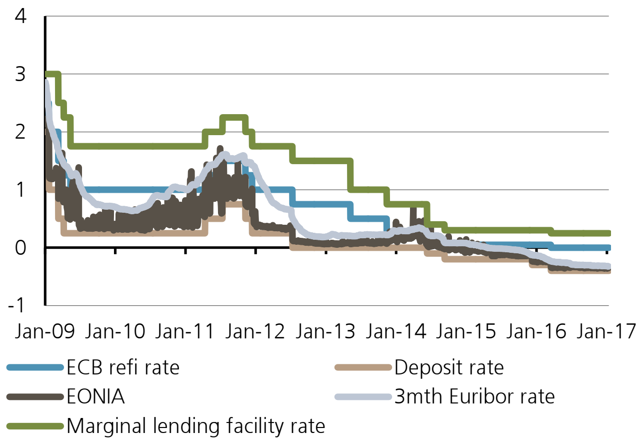
Figure 5: ECB's menu for monetary policy normalisation/tightening

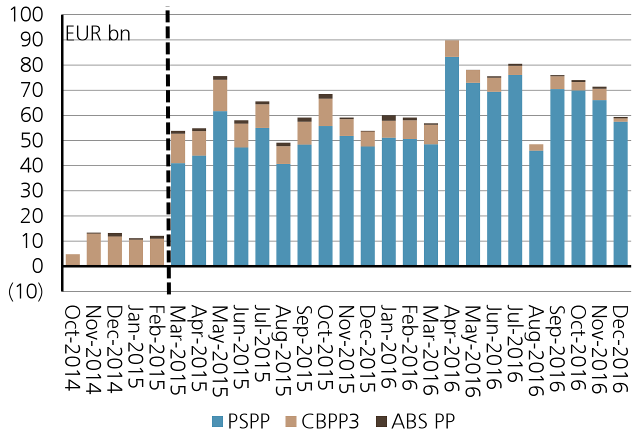
Source: UBS

Figure 6: ECB interest rates, EONIA and Euribor (%)



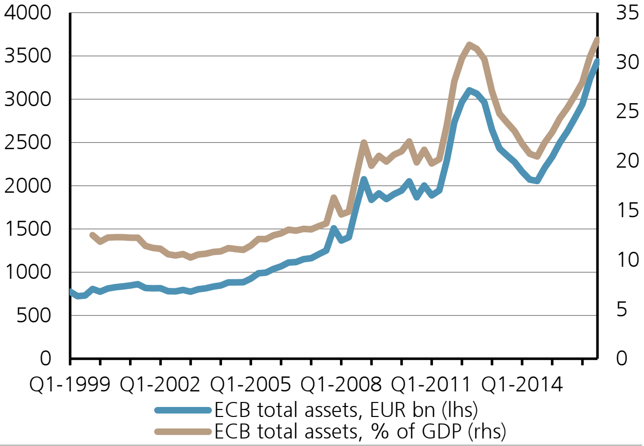
Source: Haver, UBS

Figure 7: ECB's Expanded Asset Purchase Programme



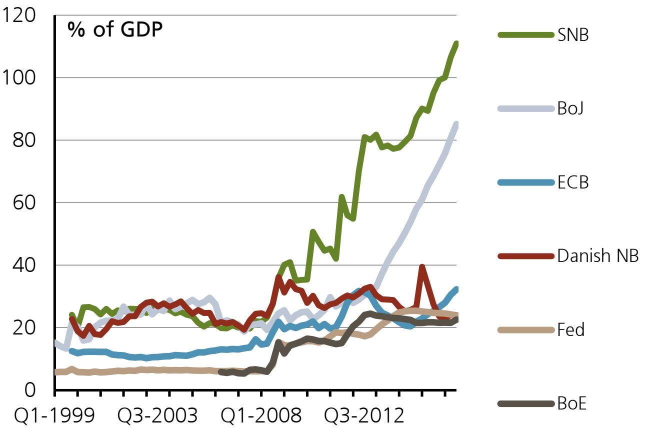
Source: ECB, Haver, UBS. PSPP: Public Sector Purchase Programme, i.e., sovereigns, agencies, supranationals. ABS PP: Asset Backed Securities Purchase Programme. CBPP3: Covered Bond Purchase Programme 3.

Figure 8: ECB balance sheet



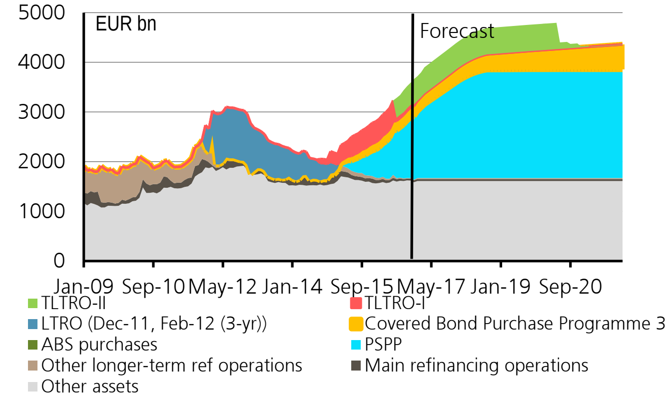
Source: ECB, Haver, UBS

Figure 9: Other central bank balance sheets, % of GDP



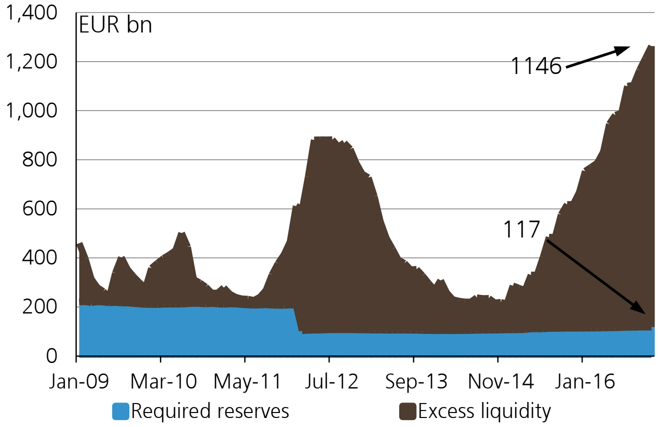
Source: Haver, UBS

Figure 10: ECB balance sheet forecasts*



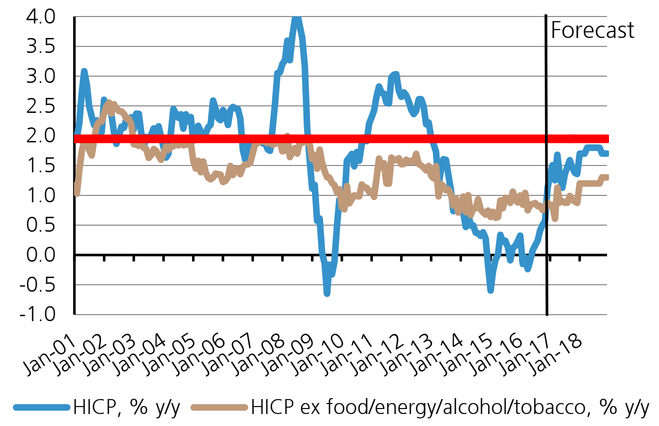
Source: Haver, UBS. *Assumptions: 6-mth extension in QE beyond Mar-17, followed by tapering over the course of one year; i.e. QE to end in the fall of 2018.

Figure 11: ECB excess liquidity



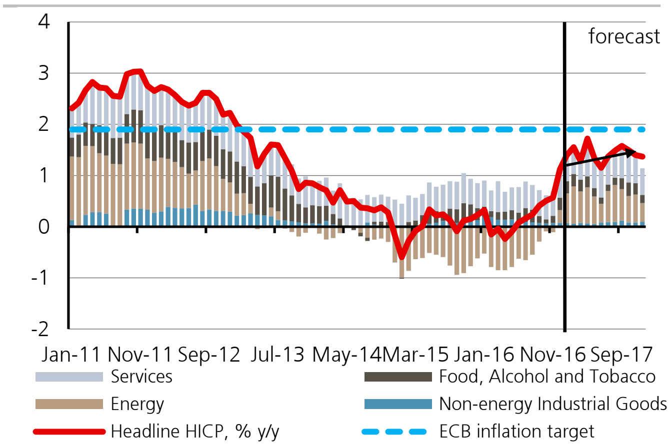
Source: Haver, UBS

Figure 12: Eurozone headline and core inflation



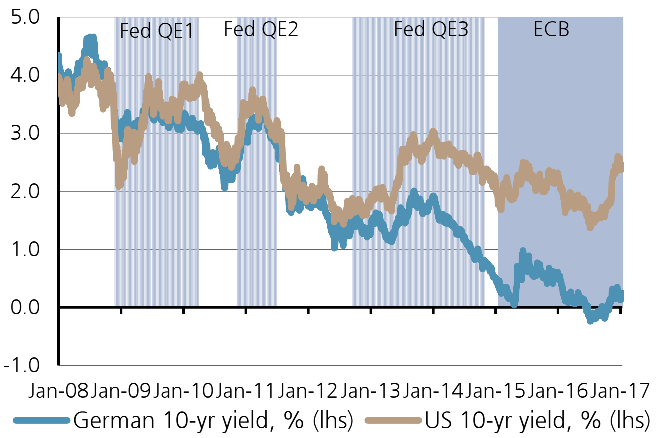
Source: Haver, UBS

Figure 13: Contributions to Eurozone HICP inflation, ppt



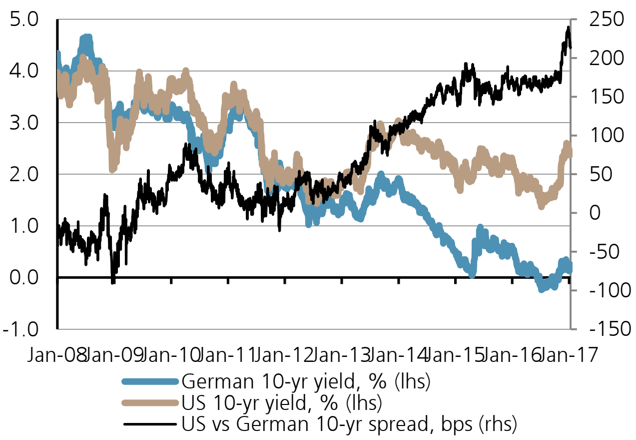
Source: Haver, UBS

Figure 14: German and US 10-year yields and QE phases



Source: Haver, UBS

Figure 15: German and US 10-year bond yields vs spread



Source: Haver, UBS

Valuation Method and Risk Statement

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

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