Macro-Strategy Key Issue
ECB: Draghi trying to keep the hawks at bay

Economics

Europe including UK

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ECB remains committed to its plan from December

ECB President Draghi tried to convey the impression today that the ECB remains firmly committed to its accommodative policies, as announced on 8 December, despite surprisingly strong sentiment and inflation data recently. He stressed that the recovery in inflation needs to be broad-based (for the whole Eurozone, and not just individual countries, such as Germany), sustainable (not just driven by temporary base effects related to energy) and self-sustained (i.e. sustainable even when super-accommodative monetary policy has ended).

Call unchanged: ECB to start tapering in Jan 2018, wind down QE by end-2018

Despite the good data recently, our ECB call remains unchanged: We expect the ECB to conduct monthly asset purchases of €60bn per month from April to December 2017, in line with the Bank's decision from 8 December. As of January 2018, however, we expect the ECB to start tapering and wind down its asset purchases over 12 months, i.e. until December 2018, with a decision due possibly as early as 7 September, or 14 December at the latest. With inflation likely to rise further over the coming months, we think the monetary policy discussion will turn more hawkish, not least in the context of the upcoming elections in Germany.

Rates Strategy: underwhelming details on sub-depo purchases

As widely expected the ECB did not alter its monetary policy stance. The sound forward guidance was retained and any signs of "hawkish" nuances, reflecting better data and improving market-based inflation expectations, were nowhere to be seen. The ECB's details for APP purchases below the deposit rate did not provide a lot of transparency. A focus on the PSPP should have been expected, while it confirms that, on aggregate, shorter Bund PSPP purchases will not be very drastically skewed to the front-end. We stick to our established recommendations of US vs German real rate spread tighteners, and regression-weighted 10y Bund breakeven (EUR ILS) tighteners. Moreover, in our view, the back-up in front-end Eonia forward rates provides attractive entry levels, we hold on to 5s30s Bund steepeners and recommend to scale into 10y Bund ASW wideners on further tightening.

Draghi trying to keep the hawks at bay

ECB President Draghi displayed a lot of confidence today, presenting the solid Eurozone growth performance and the pick-up in inflation as vindication of the Bank's accommodative monetary policy in recent years. Mr Draghi re-confirmed the Bank's commitment to the policy measures announced on 8 December and – to prevent from the outset the impression of growing hawkishness – even reiterated that the ECB stands ready to do more in the event of new setbacks.

How will the ECB judge inflation, as it recovers?

As we had expected, a key focus of today's ECB press conference was the surprisingly strong pick-up in inflation in December – not only in the Eurozone (1.1% y/y), but particularly in Germany (1.7% y/y). Journalists were trying to figure out how high the hurdle will be for the ECB to turn significantly more hawkish and abandon the monetary policy course outlined in December – not least given the sharp rise in German inflation and related criticism of the ECB.

Mr. Draghi acknowledged the marked pick-up in inflation and indicated that the Eurozone HICP trajectory in Q1 and Q2 2017 would likely be higher than anticipated in the ECB staff macroeconomic projections from December. He stressed that higher inflation was mainly driven by energy and that there was still no convincing signs of a pick-up in underlying (core) inflation. Still, the ECB would monitor closely how second-round effects from higher oil prices would evolve. But more specifically, when assessing the inflation outlook vis-à-vis the target, the ECB would want to see the following four criteria fulfilled:

1. The inflation target (HICP close to, but below, 2%) is a **medium-term** target; i.e. short-term deviations are possible.
2. The ECB is aiming for a **durable** conversion towards target, i.e. not just driven by energy-related base effects.
3. The recovery in inflation has to be **self-sustained**, i.e. it needs to persist even when unprecedented monetary policy support has ended.
4. **Eurozone** inflation (HICP) needs to return to target, not just the inflation rates of individual countries, such as Germany.

As before, Mr Draghi fended off journalists' questions regarding the likelihood of an early tapering by stressing that this had not been discussed.

UBS call unchanged: tapering to start in January 2018

Despite the good data recently, our ECB call remains unchanged: We expect the ECB to conduct monthly asset purchases of €60bn per month from April to December 2017, in line with the Bank's decision from 8 December. As of January 2018, however, we expect the ECB to start tapering and wind down its asset purchases over 12 months, i.e. until December 2018, with a decision due possibly as early as 7 September, or 14 December at the latest. With inflation likely to rise further over the coming months, we think the monetary policy discussion will turn more hawkish, not least in the context of the upcoming elections in Germany.

Rates Strategy: Forward guidance remains unscathed and underwhelming details on sub-depo purchases

No signs of "hawkishness"

No signs of "hawkish" nuances

As widely expected, the ECB's monetary policy stance remained unchanged compared to last December, embracing its "steady-hand" approach highlighted in the latest minutes. Despite sound data and increasing market-based inflation expectations over the past few weeks (and months), any "hawkish" nuances were nowhere to be seen in Mr Draghi's press conference (we highlighted the risk that the hawkish wing of the GC has been provided with additional arguments in our ECB Preview).

Forward guidance remains firmly in place

Tapering remained undiscussed at the GC meeting and the sound forward guidance from December was retained. Additionally Mr. Draghi underlined in the Q&A (on the question of not being able to source sufficient bonds for another extension of QE) that the QE strategy could be revised and upgraded in case needed. We highlighted after last December's ECB meeting that the new technical QE framework (extended 1y-31y eligibility pool and sub deposit rate purchases) allows Bund PSPP purchases (running out of paper has been the most pressing concern) well into 2018 already. Further QE design changes will not be a focal point for the GC anytime soon, but we surely expect QE not to end due to the technical parameters until the inflation trajectory has sufficiently improved.

Not a lot of transparency on sub deposit rate purchases

The ECB's details on APP purchases of assets with yields below the deposit facility rate (DFR) were rather underwhelming:

- Purchases of assets with yields below the DFR will only occur under the PSPP, while no such purchases are foreseen for the CBPP3, ABSPP and CSPP
- For each jurisdiction, priority will be given to PSPP purchases of assets with yields above the DFR

No surprises from the sub-depo purchase focus on PSPP

The first point should not come as a big surprise, given the fact that the deposit rate threshold for QE purchases was first and foremost an impediment for QE implementation in the German sovereign bond market. The second point was indirectly already stressed in the press conference from last December. Back then Mr Draghi emphasised that purchases below the deposit rate will only be conducted to the "extent necessary".

Bund PSPP purchases will not be very drastically skewed to the front-end

This manifests our prevailing opinion, that we doubt that Bundesbank purchases will be very drastically skewed to the front-end of the German curve. Therefore, 2y Schatz swaps spreads do not have to re-widen against 5y Bobl spreads going forward. Nonetheless, on aggregate German PSPP purchases should still be shorter going forward. In our view, a smooth implementation of the PSPP would entail sub-depo purchases before issue limits of paper yielding above the deposit rate are fully exhausted. This should support the 2y to 5y segment of the German curve and we stick to our steepening view expressed via 5s30s Bunds.

How to position going forward?

The ECB meeting did not alter our market views meaningfully and we stick to our recommendations established and reiterated in our latest edition of the Global Rates Landscape.

We like US vs German real rate spread tighteners as a strategic trade that can work from both legs. In case the reflation dynamics abate, TIPS should outperform in the spread, while sustained global reflation feeding into the euro area economy (having been supported by the ECB) should also lift higher Bund real yields from extremely low levels.

Stick to US vs Bund real yield spread tighteners and…

The divergence of inflation expectations and nominal rates in the euro area should be approached from both ends and we recommended regression-weighted 10y Bund breakeven (EUR ILS) tighteners.

… regression-weighted Bund break-even (EUR ILS) tighteners

Receiving 2y1y Eonia forwards remains at attractive levels (especially after the recent back up in front-end rates) to counter pre-mature deposit rate hike expectations while providing a good rolldown. From this perspective the ECB's introductory statement repeatedly highlights that key ECB interest rates are expected "*(…) to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases*".

2y1y Eonia forwards provide good entry levels

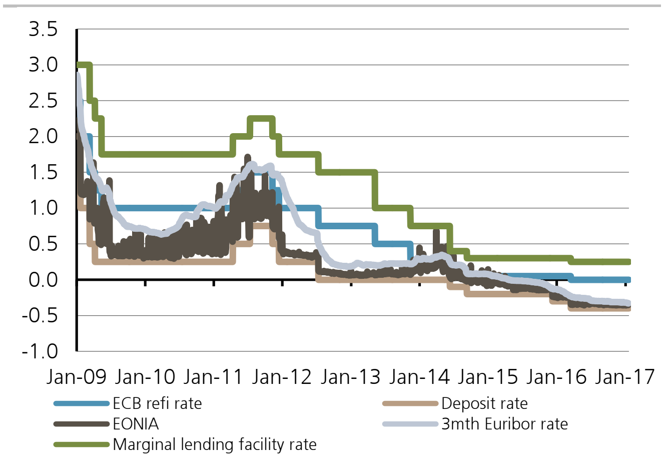
On the curve we recommend holding on to 5s30s Bund steepeners on strategic grounds (with the carry being supportive). Even though the curve will remain outright dependent, we would add on flattening phases as ultra-long Bunds remain the weakest link on the German curve (with ultra-long curves flattening less in a rally, but steepening more in a sell-off).

Add to 5s30s Bund steepeners on flattening stints and…

With respect to German ASW (beyond our views outlined above) we think that swap spreads are bound to stay structurally wide across the curve given that the QE induced supply-demand imbalance in Bunds prevails. While 2y to 5y German ASW spreads have been well supported by the QE design changes, we would also use any further extension of the tightening we have seen especially in the 10y Bunds to scale into swap spread wideners.

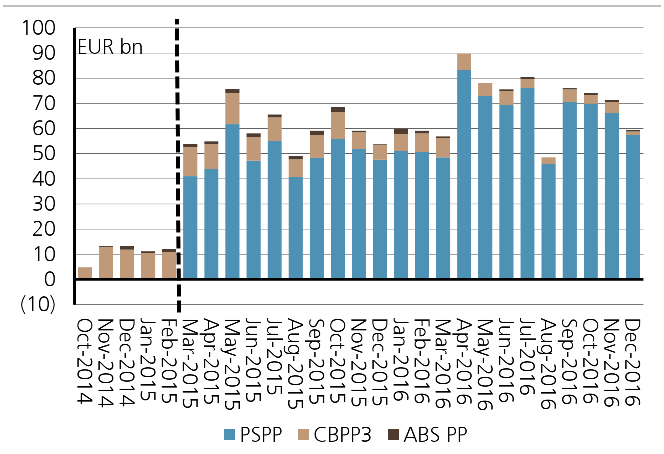
… scale into 10y Bund swap spread wideners on any further tightening

Figure 1: ECB interest rates, EONIA and Euribor (%)



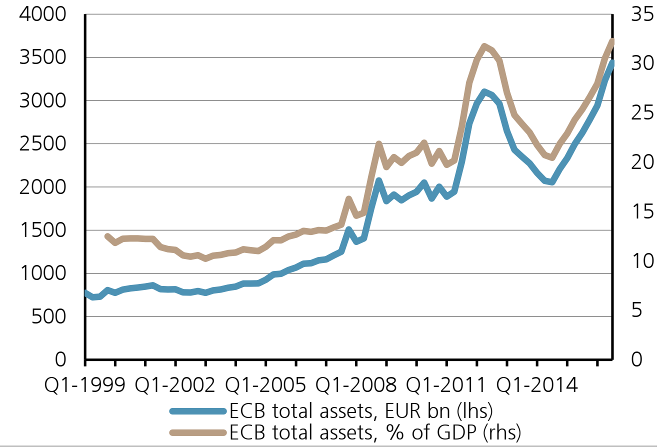
Source: Haver, UBS

Figure 2: ECB's Expanded Asset Purchase Programme



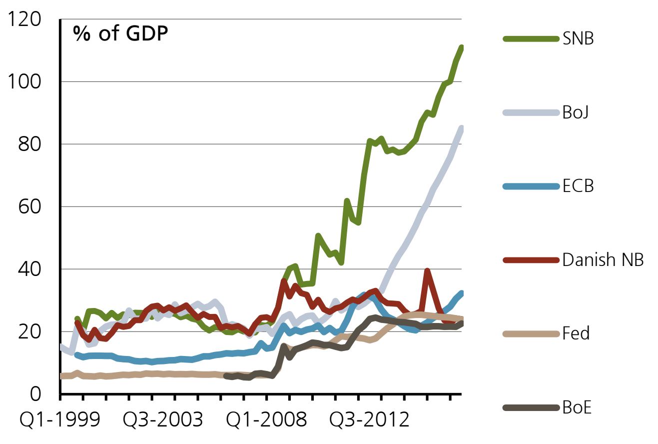
Source: ECB, Haver, UBS PSPP: Public Sector Purchase Programme, i.e., sovereigns, agencies, supranationals. ABS PP: Asset Backed Securities Purchase Programme. CBPP3: Covered Bond Purchase Programme 3.

Figure 3: ECB balance sheet



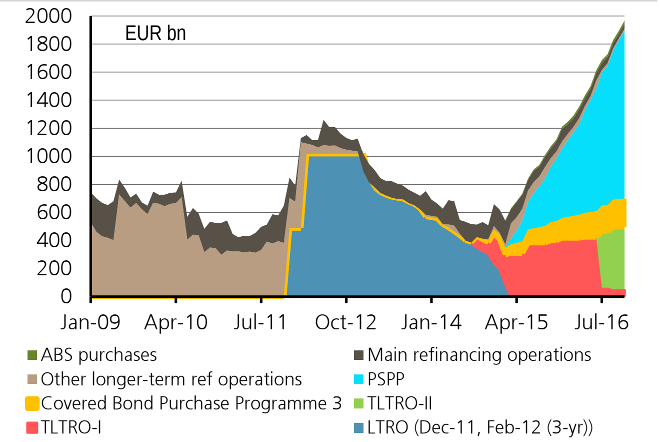
Source: ECB, Haver, UBS

Figure 4: Other central bank balance sheets, % of GDP



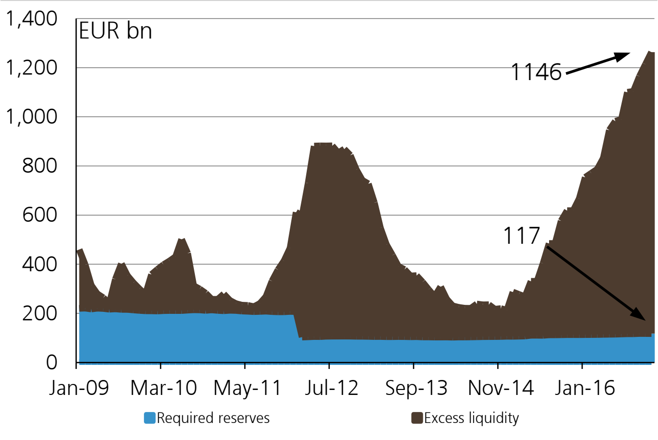
Source: Haver, UBS

Figure 5: Asset side of ECB balance sheet



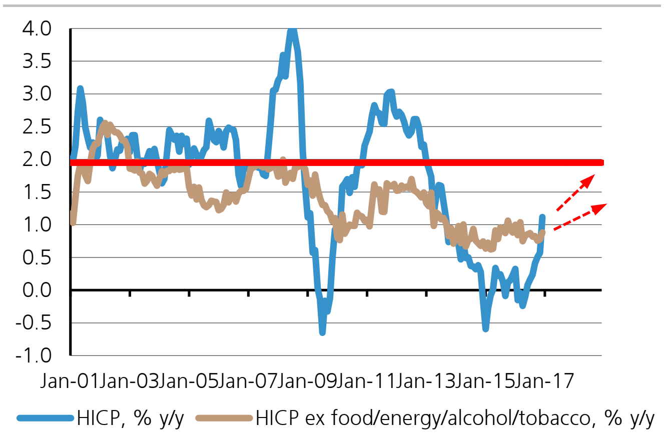
Source: Haver, UBS

Figure 6: ECB excess liquidity



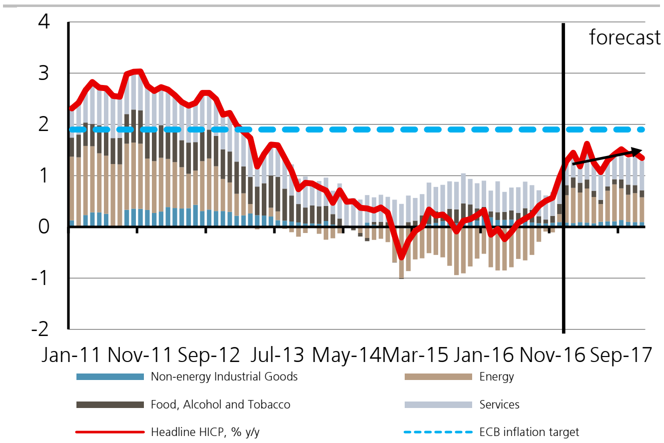
Source: Haver, UBS

Figure 7: Eurozone headline and core inflation



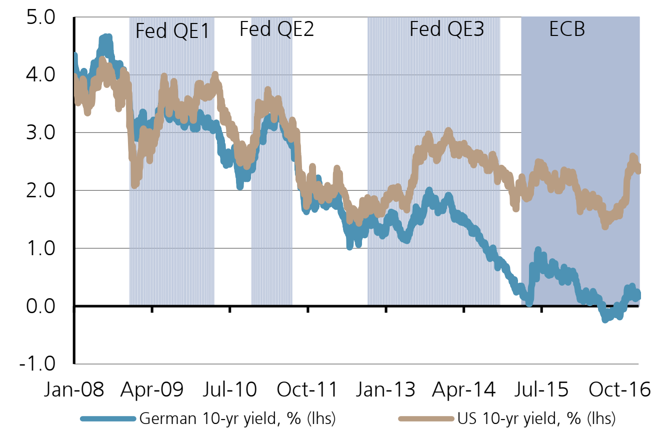
Source: Haver, UBS

Figure 8: Contributions to Eurozone HICP inflation, ppt



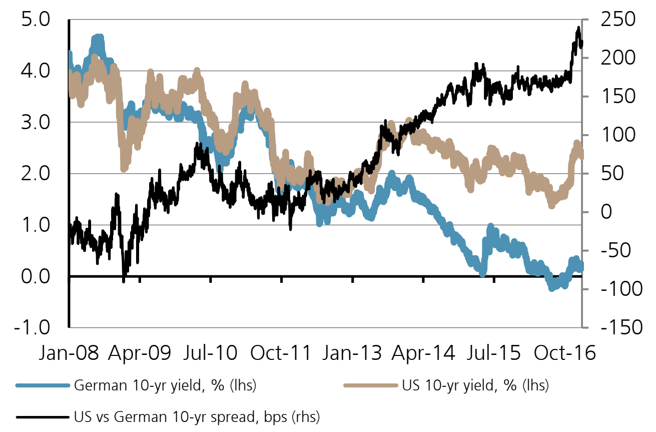
Source: Haver, UBS

Figure 9: German and US 10-year yields and QE phases



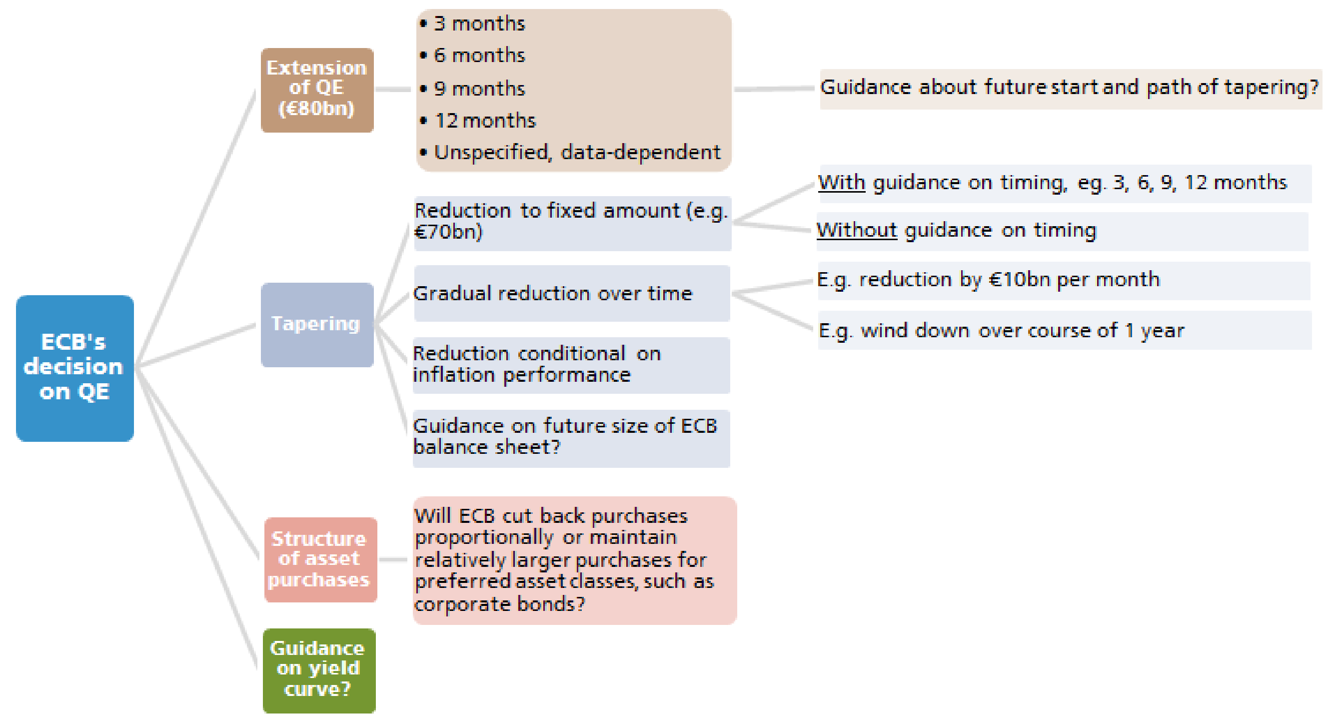
Source: Haver, UBS

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



Source: Haver, UBS

Figure 11: The ECB's choices on QE



Source: UBS

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