Economics

DBS Flash

Eurozone: Not a matter of if but when and how policy eases

Economics/Growth/ECB/Eurozone

DBS Group Research

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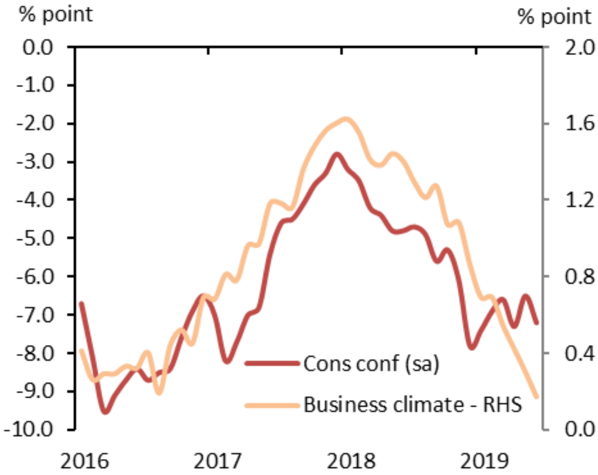
- *The European Central Bank has sounded the dovish bugle*
- *The bar to act is low*
- *Sentiment and real data remained sluggish in the EU. Inflation is below target and inflationary expectations have corrected sharply*
- *We explore the available policy options ahead of the ECB Presidency handover in late-October*
- *Some stimulus could be forthcoming at the July 25 ECB rate review*
- ***Implications for our forecasts**: No change is likely in the benchmark main refi rate (at 0%), while there might be tweaks in other parameters*
- ***Implications for markets**: European Government Bond yields to stay lower for longer*
- *Look for EUR to resume its depreciation*

Policy narrative amongst the developed markets' central banks has turned on its head in the past 6-8 months. From policy tightening, focus has shifted to defending a deteriorating trade outlook, prolonged trade conflicts and prospects of a broader slowdown in global growth. Preferring to be ahead-of-the-curve, the European Central Bank chief Mario Draghi sounded the dovish bugle in his speech at the ECB Forum in Sintra, Portugal in mid-June. The bar for policy easing has been lowered after the authorities pledged to act, not only if the outlook weakens further but also if growth does not get better going forward and inflation stays consistently below the 2% target. This has opened the door for possible stimulus measures at the upcoming July 25 meeting, days before the US Federal Reserve meets to decide on its rates.

Data remains weak, inflation sub-target

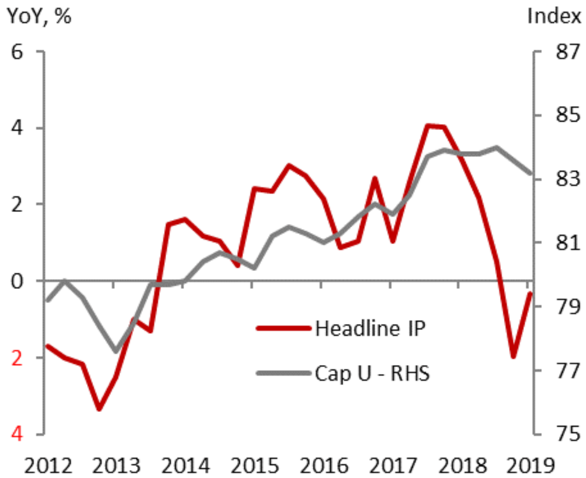
Most sentiment and real data have continued to drift lower. Adding to the string of downbeat indices, July's Sentix investor confidence declined to -5.8 vs -3.3 in the month prior and against expectations for stabilisation; the weakest in nearly four years. Other consumer confidence and business indices have also been under the weather, clouding the outlook.

Consumer and business confidence indices slip



Source: CEIC, DBS

Industrial production moderates, weighing on CapU



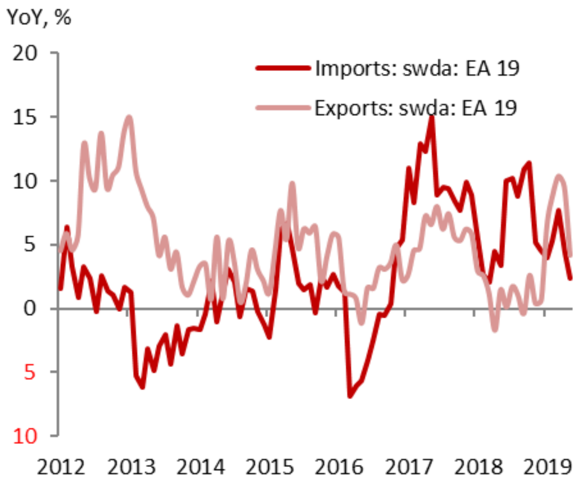
Source: Bloomberg, CEIC, DBS

Amongst real data, production and exports had started to weaken in 2H18 owing to idiosyncratic forces (particularly auto) and has since widened. Given that Europe, and Germany in particular, are highly exposed to trade, a fallout from the trade conflict (some of which is aimed at the EU) could hurt trade performance further. **In fact, changes in the contribution of net exports have been the key reason behind the growth fluctuations in the past eight and more quarters.** Other headwinds include the China slowdown, weak global economic activity and the Brexit overhang.

Moderation in manufacturing goods and intermediate inputs are the main drags on production, nudging units to pare back on their capacity utilization rates. Manufacturing PMIs continue to moderate even as composite readings have stabilised in recent months.

Weakness in production and trade-oriented industries is spilling over into service sector, as demonstrated by the flagging retail sales.

Soft exports, imports too,pointing to weak demand

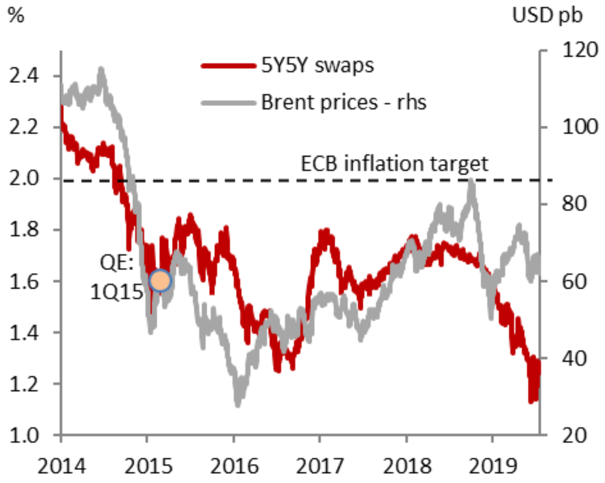


Source: CEIC, DBS

Demand/consumption has fared better on an easing unemployment rate, an improvement in wage growth and tepid inflation. Protracted weakness in real activity is likely to impinge on demand sooner rather than later, prodding us to maintain our GDP growth forecast at 1.2% YoY for 2019. **While the bloc is in midst of a slowdown, recessionary conditions appear unlikely.**

April's inflation spurt proved short-lived, slipping in May-June (1.3% YoY), along with the market's inflationary expectations gauge (5Y5Y swaps) sharply lower in recent months despite stable oil prices. Constrained pricing power of manufacturers and moderating cost-push pressures have kept a lid on prices, underscoring the central bank's recent dovish guidance.

Markets-based Inflation expectations vs oil prices



Source: Bloomberg, DBS

This begs the question how much policy space do policymakers have?

With economic weakness keeping inflation well below the 2% target, the ECB has reaffirmed its dovish guidance. Focus is on what policy action could be forthcoming, in July or by September (when staff projections will also be unveiled). Possible options in 2H19 include:

a) A possible 10-20bp reduction in the main refinance rate (0%) but we doubt this will be the first line of defence.

b) Further cuts to the deposit facility rate from the current -0.4%.

c) A cut here will need to be accompanied by a tiered system for excess liquidity to mitigate further costs to the banking system (see here).

d) Restart QE i.e. bond purchases which will require a relook of the capital key restriction and relaxation of the 33% threshold of sovereign exposure.

e) Widen the scope of QE through purchases of senior bank bonds and corporate bonds

f) A third tranche of Targeted Longer-Term Refinancing Operations (TLTROs) was announced earlier this year and due to start in September; funds will be lent at a small premium on the deposit rate

g) As a final resort and previously untested Outright Monetary Transactions (OMTs). This tool offers conditional liquidity insurance by promising outright purchases of sovereign bonds with maturities up to 3 years on the condition that the countries meet domestic economic conditions laid out by an agreement with the European Stability Mechanism. This tool might however not be very useful in the present context as liquidity is flush and the members' sovereign yields have corrected sharply on the back of ECB's QE purchases and better fiscal management.

h) Several other liquidity-infusing and non-standard measures in wake of the GFC and debt crisis thereafter. As highlighted above, all of these are unsuitable and unnecessary at this juncture.

While available policy options are being discussed, a premature use also opens the ECB

to the risk of running out of avenues if the growth outlook takes a turn for the worse in 2020. Hence, a prudent mix of dovish guidance and a gradual rollout of easing measures is likely to ensure enough ammunition remains with the ECB. President Draghi's tenure ends in late-October, with former IMF chief Lagarde likely to take over the office November onwards. No change is likely in the dovish and accommodative bias in the ECB.

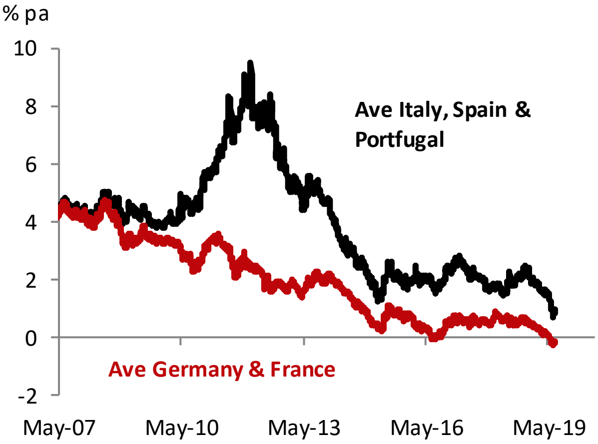
On the currency front, the Euro depreciated strongly in the wake of ECB Draghi's comments in late June. **Our DBS FX Strategist expects this trend to continue for rest of the year (towards 1.09/USD).** Even as the US Fed shifts from hikes to cuts, the concurrent dovish shift amongst other central banks (read ECB) limits the scope for rate differentials to move against the US dollar. Nonetheless, a one-sided slip in the EUR will attract a counter response from the US over alleged currency manipulation. But keeping the EUR at competitive levels will remain an (unstated) policy prerogative in midst of a challenging export/trade outlook.

Rates: The Fed & ECB cascade

Market participants have been quick to jump on to Draghi's hint that further ECB easing is on the cards. With the Fed on the cusp of the first cut since the global financial crisis (GFC), the ECB will probably hop on the easing bandwagon. Short-term EUR rates have already factored in two 10bps cuts within the next four quarters. If the ECB delivers, this would bring the deposit rate to -0.6%, just shy of the Swiss National Bank's -0.75%.

Longer-term rates have also factored in likely asset purchases in the coming quarters. Given the shortage of selected government bonds, the ECB will almost certainly need to tweak either the composition and / or existing limits on securities in order to do asset purchases in a meaningful manner. This has led to a compression in 10Y yield spreads between the core (Germany and France) and peripheral (Italy, Spain and Portugal). To provide some context, this core/ peripheral spread was negligible before the GFC and widened out to 700bps during the peak of the Eurozone crisis. Significant spread (currently just above 100bps) narrowing has already taken place with more to come in the coming months.

Peripheral 10Y yields converging to core yields on ECB QE expectations



Source: Bloomberg

Looser Fed and ECB policies have significant cascading effects unto global rates. Developed Market central banks could try to out-dove one another, worsening the glut in negative yielding bonds. In any case, it is quite clear that the ECB will not be able to raise rates for an extended period and this should provide the backdrop for global yields to stay depressed. **For the US, yields would be lower than fundamentally warranted, providing a supportive backdrop for EM govvies.**

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).