DNB

Preview
07.06.2018

14/6: ECB to keep APP until year-end

- **Economic growth has moderated, but should remain above potential in the remainder of the year**
- **ECB increasingly optimistic on three criteria for inflation**
- **We expect that the ECB will signal that QE will be ended at year-end at next week's meeting**

Assessment: We expect the ECB to signal that APP will be ended at the end of the year at the meeting next week. We anticipate that net asset purchases will be reduced to EUR15bn. In light of Peter Praet's speech on 6 June, where he signalled that the ECB is becoming increasingly positive that the three criteria for inflation have been met, we believe that the ECB already at this meeting will specify the amount of purchases. However, there is a significant risk that the ECB will delay specifying purchases until July in order to keep all doors open for as long as necessary. As for interest rates, we believe that the ECB will stick to its communication that rates will remain unchanged well past the horizon of the net asset purchases. We believe that the deposit rate will be raised in September 2019, somewhat later than consensus expectations.

Economic growth has moderated, not reached a turning point: While economic data have continued to disappoint, there are clear signs that the slowdown in Q1 was due to temporary factors and a pull-back from last year's strong momentum. We expect GDP to grow by 0.5% q/q for the remainder of the year, marginally higher than the 0.4% increase recorded in Q1. This should be enough to bring unemployment further down from today's 8.5%, and in turn put additional pressure on labour costs.

Two major factors could lead to weaker growth in the medium term. Firstly, political uncertainty in Italy has increased since the last ECB meeting. We maintain our view that the turmoil will recede rather than escalate into a new euro crisis. With that said, the Five-star movement and the League have ambitions to increase public spending and lower taxes dramatically. If they succeed, this would put pressure on state finances, increase public debt from an already high 132% of GDP, and lead to a more challenging political climate between Brussels and Rome. This could worsen financial conditions not just in Italy but also in other southern countries, thereby hampering the recovery. Secondly, an escalation of trade protectionism could slow growth directly via weaker exports and indirectly via dampened business sentiment and less growth-supportive financial conditions.

Inflation still low, but ECB becoming more positive on outlook: Inflation exceeded expectations in May, with headline CPI up 1.9% y/y, the highest rate in a year and up 0.7%-points from April. The improvement was largely caused by a rise in core inflation of 0.4%-points y/y to 1.1%. The upswing in price growth was due to temporary factors related to the early Easter dropping out of the numbers.

There is also evidence that labour market tightness is having a positive impact on wages. The ECB's indicator for negotiated wages rose to 1.9% y/y in Q1. This was the highest in five years, and 0.3%-points above the average in 2013–2017. Granted, the rise in Q1 was driven by Germany, where negotiated wages were up 2.3% y/y in Q1. Still, apart from a few exceptions such as Austria, France and Italy, most eurozone countries saw an improvement in wage growth at the end of last year.

More importantly, the ECB is becoming increasingly optimistic that its three criteria for inflation – convergence, confidence and resilience – are met. In a speech on 6 June, Peter Praet said that *"signals showing the convergence of inflation towards our aim have been improving, and both the underlying strength in the euro area economy and the fact that such strength is increasingly affecting wage formation supports our confidence that inflation will reach a level of below, but close to, 2% over the medium term"*. On the third criteria, Praet said that *"waning market expectations of sizeable further expansions of our programme have been accompanied by inflation expectations that are increasingly consistent with our aim."* In other words, the combination of higher inflation expectations and expectations that the ECB will scale back its policies appears to be enough for the ECB to think that inflation will remain near 2% even in the absence of net asset purchases.

Consensus expects rate hike in mid-2019: According to a May Bloomberg survey, analysts expect the deposit rate to be hiked by 10 basis points to -0.3% in Q2, and an additional 10 points in Q3. The market appears to be pricing in a small probability of a 15 point hike in the deposit rate in mid-2019, while a full hike is fully priced in at the end of the year. As for QE, a Bloomberg survey from April showed that the median analyst expected purchases to be reduced to EUR15bn after September, and terminated by the end of the year.

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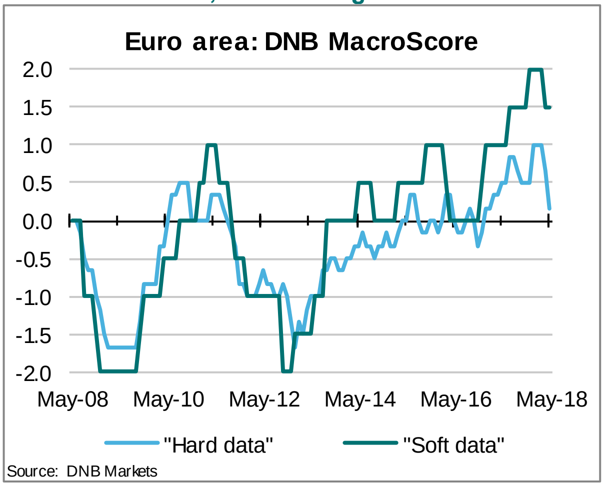
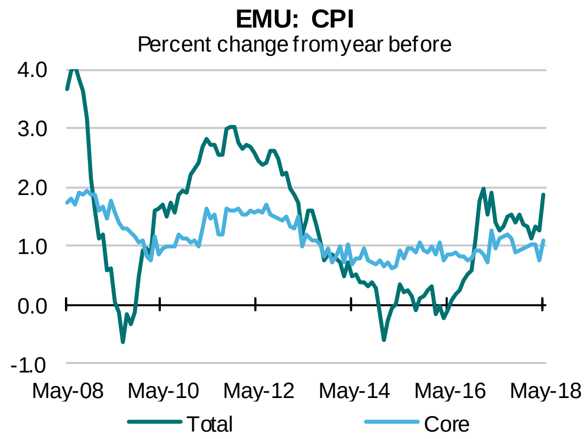
MacroScore down, level still signals “above trend”



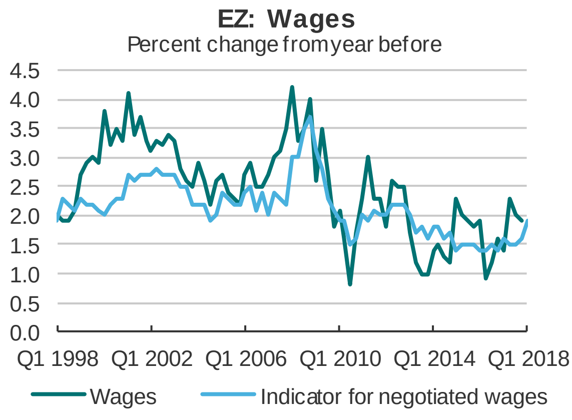
Source: DNB Markets

Inflation has improved



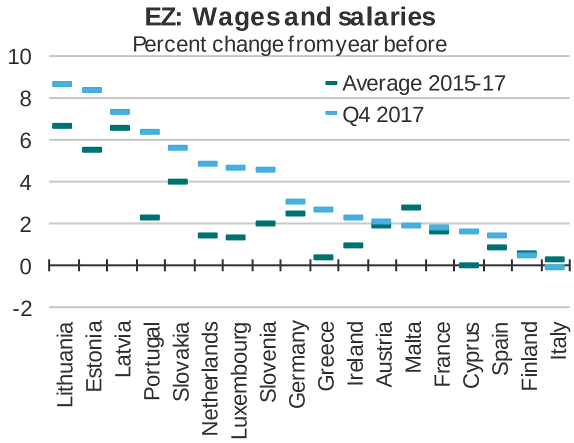
Source: Thomson Datastream/DNB Markets

Negotiated wages rising to a five-year high in Q1



Source: Thomson Datastream/DNB Markets

Broad-based rise in wage growth last year



Source: Thomson Datastream/DNB Markets

Market pricing in a rate hike by the end of 2019

	OIS Pricing at ECB Meetings				DNB's ECB Deposit Rate Forecast		
	Date	Rate, %	Change, bps	Accumulated	Rate, %	Change, bps	Accumulated
Jun-18	04/06/2018	-0.36			-0.40		
Jun-18	14/06/2018	-0.35	0	0	-0.40	0	0
Jul-18	26/07/2018	-0.35	0	0	-0.40	0	0
Sep-18	13/09/2018	-0.35	0	0	-0.40	0	0
Oct-18	25/10/2018	-0.35	0	1	-0.40	0	0
Dec-18	13/12/2018	-0.36	0	0	-0.40	0	0
Jan-19	24/01/2019	-0.36	0	0	-0.40	0	0
Mar-19	07/03/2019	-0.35	0	1	-0.40	0	0
Jun-19	13/06/2019	-0.35	0	1	-0.40	0	0
Jul-19	25/07/2019	-0.30	4	5	-0.40	0	0
Sep-19	05/09/2019	-0.30	1	6	-0.25	15	15
Oct-19	24/10/2019	-0.23	6	13	-0.25	0	15
Dec-19	12/12/2019	-0.22	1	14	-0.25	0	15
Jan-20	23/01/2020	-0.16	6	20	-0.25	0	15

Source: Bloomberg/DNB Markets

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