

2019 ECB Preview: Starting Shot for the Great Unwind

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Executive Summary

- **A pivotal year for the ECB:** Whereas 2018 will be known as the year when the ECB reached the end of its monetary easing path – with the cessation of QE net purchases under which the ECB accumulated a bond portfolio worth €2.6 trillion over the course of close to four years – 2019 will mark the beginning of monetary tightening.
- **First rate hike since 2011:** Given the challenging macro backdrop the unwinding of monetary stimulus will proceed at a gradual pace at best in 2019. Assuming that the economic upswing in the Eurozone remains intact next year, as is plausible from today's point of view, the ECB will raise rates for the first time since 2011 starting off with a 15bp hike in the deposit rate in September followed by a 25bp hike in all key rates in December. This will also reflect an attempt to win back policy room to fight the next crisis.
- **Safety nets to ensure a smooth departure from the zero lower bound:** For the great unwind to proceed without any tantrums, the ECB will put safety nets in place. For one the reinvestment of maturing bonds will weigh on long-term rates until at least 2021. In addition the ECB is likely to extend its forward guidance beyond the first rate hike to ensure that market expectations remain aligned with its monetary policy intentions.
- **Banks receive a helping hand:** The ECB will likely announce a new round of TLTRO funding in Q1 2019 to support lending conditions at a time when confidence in the Eurozone banking sector is waning. To address the risk of Eurozone banks becoming too dependent on cheap loans, the ECB could announce a floating-rate TLTRO to ensure that any rate hikes are passed through to banks.
- **Country risk is staging a comeback:** As the ECB gradually pulls back, the role of market discipline will strengthen again. Investors will increasingly differentiate between countries with strong economic fundamentals and more fragile ones. Meanwhile sound policy-making will be rewarded while the room for policy mistakes will start to disappear.

Challenging macroeconomic backdrop for the ECB to start unwinding its monetary stimulus

Economic momentum in the Eurozone has cooled notably following the Euroboom year of 2017. Weaker external demand has been the key driver behind the growth moderation. One-off factors including first and foremost disruption in car production due to new

emission testing procedures have also played a role. Forward-looking indicators are not indicative of a clear stabilization yet and rather than pointing to a quick rebound in the near term suggest lower growth is here to stay. Meanwhile the accumulation of political risks – including a no-deal Brexit scenario, a renewed debt crisis in Italy and a further escalation in the trade dispute – is increasingly weighing on economic sentiment with firms proving more cautious with regards to their investment and hiring decisions.

Are we nearing the end of the growth cycle? While we are definitely getting closer, we are not expecting the next recession to hit in 2019. There are still convincing arguments in favor of the upswing to continue – albeit at a more moderate pace – with private consumption propped up by resilient employment growth and fiscal policy becoming more accommodative. We expect GDP growth to slow but to remain decent at 1.6% in 2019 – above the potential rate for the fifth consecutive year – after 1.9% in 2018 as the weakness in export demand persists and increasingly feeds through to Eurozone domestic demand.

Table 1: Macroeconomic projections 2018-2020

	2018	2019	2020
GDP growth (%)	1.9	1.6	1.4
Inflation (%)	1.7	1.7	1.8
Core inflation (%)	1.0	1.3	1.5
Unemployment (%)	8.2	7.9	7.8

Sources: Datastream, Allianz Research.

Inflation meanwhile is registering above the ECB target of close to but below 2% in several Eurozone countries – not least thanks to energy price increases over the summer months. The outlook, however, is less encouraging for the ECB. For one, core inflation remains rather muted at around 1% – roughly where it has been since 2013. Wage growth has been stronger than anticipated in 2018, but the pass through to inflation has proven relatively weak. Meanwhile energy prices should provide no further support to headline inflation in 2019 given the recent sharp decline in the oil price.

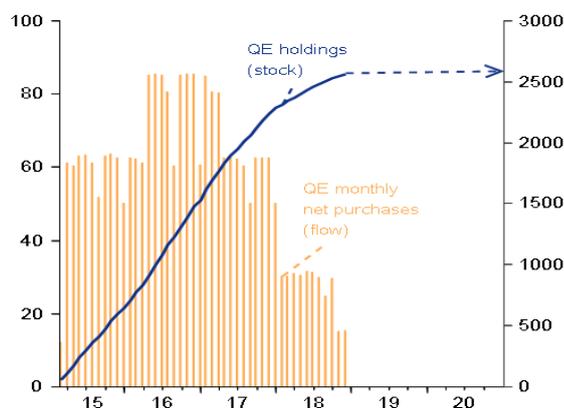
From QE towards QT – Stocks will trump flows

Despite the cooling macro backdrop, the ECB confirmed at its December press conference the termination of monthly QE net purchases – under which it accumulated a stock of around €2.6 trillion over the course of almost four years – by end-2018.

From January 2019 onwards stock will trump flow effects thanks to the reinvestment policy under which the ECB committed to reinvesting maturing bonds in its QE portfolio in an effort to keep the euro amount of its QE portfolio constant. According to our estimates this will see the ECB make reinvestment to the tune of €174 bn in Eurozone government bonds alone next year. We expect the reinvestment policy to remain fully in place until at least the beginning of 2021 after which it will be gradually phased out.

The key gauge for the degree of monetary policy accommodation in the Eurozone is now the QE portfolio's residual maturity: The longer the maturities targeted by the ECB, the more pronounced will be the downward pressure exerted on term premia and hence on Eurozone long-term yields.

Chart 1: ECB QE stock and flows (EUR bn)



Sources: Thomson Reuters Datastream, ECB, Allianz Research.

As [we have argued before](#), maintaining the current degree of monetary policy accommodation would require reinvesting principal in notably longer-dated sovereign bonds to prevent a decline of duration. But as there is an ongoing scarcity of long-term bonds, particularly in low-debt core countries, the ECB will likely be forced to tolerate at least a gradual rise in long-term interest rates.

Interest rates will be hiked for the first time since 2011

In line with the ECB's forward guidance – which states that interest rates will remain at the current level throughout the summer 2019 – we expect the ECB to start raising rates in fall 2019 with a 15bps increase in the deposit rate in September followed by a 25bp increase in all interest rates in December. Our view is that the ECB will try to win back as much room for maneuver on interest rates as possible before the end of the economic cycle is reached. The continuation of the reinvestment policy until at least 2021 will act as a safety net by keeping a lid on any excessive tightening in financial conditions.

Forward guidance gets a starring role

Forward guidance will become the key policy tool to ensure that market's interest rate expectations do not deviate from the ECB's targeted rate path. After all, the unwinding of the ECB's unconventional policy measures is uncharted territory and the market cannot refer to past empirical evidence for guidance. The ECB will likely rely even more heavily on forward guidance to help steer market expectations as it exits the zero lower bound for nominal interest rates. In H1 2019 we expect the ECB to extend its forward guidance to beyond the first rate hike in an effort to calm market nerves and reduce volatility by removing uncertainty around the future path of interest rates.

Banks receive a helping hand

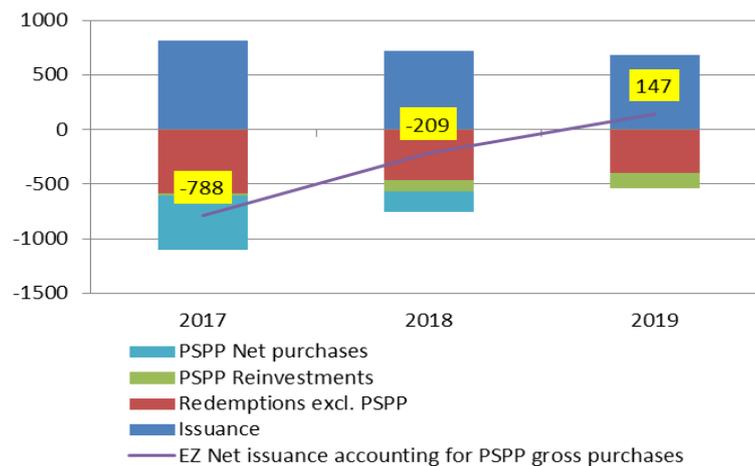
Around €700 bn in long-term loans granted by the ECB to banks will have to be refinanced by mid-2020. However, banks will have to find new financing sources already as early as H1 2019 since under regulatory standards loans can no longer be considered in the calculation of liquidity requirements once their residual maturity is less than one year. To cushion concerns about a funding cliff-edge, and to ultimately support bank

lending, the ECB will likely announce a new round of TLTRO operations by March 2019. This will leave sufficient time for its implementation before the end of H1. The liquidity operation would allow the ECB to proceed with policy normalization while avoiding tighter credit condition – notably in Italy where banks are under pressure due to elevated government bond yields. To address the risk of Eurozone banks becoming too dependent on cheap loans, the ECB could propose a flexible i.e. floating-rate LTRO so that going forward any key rate hikes are passed through to the rate on the TLTRO round.

Country risk makes a comeback

What are the implications of a shrinking ECB safety net? As the ECB is moving towards normalizing its policy in a post-peak growth and liquidity environment we expect country risk to move back into the limelight. Going forward investors will once again become more susceptible to economic fundamentals and will increasingly differentiate between countries with strong economic fundamentals and more fragile ones. Meanwhile sound policy-making will be rewarded while the room for policy mistakes will start to disappear.

Chart 2: Eurozone government bond net supply accounting for PSPP* (€ bn)



*Based on data for Eurozone countries representing 85% of ECB PSPP purchases including Germany, France, Italy, Spain, the Netherlands and Portugal.

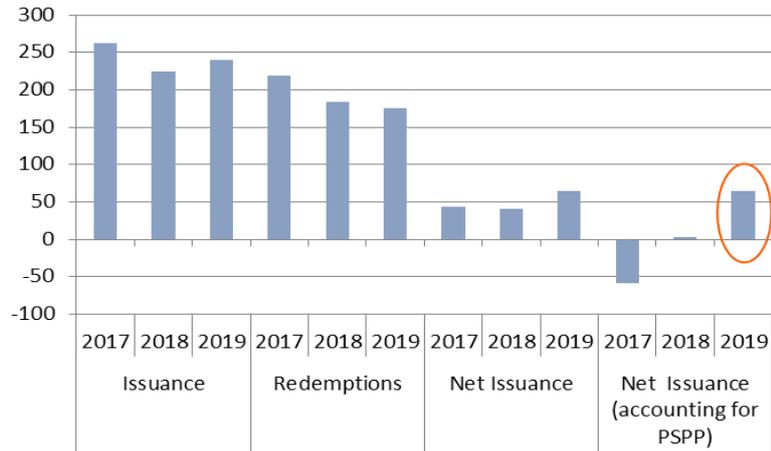
Sources: Thomson Reuters Datastream, Allianz Research.

Since 2015 Eurozone net issuance has been negative when accounting for ECB government bond purchases. This will change in 2019. As the ECB drops out as a reliable and patient bond buyer and macro as well as financial conditions become less favorable, we expect countries that fail to address large macroeconomic imbalances with ambitious reforms to have to pay higher interest rates to ensure there is sufficient demand for their government debt.

Whereas we expect the increase in the Eurozone benchmark yield to be rather muted, the rise in long-term borrowing costs for more highly-indebted Eurozone countries should prove more pronounced. Italy stands out as the non-core country that faces the least favorable stock as well as flow effects. For one, stock effects are relatively less powerful in highly indebted countries with the stock of government bond purchases

making up a lower percentage of total debt. In addition flow effects should also prove less favorable with the market having to absorb larger shares of Italian securities in 2019. After all the end of ECB net purchases is coinciding with higher net issuance of Italian sovereign bonds thanks to the government’s expansionary fiscal policy targets.

Chart 3: Italy: Medium & long-term public debt securities (€bn)



Sources: Italian Ministry of Finance, Allianz Research.

New ECB president: Goodbye Draghi, hello ???

Last but not least in 2019, the ECB will see a change in its leadership with a raft of top spots changing hands – including its presidency. On October 31 ECB President Mario Draghi’s 8-year term will end. Speculations around who will succeed him are already running wild but a candidate will only be announced around mid-2019. The impact on 2019 monetary policy should be marginal at best; however the incoming ECB president is likely to call for a reassessment of the central bank’s monetary policy strategy including the inflation target, the findings of which may have larger implications for the ECB’s policy in the years to come.

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