GIAM Macro & Market Research - Market Commentary

ECB turns into easing mode as the macro outlook became clouded

- **The ECB revised its macro outlook significantly down and even continues to see the activity risks on the downside.**
- **At today's meeting the ECB stepped up its forward guidance. It now expects rates to remain at current levels "*at least through the end of 2019*".**
- **It also announced a series of seven new quarterly TLTROs starting in September with 2Y maturity but as less favourable conditions than for the last TLTROs.**
- **Today's ECB decisions are a moderate positive for equities as well as credits and will dampen the rise in core government bond yields in 2019.**

At today's Governing Council meeting, the ECB surprised markets by adopting a series of supportive monetary policy measures: Key rates will not be altered at least until year-end 2019 (from "*through summer 2019*" before), a series of new TLTROs was announced and the fixed-rate full allotment procedure was extended until at least March 2021.

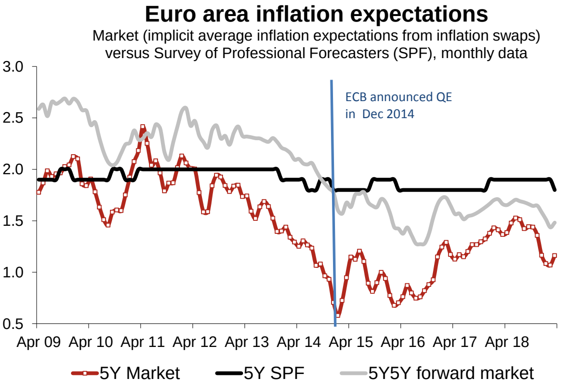
Assessment of macro outlook: Following continued weak activity data since the December meeting, the ECB adjusted its growth and inflation projections significantly to the downside. It was acknowledged that "*uncertainties related to geopolitical factors, the threat of protectionism and vulnerabilities in emerging markets appears to be leaving marks on economic sentiment*". In the Q&A session Draghi pointed out that factors standing behind the slowdown were mostly exogenous with the slowdown in world trade for the 2019 sharp growth revision explicitly mentioned. However, unlike to the previous statement, no reference to the underlying strength of domestic demand was made. Bottom line, the ECB's growth projection is consistent with a recovery of growth towards potential over the course of the year. The ECB still has confidence in the base case but now expects that inflation needs more time to recover towards its objective in times of weaker growth.

Risks still on the downside: In spite of a reduced macro outlook the ECB continues to see the activity risks "*still tilted to the downside*". As Draghi pointed out this is unusual and due to the fact that factors like protectionism, Brexit and slower US growth could not be captured by lower forecasts. Against the backdrop of pervasive uncertainty and worsening projections the ECB tries to "*be pro-active and not reactive*".

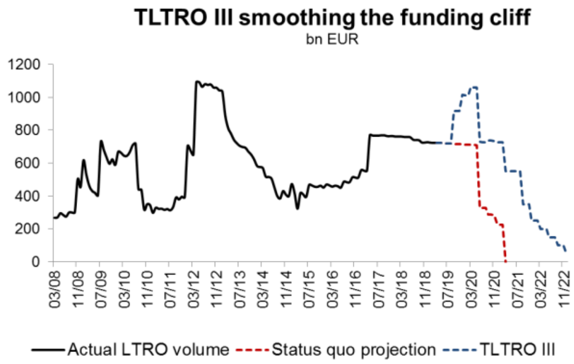
Key ECB Macro Forecasts

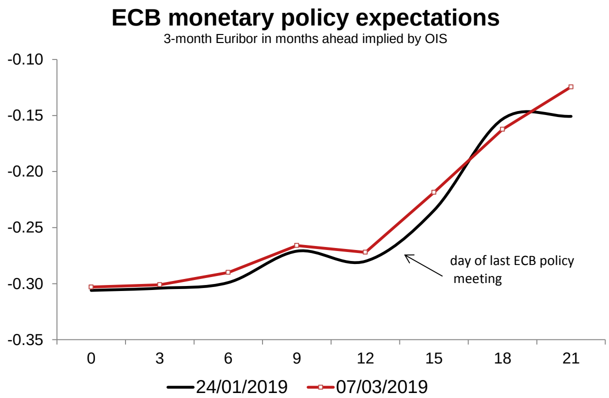
ECB staff mid-point projection, % yoy

	2018	2019	2020	2021
GDP				
Mar-19	1.9	1.1	1.6	1.5
Dec-18	1.9	1.7	1.7	1.5
Inflation				
Mar-19	1.7	1.2	1.5	1.6
Dec-18	1.8	1.6	1.7	1.8
Core inflation				
Mar-19	1.0	1.2	1.4	1.6
Dec-18	1.0	1.4	1.6	1.8



TLTRO III to start in September: Probably in order to maintain favorable financing conditions and to keep lending up also in times of potential financial market stress, the ECB announced seven new quarterly TLTROs from September 2019 until March 2021 with a two year maturity. Under the TLTRO III banks will be entitled to borrow up to 30% of the stock of eligible loans as at 28 February 2019 at a rate indexed to the interest rate on the main refinancing operations over the life of each operation. Further details will follow. Probably in order to avoid potential liquidity problems at the time when the last TLTRO II will expire (March 2021), the ECB also announced that lending operations will continue to be conducted as fixed rate tender procedures with full allotment until at least March 2021. While Draghi mentioned in the Q&A session that a smoothing of liquidity was an objective he gave no clear answer on the question why the ECB did not start the first TLTRO in June, when the Net Stable Funding Ratio will start to deteriorate for banks that funded via the first TLTRO II.





Start of policy rate normalization postponed into 2020: Before today's ECB policy meeting markets saw only a 23% chance of 15 bps rate increase by December. Today the ECB extended the commitment towards constant policy rates further. It now expects them "*to remain at their present levels at least through the end of 2019*", after "*summer 2019*" in previous statements. Hence, the ECB will most likely leave its key rates constant for the time being and wants to wait until the uncertainties surrounding the outlook have eased and. Moreover, given the postponement of the first rate hike, we feel supported in our view that the APP reinvestment period will last for three years (until the end of 2021).

Unanimous decision: It is worth noting that today's policy measures were taken unanimously within the Governing Council. But we also learned from Draghi that this was the outcome of a discussion in which several GC members presented options to change guidance even to March-2020 whereas others discussed the adverse consequences of protracted negative rates.

What this means for markets: Markets now no longer expect an ECB rate hike in 2019. Today's ECB decisions will be moderately supportive for stocks with the notable exception of financials that will continue to suffer from negative rates for still quite some time. Also, we expect some support for credits and see even more headwinds for core yields on their way up.

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