Will the ECB be forced to re-enter the currency war?

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Euro set to continue higher – can the ECB remain sidelined?

• We expect the continued low inflation in the euro area to eventually trigger additional easing from the ECB, but we do not expect the ECB to address this by rate cuts. Instead, we find it likely the ECB will extend the QE purchases beyond March 2017, but believe this should not be announced in the near future.

• According to the ECB, the closing output gap will support wage growth and hence core inflation, but so far the improved labour market conditions have not resulted in upward pressure on wages. Based on our detailed inflation forecast, we believe the ECB is too optimistic on its outlook for core inflation.

• The biggest risk to our expectation that the ECB will not cut rates further is a strong appreciation of the effective euro. The effective euro has already appreciated 2.5% following the ECB easing in March and, based on our forecasts for bilateral exchange rate, the upward pressure on the currency is set to continue over the coming 12 months.

• The stronger euro set to be a headwind to inflation. The ECB has made an alternative inflation forecast, where the effective euro gradually appreciates 5.5% towards 2018. It estimates that this on average will keep the euro area in deflation during 2016, while inflation will only reach an interval of 1.2-1.5% on average in 2018.

• Despite a stronger euro, we expect some patience from the ECB, as it should be aware that the easing announced in March is not a quick fix in terms of achieving higher inflation. First, the easing is addressed at the domestic economy and it will take some time before a closing output gap lifts wages and prices. Second, the first TLTRO II auction and the purchases of corporate bonds will not start until June, which should keep the ECB sidelined for some time.

• Even though we look for a stronger effective euro, we still believe market pricing of inflation is too pessimistic. Core inflation has to decline considerably to be consistent with the current pricing of inflation.
ECB has less focus on rates, but additional cuts are priced in

• The ECB exited the global currency war at the March meeting, where Mario Draghi concluded that ‘more and more the emphasis will shift from rates instruments to other, non-conventional instruments’. Hence, the ECB is less focused on the interest rate, currency channel and more on the bank-lending, credit channel, see ‘ECB’s easing package and markets zig-zag and The ECB exits the currency war’, 11 March 2016.

• Nevertheless, speculation about additional rate cuts is still priced in, which could reflect a number of factors.
  − the ECB has previously stated that it had reached the lower bound on policy rates, but eventually cut rates further.
  − the ECB has maintained its forward guidance on policy rates, saying key interest rates are expected to ‘remain at present or lower levels for an extended period of time’.
  − the ECB’s chief economist Peter Praet said – less than a week after the ECB meeting in March – that the ECB has not reached the lower bound on interest rates, see interview.
  − the ECB minutes revealed that ‘the Governing Council would not rule out future cuts in policy rates, as new shocks could change the outlook for inflation’.

• In our view, the ECB will not re-enter the currency war by cutting rates. However, more easing is likely to be needed to fight low inflation, but we expect it to use other tools.

Despite Draghi saying the ECB will shift focus away from the rate instrument, the markets still price in a 10bp deposit rate cut in September with more than a 50% probability

Comments from Draghi suggesting the ECB will not cut rates again, 10 March:
‘We don’t anticipate that it will be necessary to reduce rates further’
‘The emphasis will shift from rates instruments to other, non-conventional instruments’
The Governing Council ‘is increasingly aware of the complexities this measure entails’
The Governing Council decided not to [having a tiering system], exactly for the purpose of not signalling that we can go as low as we want on this’ [together with the complexity]
‘Let’s not forget that in the G20 in Shanghai all countries took a solemn agreement that basically they would avoid such [currency] war’

Source: Bloomberg, ECB, Danske Bank Markets
Euro set to continue higher – can the ECB remain sidelined?

The euro weakened and thus supported inflation in 2015, but assuming the effective euro is unchanged at the current level, it will on average appreciate 4.3% in 2016.

The euro has appreciated 2.5% since the ECB meeting in March and based on our forecasts for bilateral exchange rates, it will continue to strengthen on a 12M horizon.

Source: Bloomberg, ECB, Danske Bank Markets

The ECB assumes unchanged bilateral exchange rates when making its projections. In our view, this gives a too optimistic inflation forecast, as we expect the effective euro will continue to appreciate on a 12m horizon.

Source: Bloomberg, ECB, Danske Bank Markets
FX outlook: ECB may see some temporary relief

- Near term, the ECB may see some temporary relief from a weaker EUR/USD as much less stretched short positioning in the cross leaves room for relative rates to weigh on the cross in 1-3M; indeed, we see potential for ECB-Fed divergence to see a short-lived return in Q2/Q3.

- Moreover, Brexit fears may help drag the cross lower ahead of the UK's EU referendum. At the same time, recent JPY strength and the fading momentum in CNY depreciation helps dampen the uptick in the effective euro, at least for now. This should buy the ECB some time near term to await the uptick in inflation that we expect to gain traction at the end of the year.

- That said, we continue to look for a stronger effective EUR in 6-12M as EUR/USD sees another leg higher driven mainly by fundamentals such as undervaluation and current-account flows continuing to support the cross as the ECB-Fed policy surprise divide fades.

- Further out, a GBP recovery (assuming no Brexit) helps to weaken EUR/GBP, but another round of JPY and CNY weakness will add to the challenges of the ECB once again. However, this should happen at a time when the euro outlook has improved to an extent that allows the ECB to observe the current ceasefire on currencies.

Source: Bloomberg, Commodity Futures Trading Commission, EVIEWS, Danske Bank Markets.

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ECB: 5% stronger euro will keep inflation below 1.5% in 2018

ECB estimates that a 5.5% effective euro appreciation will result in 0.1-0.4pp lower inflation in 2016-18 compared to its base case, see **ECB’s projections**

As a rule of thumb, a 5% euro appreciation will result in an aggregate 0.5pp lower inflation rate after three years, see **OECD’s new global model**

Impact on HICP inflation from a stronger euro:

1. Direct impact via the retail chain as imported consumer goods become cheaper
2. Indirect impact via lower costs due to cheaper imported inputs feeding through the different stages of domestic intermediate and final goods production
3. Indirect impact via the downward price pressure which ultimately results from the drag on economic activity from a stronger currency

Source: **ECB monthly bulletin**, issue 4, 2015

Source: **OECD, Danske Bank Markets**

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The past euro weakening supported core inflation

In 2015, core inflation increased from 0.6% in January to a peak of 1.1% in October mainly due to higher inflation in Non-Energy Industrial Goods (NEIG) prices.

The higher inflation in NEIG prices is driven by durable goods prices, which were supported by the weaker euro. Looking ahead, the euro appreciation will be a headwind.

The appreciation of the effective euro since April 2015 points to lower core inflation.

Source: Eurostat, Danske Bank Markets

Source: Bloomberg, Eurostat, Danske Bank Markets

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ECB is too optimistic on its core inflation projection

The ECB expects core inflation to rise to 1.1% in 2016. Although muted, we see it as too optimistic not least in light of the headwind from the stronger effective euro.

ECB’s argument for higher core inflation is improving labour market conditions and higher wages, but so far labour market slack has kept wage growth very subdued.

Source: ECB, Eurostat, Danske Bank Markets

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Improved labour market conditions have not yet lifted wages

The Phillips curve suggests wage growth picks up when the unemployment rate declines, but so far the progress in the labour market has not translated into higher wages.

Lack of upward pressure on wages is likely to reflect slack in the labour market, which needs to come down further, before a lower unemployment rate gives higher wages.

In light of the continued very subdued wage growth, we see the ECB’s core inflation forecast as too optimistic.

Source: ECB, Eurostat, Danske Bank Markets

Source: Eurostat, Danske Bank Markets
Unchanged core inflation but headline inflation likely to rise

We only expect core inflation to increase to 0.9% in 2016 versus the ECB’s forecast of 1.1%. In our view, NEIG inflation will go lower and service inflation will be modest.

Headline inflation is set to be supported by a fading drag from the past oil price decline towards the end of the year, but not to go back to 2% within our forecast horizon.

Source: ECB, Eurostat, Danske Bank Markets

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Low inflation expectations keep easing expectations alive

The declining 5Y5Y inflation expectations are adding pressure on to the ECB, but rate cuts should not be the preferred tool in terms of supporting inflation expectations.

Later this year, when the drag from the oil price fades, inflation expectations are likely to go higher, as spot inflation usually drives the entire inflation curve, here 10Y10Y.

Source: Bloomberg, ECB, Danske Bank Markets

Source: Bloomberg, Eurostat, Danske Bank Markets

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Changes in inflation mostly driven by commodity prices

- inflation markets are still too pessimistic on the outlook for inflation
Changes in inflation are mostly driven by commodity prices

Inflation and contribution from its components

Variation in inflation driven by commodity prices

--- HICP weights ---

Core 70.7%
Food 19.5%
Energy 9.7%

--- % of absolute monthly variation in annual inflation ---

Core 28.0%
Food 20.4%
Energy 51.5%

Source: Eurostat, Danske Bank Markets

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Headline inflation set to rise, even if oil price stays fairly low

A higher oil price would imply that inflation will increase sharply in H2 16, but until summer it should remain in deflation territory due to the large drag from energy prices. In our base case, the oil price increases modestly, implying the drag from energy price inflation will fade and have a positive contribution to headline inflation in 2017.

Source: Eurostat, Danske Bank Markets

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Different oil price scenarios – all point to higher inflation

Source: Bloomberg, Eurostat, Danske Bank Markets

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Inflation set to go higher, even if the oil price declines again

In our first alternative scenario, the oil price performs in line with the forward market, thus it is fairly stable around the current level, but it will still result in higher inflation.

In our second scenario, the oil price declines and goes down to USD20/bbl. Even in this case, inflation will go higher in Q4 as the drag from energy price inflation fades.

Source: Eurostat, Danske Bank Markets

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Risk of upside inflation surprises underpriced, in our view

The profile for our base case for inflation is similar to current market pricing, but our level is higher and in 2017 our scenario is significantly higher than is priced in.

All our oil scenarios give inflation ABOVE the market pricing in 2017 (difference to market pricing in the four scenarios in the charts below).

Source (both charts): Bloomberg, Eurostat, Danske Bank Markets

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Core inflation has to decline to 0.4% to match market pricing

Core inflation has to decline sharply to match the market pricing of inflation (in case the oil price follows the forward market)

Core inflation has to decline to 0.4% on average for the rest of 2016 to be consistent with the current market pricing.

Source: Eurostat, Danske Bank Markets

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We expect modest core inflation and no sharp decline.

- A closing output gap should so far not be enough to lift core inflation.
We expect modest core inflation and no sharp decline, as service inflation will be modest and NEIG inflation will go lower.

Service price inflation is highly dependent on labour input. In 2016, it declined to a historically low level of 0.9%, but was 1.3% in March partly due to the timing of Easter.

Inflation in NEIG prices have been supported by the past effective euro depreciation, but the low oil price still has a negative indirect impact.

Source (both charts): Eurostat, Danske Bank Markets
The oil price has an indirect impact on core inflation

In NEIG prices, durable goods price inflation has reached an historically high level, whereas non-durable goods price inflation have declined to an historically low point.

The very low inflation in non-durable goods prices is partly due to the indirect impact of the low oil price. The effect comes with a lag, hence the inflation rate should stay low.

ECB: "Indirect effects from the assumed increases in commodity prices, together with fading downward effects from their past declines, are expected to support the pick-up in core inflation."

Source: Eurostat, Danske Bank Markets

Source: Bloomberg, Eurostat, Danske Bank Markets

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Unchanged euro set to become a headwind to core inflation

Weaker euro has temporarily supported core inflation with durable goods prices, but the latest euro appreciation is set to become a strong headwind to core inflation.

Semi-durable goods prices lag durable goods prices and hence the impact of the development in the euro, which implies it should continue to increase in coming months.

Source: Bloomberg, Eurostat, Danske Bank Markets

Source: Eurostat, Danske Bank Markets

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Service price inflation lifted by volatile components in March

Service price inflation rose by 0.4pp to 1.3% in March. We expect the rise occurred mainly due to the early timing of Easter, which lifted inflation in the volatile 'package tours'.

Inflation in package holidays has on average added 0.1pp to core inflation. We expect a lower contribution in 2016, especially when excluding the high print in March.

In 2013, Easter also fell in March, and prices on package holidays rose considerably followed by a fall in April. We look for a similar pattern in Spring this year.

Source: Eurostat, Danske Bank Markets
Inflation in recreation and personal care – the biggest part of core inflation – is affected by the economic situation

The closing output gap points to increasing inflation in recreation and personal care, but it should be modest. Tax hikes are not expected to lift inflation as in 2012-13

A simple model including GDP growth, the unemployment rate and HICP inflation also points to a slow upward move in inflation in recreation and personal care

Source: Eurostat, Danske Bank Markets

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Rental for housing is partly affected by cost of borrowing

A simple model including house prices, cost of borrowing and HICP inflation points to continued low inflation in prices on services related to housing.

Cost of borrowing, which is affected by the ECB's key policy rates, has a negative impact on inflation in prices on services related to housing.

Source: ECB, Eurostat, Danske Bank Markets

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Services prices are also negatively affected by the oil price

Inflation in services related to transport is negatively affected by oil price, hence some downward pressure on service inflation will persist despite a closing output gap.

Wages and salaries within transportation and storage have started to increase, which gives some upside risk to our expected inflation in services related to transport.

Source: Bloomberg, Eurostat, Danske Bank Markets

Source: Eurostat, Danske Bank Markets
Inflation in communication should also remain a drag.

Inflation in services related to communication has trended higher, but we expect it to go negative again and continue to be a drag on service price inflation as seen in Germany.

We expect the remaining part of service price inflation – miscellaneous – to continue slowly higher over the forecast horizon.

Source: Eurostat, Danske Bank Markets
HICP inflation component overview

Core inflation
- Semi durables
  - Garments 4.4%
  - Footwear 1.2%
- Durables
  - Motor cars 3.5%
  - Furnitures 1.9%
- Non-durables
  - Electrical app. 1.7%
  - Pharmaceutical 1.3%

HICP weight: Core weight:
- Semi durables 10.1% 37.9%
- Durables 8.5% 31.9%
- Non-durables 8.0% 30.1%

Services
- Recreation and pers. care
  - Restaurants and cafés 7.1%
  - Rentals for housing 6.4%
- Housing
  - Rentals for housing 6.4%
- Miscellaneous
  - Social protection 1.5%

HICP weight: Service weight:
- Recreation and pers. care 11.7% 26.4%
- Housing 10.7% 24.2%
- Miscellaneous 9.0% 18.2%

Transport
- Maintenance and repair 2.5%
- Package tours 1.7%

HICP weight: Service weight:
- Maintenance and repair 2.5%
- Package tours 1.7%

Food price inflation
- Processed
  - Bread and cereals 2.6%
  - Tobacco 2.4%
  - Milk, cheese and eggs 2.1%
- Non-processed
  - Meat 3.5%
  - Vegetables and fruit 2.9%
  - Fish 1.0%

HICP weight: Food weight:
- Processed 12.1% 62.1%
- Non-processed 7.4% 37.9%

Energy price inflation
- Fuels pers. transport 4.2%
- Electricity 2.7%
- Gas 1.9%
- Liquid fuels 0.6%
- Heat energy 0.2%
- Solid fuels 0.2%

HICP weight: Energy weight:
- Fuels pers. transport 4.2% 42.7%
- Electricity 2.7% 28.1%
- Gas 1.9% 19.1%
- Liquid fuels 0.6% 6.5%
- Heat energy 0.2% 1.9%
- Solid fuels 0.2% 1.7%

Source: Eurostat, Danske Bank Markets

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Does the market believe in the ECB? Not really – break-even inflation rates are still very low in the euro area

Inflation expectations are still declining in euro area, while rising in the US – usually these are closely correlated, but euro inflation expectations have failed to rise recently

A similar picture is seen in the 10Y bond break-evens even though we have seen a small rise in the BE inflation rate

Source: Bloomberg, Danske Bank Markets

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QE works in Bunds but not in the periphery

Bund spread is ‘testing’ the upper limit in the 30-40bp range – diverging from the US swap spread. A scarcity premium is becoming more evident despite the issuance of 5Y5Y forward rates in Germany are now lower than in April 2015 – while peripheral yields are higher.

Source: Bloomberg, Danske Bank Markets

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