11 March 2016

Strategy

The ECB exits the currency war

The ECB made an interesting policy shift at its policy meeting yesterday. At the press conference, ECB president Mario Draghi said that the ECB expected this to be the last policy rate cut and that it will instead focus on other unconventional measures, which it did with the expansion of QE to EUR80bn per month, the buying of corporate bonds and the introduction of a new series of longer-term refinancing operations (TLTRO II). (For more details, see *ECB's easing package and markets zig-zag*, 11 March 2016.) Admittedly, Draghi has previously said that the ECB had reached the lower bound on policy rates and then changed it later. Still, the signalling effect from yesterday's meeting was very clear. Arguably, lower interest rates are the most direct way to influence the exchange rate. **So, the ECB has, for now, exited the currency war, which it entered in June 2014, and instead is focusing on the credit/bank lending channel.**

We believe the ECB's shift from targeting the exchange rate to targeting the credit/bank lending channel is a sensible step. There is a limited pass-through from negative policy rates to household deposit rates (see Chart 1). As the Bank for International Settlements (BIS) has argued, negative interest rates have actually raised mortgage rates in, for example, Switzerland. In our view, it is not clear that a deeper rate cut by the ECB would have helped much, as it would have signalled policy exhaustion. Negative rates have not fuelled bank credit growth as they have tended to erode bank profitability (see Chart 2). The EUR is fundamentally undervalued, which makes it increasingly difficult for the ECB to weaken the exchange rate.

Will the new ECB measures be successful in lifting growth and inflation expectations in the Eurozone? The focus on the bank lending channel is correct, in our view, as small- and medium-sized companies, which are the backbone of the European economy, are dependent on banks. Still, it is not clear that an additional supply of bank lending will help much, as actual bank lending will depend on demand for bank lending. The problem is not a lack of supply of bank credit, but rather a lack of demand. **Therefore, central bank fatigue is not a problem of central banks' *willingness* to do more, which Draghi said that yesterday's monetary decision was clearly evidence against, but rather their *ability* to influence growth and inflation.**

Chart 1: Limited pass-through to household deposit rates from negative rates

Pass through of policy rates to the retail level

	December 2015 level (Change from May 2014 - Dec 2015 in parantheses)			
	Denmark	Sweden	Euro area	Switzerland***
Policy rate	-75 (-80)	-35 (-110)	-30 (-30)	-75 (-87.5)
O/N money market rate	-57 (-70)*	-35 (-110)	-20 (-45)	-72 (-70)
Household deposits	54 (-40)**	8 (-43)	64 (-75)	1 (-3)
Housing loans	213 (-129)	141 (-88)	228 (-64)	268 (-1)
Corporate deposits	-42 (-68)**	3 (-53)	23 (-41)	
Corporate loans	156 (-10)	165 (-116)	182 (-83)	165 (0)

*average weekly CITA TN fixing

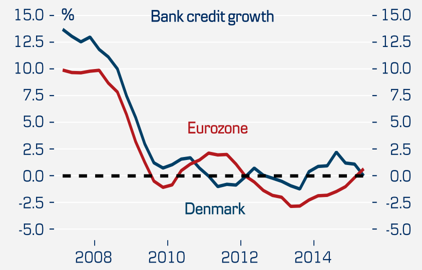
** maturities less than one year for DKK denominated deposits, *** Based on Jun-15 levels

Source: National central banks

Key points

- The ECB has shifted from targeting the exchange rate to supporting the credit/bank lending channel.
- The ECB's policy shift is sensible as negative rates do not appear to have fuelled bank lending, but it remains to be seen how successful the new measures will be.
- The ECB's measures are positive for risky assets, particularly equity and credit markets.
- The ECB's policy shift supports our long-held view that EUR/USD will head higher in 2016.
- The menu of easing measures supports flatter curves in core euro FI.

Chart 2: Negative rates have not fuelled bank credit growth



Source: Macrobond Financial

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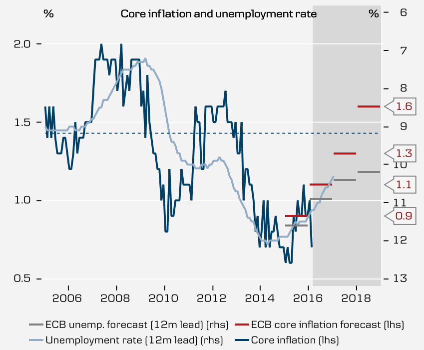
In our view, more expansionary fiscal policy together with structural reforms are needed to lift the longer-term growth prospects for the euro area. In addition, a stronger EUR will eventually pose new headaches for the ECB as it will struggle to meets its 2016 core CPI forecast of 1.1%.

Stronger risk appetite, higher EUR and flatter yield curves

We find the ECB's measures positive for risky assets as they, after all, are targeting the bank lending, credit channel and thereby economic growth rather than the currency channel, which is a zero-sum game**. As such, the ECB's decision is a further shot in the arm for equity and credit markets.** In FX markets, the measures are bullish for the EUR against other low yielding currencies such as the USD, GBP and JPY. We continue to see EUR/USD in a 1.05-1.15 range where a more hawkish Fed next week should cap the top side. **However, the ECB exiting the currency war supports our long held view that EUR/USD will head substantially higher in 2016, eventually breaking the 1.15 level.**

The menu of easing measures should imply gradually flatter curves in core European fixed income (FI) markets with the front end being anchored. Investors, banks and other market players should gradually seek further out on the yield curve. The risk is that these could be seen as the last measures from the ECB, which could drive a sell-off from the long end, but that is not our base case.

Chart 3: ECB remains too positive on core inflation



Source: ECB, Eurostat, Danske Bank

Chart 4: Global market views: three-six months

Asset class	Main factors
Equities	
Short term: buy on dips Medium term: moderately positive	Fears over Chinese growth have been parked for a while as a market theme and equity markets are, in our view, too negative on the US growth outlook. A full-blown European banking crisis is not in the cards, but pressure will remain on Italy and Portugal. Finally, commodities seem to be stabilising. Earnings still look decent.
Bond market	
Core yields: Bund yields close to bottoming out, higher medium term	Higher QE and new TLTRO means that the 'hunt for yield' continues, but no more rate cuts and higher US yields
US-euro spread: wider	Policy divergence is still evident as the market is pricing in too few hikes in the US, in our view.
Peripheral spreads set to tighten further from here	QE, improving fundamentals and search for yield. But vulnerable to risk sentiment and political uncertainties.
Credit spreads: neutral to tighter	Liquidity abundance and QE in corporate bonds.
FX	
EUR/USD - range bound short term, rebound further out	Fundamental factors support cross in the medium to long term, driven short term by risk sentiment and US rates.
USD/JPY - range bound with risks skewed to the upside	USD/JPY set to head higher again on a more hawkish Fed. The BoJ likely to be less tolerant of further JPY appreciation.
EUR/SEK - stuck between 9.10-9.50 near term, lower medium term	Riksbank loosening up on SEK appreciation aversion; EUR/SEK set to fall on strong Swedish fundamentals.
EUR/NOK - higher short term, then lower as cycle turns	Oil and risk sentiment connection leaves cross vulnerable to upside, fundamentals point to lower EUR/NOK in H2 16.
Commodities	
Oil prices – range-bound near term, subdued recovery in 2016	Price support from OPEC is gone; now awaiting non-OPEC supply cuts and weaker US dollar.
Metal prices – staying low	Chinese manufacturing slowdown to cap upside; consolidation in mining industry puts a floor under prices.
Gold prices – flat near term	Short-term support from repricing of Fed rate hikes.
Agriculturals – risks remain on the upside	Attention has turned to La Niña weather risks in H2 16.

Source: Danske Bank Markets

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