Macro-Strategy Key Issue
ECB: will dovish talk be followed by action?

Economics

Europe including UK

Reinhard Cluse
Economist
reinhard.cluse@ubs.com
+44-20-7568 6722

Nick Nelson
Strategist
nick.nelson@ubs.com
+44-20-756 81960

Karen Olney, CFA
Strategist
karen.olney@ubs.com
+44-20-7568 8944

Considering the ECB's options

Amid heightened concerns about external risks, the ECB has turned more dovish recently, arguing that it stands ready to "do more", if needed. Our base case scenario remains that the ECB will run QE in its current form (€60bn) until September 2016, followed by some form of tapering. But given growing risks, we discuss the ECB's alternative policy options: (a) an increase in the QE programme in the short term ("QE-2"); (b) an extension of QE beyond September 2016; and (c) another cut in the deposit rate.

Hurdle towards QE-2 still seen as high; extension beyond Sept-16 more likely?

In our view, the hurdle towards an increase in QE in the short term is still reasonably high. The hawks will argue that QE is a powerful policy tool that is not suited for fine-tuning and that more policy action is premature as sentiment data and core inflation have held up reasonably well. Instead, while not our base case scenario, we attach a higher probability to the alternative scenario that, sometime in the spring or summer of next year, the ECB might have to announce an extension of QE beyond September 2016. As regards negative deposit rates, we argue that another cut should not be seen as a significant easing step and hence not a substitute for bigger or longer QE; instead it would be mainly a tool to weaken the EUR. We think another cut is unlikely, as the ECB has previously signalled that deposit rates have bottomed, hence another cut could have negative consequences for the ECB's credibility.

What might further ECB easing mean for European equities?

The launch of QE on 22 January helped spark a 16% rally in European equities. But we have now given all that performance back: valuations have returned to levels seen at the beginning of the year (12m forward P/E of 13.9x), cyclicals' pricing relative to defensives is now below 2009 lows, equities have given up their outperformance over Bunds and value is now underperforming quality. We suspect this time round, if further QE is launched, the effect would be more muted given fresh concerns over the impact of China and EM on the global economy. Nonetheless we believe it would likely spur a rally and sector rotation. Sectors: the winners in the 9 previous announcements of QE (3 each in the US, UK and Japan) were cyclical sectors such as Construction, Retailing and Semis. Staples and Healthcare have tended to underperform.

ECB: will dovish talk be followed by action?

Amid heightened concerns about a hard landing in China and greater disturbances from the EM world, the ECB has struck a more dovish tone in recent weeks. Since its last meeting on 3 September, senior ECB policy makers have argued repeatedly that the Bank is monitoring external risks closely and stands ready to act. It was pointed out that the QE programme can be adjusted flexibly in size, composition and duration.

The ECB has signalled its readiness to "do more", if needed

As we argued on 3 September, our **base-case scenario** is that the ECB will run QE in its current form (€60bn) until September 2016, followed by some form of tapering. Yet given the likely delayed return of inflation to the target of "close to, but below 2%" (related to the latest commodity and oil price declines on the back of EM growth concerns), we pointed to a risk that the ECB might have to run QE for longer than previously assumed, i.e., beyond September 2016. In contrast, we attached a lower probability to *substantial*[1] changes to the QE programme in the short term (see our note **ECB: striking a dovish tone**, 3 September 2015). After all, we regard big shocks from China/EM and a subsequent derailing of the Eurozone recovery as the *risk* scenario, not the base-case scenario.

Our base case scenario: QE to run until September 2016 in its current form, followed by some form of tapering

Still, given the widespread discussion about the ECB's options, which has gained new momentum following Friday's weak US labour market data, we consider the arguably most important alternative scenarios below.

Alternative scenario 1: Increase in QE in the short term (QE-2)

The ECB might decide to substantially increase the degree of monetary stimulus in the short term, should it come to the conclusion that the inflation and/or growth outlook has worsened markedly. The most powerful way to do this, we believe, would be to deliver a substantial increase in the monthly asset purchases, from currently €60bn (e.g., to €70bn or so) – a scenario we would refer to as "QE-2".

Will the ECB increase the QE programme in the short term?

The following events could potentially trigger a QE-2 decision by the ECB:

- Additional massive shocks from China or the EM world, which would suggest substantial fallout in the Eurozone economy over the coming months. Key leading indicators for the ECB to watch would be Eurozone PMIs and the German Ifo index, amongst others.

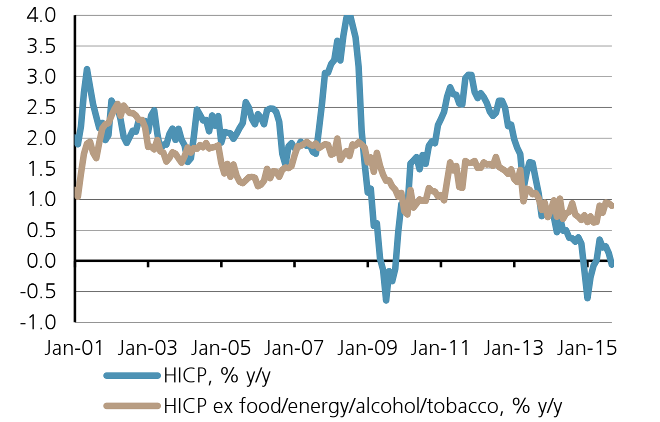
- Very low inflation prints in the Eurozone, and a subsequent deterioration in inflation expectations. This could either be very low headline inflation (although the ECB was aware that HICP might go negative in the short term) or a visible decline in core inflation. A renewed drop in inflation expectations could also force the ECB's hand. Headline inflation was very low in September, with HICP at -0.1% y/y, but core inflation was stable, at 0.9% y/y. Positive base effects related to oil prices are likely to push inflation up again more visibly in Q4 – which could arguably create a "window of opportunity" for the ECB to act early, in the upcoming meeting on 22 October.

[1] This does not rule out smaller technical changes, such as the recent change to issue-limits.

- A downward revision in the ECB's inflation and growth forecast when the next set of staff macroeconomic forecasts will be published on 3 December 2015. This date seems to be the favoured one for those observers who expect QE-2 in the short term.

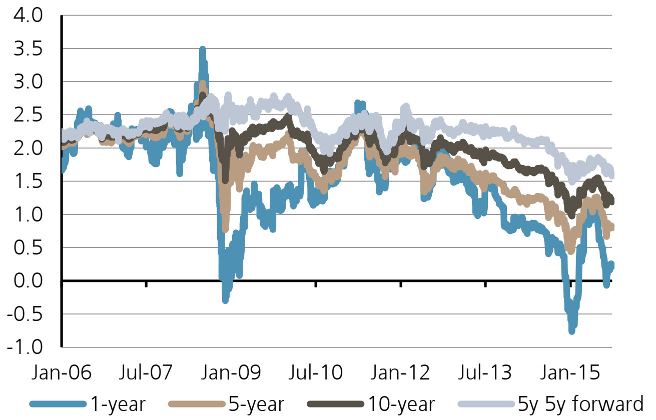
3 December could be a potential date for "QE-2"

Figure 1: Eurozone headline and core inflation



Source: Haver, UBS

Figure 2: Eurozone inflation breakevens*

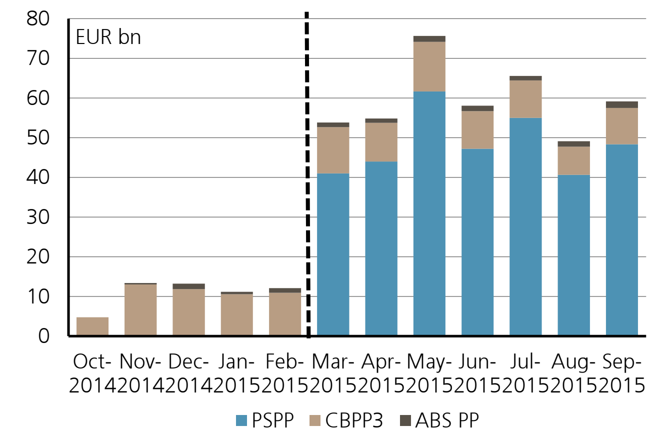


Source: Bloomberg, UBS. *Using inflation-linked swaps.

If the ECB were to increase QE in the short term, by far the most important decision would be to determine by how much it would raise the monthly purchases above the current size of €60bn; after all, this would determine the impact on the ECB's balance sheet. However, the ECB would also have an opportunity to change the structure of asset purchases, for example by expanding into corporate bonds. This could give extra impact to the QE-2 announcement and its economic effects.

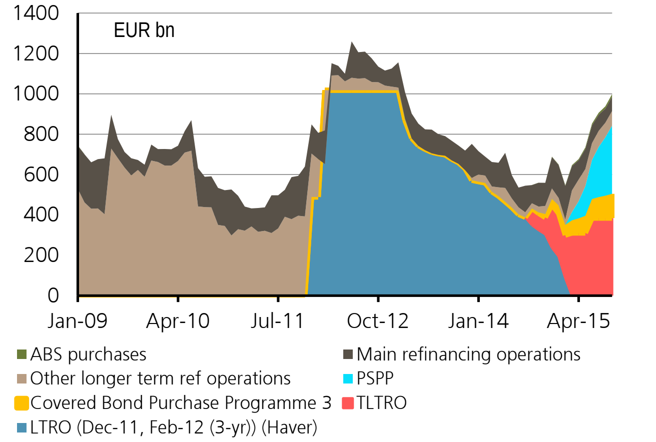
If QE were to be increased, would the ECB widen the pool of eligible assets?

Figure 3: ECB's Expanded Asset Purchase Programme



Source: ECB, Haver, UBS. PSPP: Public Sector Purchase Programme, ie, sovereigns, agencies, supranationals. ABS PP: Asset Backed Securities Purchase Programme. CBPP3: Covered Bond Purchase Programme 3.

Figure 4: Monetary operation of the ECB



Source: Haver, UBS

QE-2 is certainly a relevant scenario – but it is not our base case scenario for a number of reasons:

Firstly, and most fundamentally, the hawks on the ECB Governing Council will likely argue that QE is such a powerful policy tool that it is not suited as a fine-tuning device. Instead, the hawks will likely demand a "wait and see approach" until it has become clearer that more stimulus will be needed. Of course, a minority of hawks can always be overruled, but this would make the QE-2 decision quite

We expect the hawks to oppose any "fine tuning" of QE

controversial. In the past, Mr Draghi was keen to base important policy decisions on a broad majority in the Governing Council.

So far, sentiment indicators are holding up reasonably well

Secondly, available sentiment indicators suggest that the problems in China and EM have not caused major fallout in Eurozone corporate sentiment, so far (see our note: **Eurozone flash PMIs: holding up respectably**, 23 September 2015). Hence, while a slowdown in China/EM seems likely, a hard landing is not the most probable scenario, in our view.

Thirdly, as argued above, while headline inflation returned to negative territory in September (-0.1% y/y), core inflation was stable at 0.9% y/y and base effects related to energy prices are likely to push inflation up visibly in Q4.

Will the ECB lower its inflation and growth forecasts substantially on 3 December?

Fourth, many observers seem to take it for granted that the ECB will make major downward revisions to its staff macro forecasts on 3 December. However, we would stress that this will depend crucially on the underlying assumptions for oil prices (Brent futures curve) and the EUR/USD exchange rate, which the ECB will base on the average price/rate during the two weeks prior to finalizing its projections around 12 November. Compared with the assumptions of the September ECB staff projections (a EUR exchange rate of 1.10 and oil prices rising towards US$/bbl 60.9 by 2017; see Figure 5, below), EUR/USD has strengthened a bit, but oil futures have increased by around US$3/bbl. Both variables can still move a lot before mid-November, but if they were to stay at current levels, the ECB projections might not move by a lot. But even if the ECB's forecast for headline inflation were to be lowered, the outlook for core inflation – which is important as well – might be less affected.

Last but not least, if in any doubt, the ECB might also want to wait and see whether the US Fed hikes rates on 16 December and how the markets (and hence Eurozone financial conditions) would react to this.

Overall, we believe that the hurdle for a substantial increase in QE in the short term is reasonably high.

Figure 5: Eurosystem staff macroeconomic projections for the Euro area, annual % change

	September 2015			
	2014	2015	2016	2017
Real GDP	0.9	1.4	1.7	1.8
HICP	0.4	0.1	1.1	1.7
HICP ex food and energy	0.8	0.9	1.4	1.6
Oil price (in USD/barrel)	98.9	55.3	56.1	60.9
USD/EUR exchange rate	1.33	1.11	1.10	1.10

Source: ECB '*September 2015 ECB staff macroeconomic projections for the Euro area*', 3 September 2015
www.ecb.europa.eu/pub/projections/html/index.en.html

Alternative scenario 2: Extension of QE beyond September 2016

Return of inflation back to the target seems to be proceeding slower than previously assumed

Irrespective of our scepticism of QE-2 in the short term, we acknowledge that the medium-term inflation outlook has failed to improve a great deal. In fact, the renewed decline in oil and commodity prices since the summer (related, *inter alia*, to Iran's agreement with the P5+1 and concerns about China/EM) suggests a significant risk that the return of Eurozone inflation back to the target of "close to,

but below 2%" will take longer than previously assumed – and sooner or later, the ECB might have to come to the same conclusion.

ECB expected to issue 2018 forecasts for the first time on 10 March 2016

An important date in this regard could be 10 March, 2016. On that day, the ECB will once again present a new set of staff macro forecasts, but we believe it will then include 2018 projections for the first time. Should the ECB inflation projection suggest that headline inflation (but also core) will still not be close to the target in 2018, it could create a lot of pressure on the ECB to declare that QE will have to run for longer than September 2016. With a 2018 inflation projection of well below 2%, even the hawks might have to admit that the inflation outlook is still not satisfactory vis-à-vis the target. In this event, an extension of QE beyond September 2016 would be in line with the ECB's initial guidance – delivered in January 2015 – which was that QE would run until September 2016 "or in any case" until the path of inflation points back towards the target.

The scenario of QE running for longer than September 2016 seems more likely to us than an increase in QE in the short term

In our view, the alternative scenario of an extension of QE beyond September 2016 carries a higher probability than the alternative scenario of an increase in QE in the short term (as we already argued in our **note** from 3 September). Nevertheless, important reservations apply.

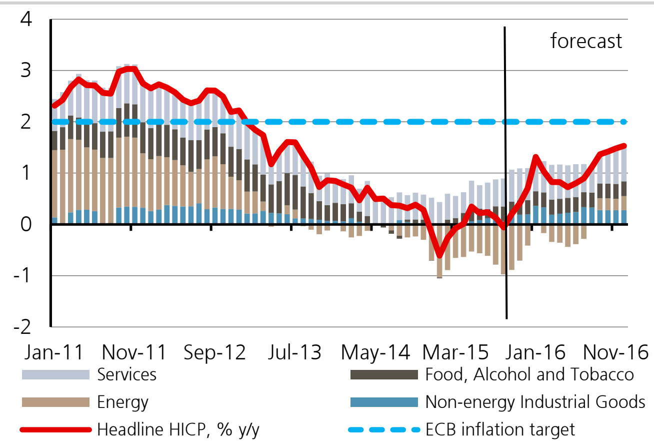
Firstly, according to our projection, Eurozone headline inflation will be back above 1% y/y by Q1 2016, a lot higher than currently (-0.1% y/y in September). This could arguably strengthen the hawks' opposition against an extension of the QE programme.

Secondly, the 2018 projections, when released for the first time in the spring of 2016, will be based on rather mechanical assumptions and will be subject to a high degree of uncertainty. Hence, the ECB Governing Council might not immediately draw hard conclusions on the extension of QE.

ECB might not decide on an extension of QE before the summer of 2016

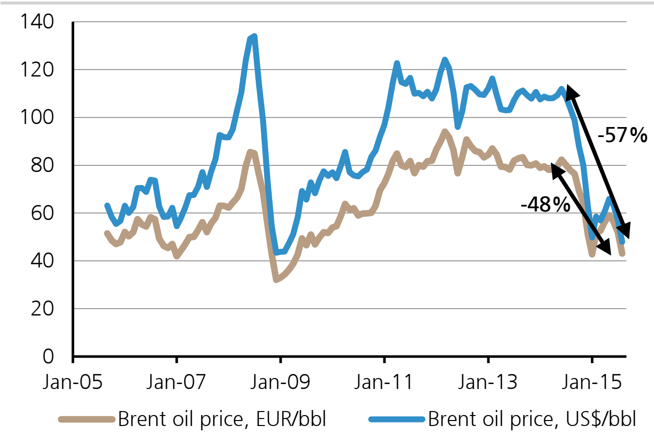
As a result, the ECB might not want to make a decision on an extension in QE as early as 10 March – six months before the programme is due to expire. Instead, the ECB might want to wait longer to see how the growth and inflation environment develops; it might also want to observe how the monetary policy cycle in the US and the UK develops. Hence, the ECB might want to delay a decision until the next set of macroeconomic projections are released on 2 June 2016 or – *in extremis* – until the last possible date, which would be 8 September 2016.

Figure 6: Contributions to Eurozone HICP inflation, ppt



Source: Haver, UBS.

Figure 7: Brent oil price in US$ and EUR



Source: Haver, UBS.

Alternative scenario 3: deposit rate cut

The ECB cut the deposit rate from zero to -0.1% on 5 June 2014 and to -0.2% on 4 September 2014. At that time, Mr Draghi said, "Now we are at the lower bound, where technical adjustments are not going to be possible any longer." More recently, ECB Governing Council member Benoît Cœuré argued that the deposit rate could "in theory be kept at an even more negative level". But he added, "We have been very clear: the current constellation of policy rates is for us the effective lower bound. We do not intend to lower short-term policy rates further."[2]

ECB has argued that deposit rates won't be cut again

Obviously, a further cut in the deposit rate would be theoretically possible – but it would come at a cost for the ECB's credibility as the Bank would violate its prior guidance. For this reason, we think another deposit rate cut is unlikely.

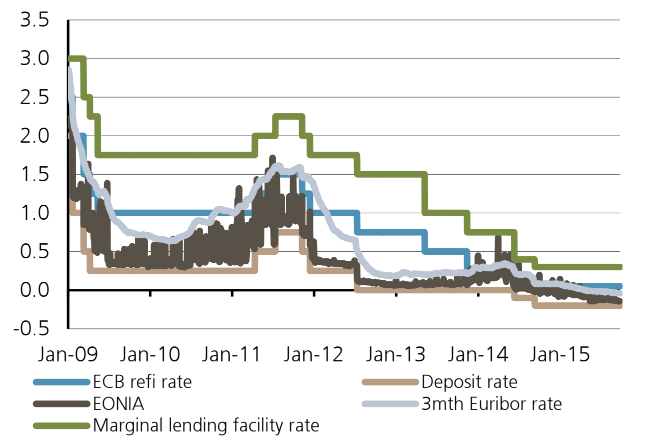
Another deposit rate cut could harm the ECB's credibility

In any case, we believe another deposit rate cut should not be seen as a meaningful easing step. In other words, a deposit rate cut would not be a substitute for an increase in the QE programme. Hence, if the ECB concluded that external risk had increased sharply or that the medium-term inflation outlook had deteriorated substantially, a deposit rate cut would not be the appropriate tool – an increase or an extension in QE would be needed in this case. In contrast, we would see a deposit rate cut mainly as a tool to weaken the EUR (which, in our view, is why the ECB opted for a deposit rate cut in the first place, soon after EUR/USD hit a temporary high of 1.39 in May 2014).

We see deposit rate cuts as a tool to weaken the currency, not to achieve major stimulus for the economy

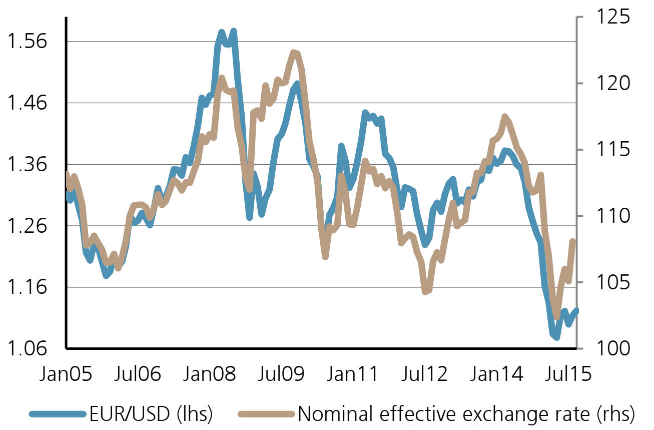
Consequently, should the EUR appreciate substantially over the coming months, we think the ECB might potentially consider another deposit rate cut, but given the likely damage to its credibility, we believe it would eventually shy away from this step.

Figure 8: ECB interest rates, EONIA and Euribor (%)



Source: Haver, UBS

Figure 9: EUR/USD and nominal effective exchange rate



Source: Haver, UBS.

[2] Benoît Cœuré: 'How binding is the zero lower bound?', speech given on 18 May 2015.

How would additional QE affect European Equities?

Market: Back in January we argued that the launch of QE in Europe was not fully priced into equities (**What is the impact of QE on European Equities?**, 12 January 2015).

After the ECB launched QE European equities rallied 16%...

Then the launch of QE spurred a 16% rally in the Stoxx 600 up to mid-April, but they have since given that all back. This reversal has occurred not just at a market level, but across many different indicators: (1) the P/E multiple is now back down to 13.9x where it was at the beginning of the year; (2) cyclical outperformance relative to defensives has now been wiped out; (3) Equities had outperformed Bunds by 23% around the peak in the market, now are basically flat relative; and (4) value as a style was up 7% in mid-April and is now underperforming quality YTD. *For more details see:* **European Strategy Market Temperature - Fear up 80% since Jan**, 28 August 2015.

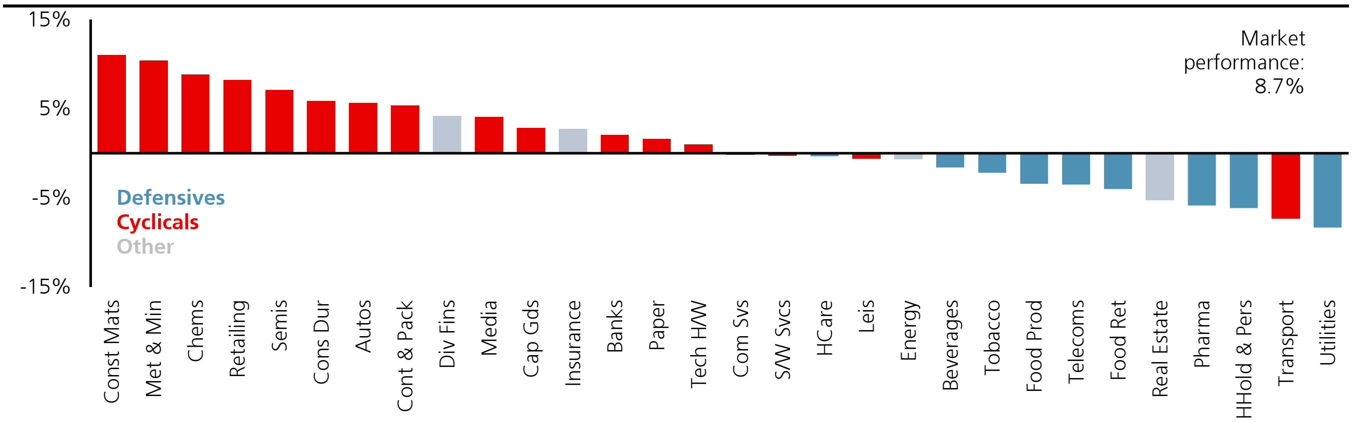
...but they have since given all that back, as have: (1) valuations, (2) performance of cyclicals, (3) equities relative to bonds and (4) value as a style

This suggests that from an Equity perspective we are effectively back to square one as if QE had never been launched. If we were to see an extension of QE, or further aggressive easing by the ECB, we suspect this would be supportive for the wider market. However, investors' concerns have shifted to the impact of China and EM on developed markets and those longer-term concerns would need to be addressed as well. This suggests a less dramatic move than after 22 January.

Sectors: We now have 9 different samples of sector performance after the announcement of a new stage of QE – three in each of the three countries: US, UK and Japan. Whilst each of these occurred at a different stage of the cycle and with differing equity market valuations, the average sector performance nonetheless suggests a strongly supportive backdrop for cyclicals: the average rise for the market as a whole over the 6 months following a QE announcement was +8.7%.

In the 9 previous QE announcements, cyclicals have tended to outperform

Figure 10: Average Relative Sector Performance in the US, UK and Japan 6m after each announcement of QE

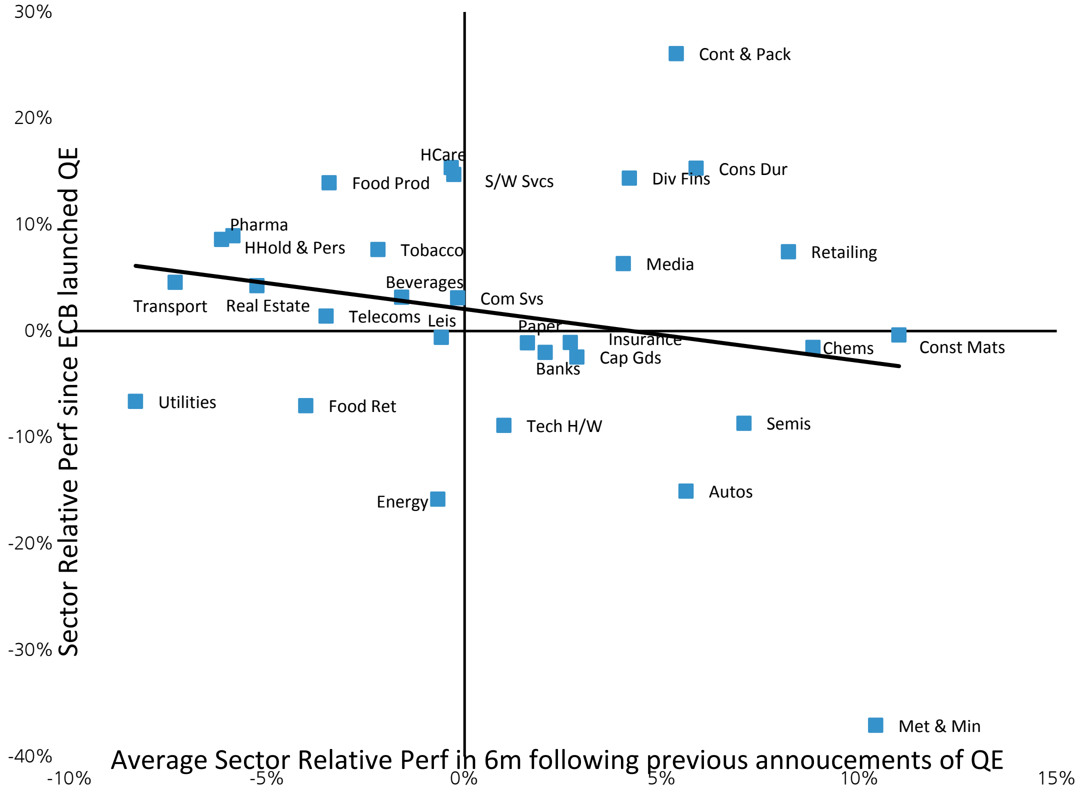


Source: Thomson Datastream, UBS

If we map the relative performance of European sectors against the average occurrence in the 9 other examples of QE, we find an inverse correlation: cyclical sectors, which we could have expected to do well, have underperformed and vice versa.

But the reverse has been the case in Europe

Figure 11: European Sectors: Relative Performance since ECB launched QE has not followed previous QE trends…



Source: Thomson Datastream, UBS

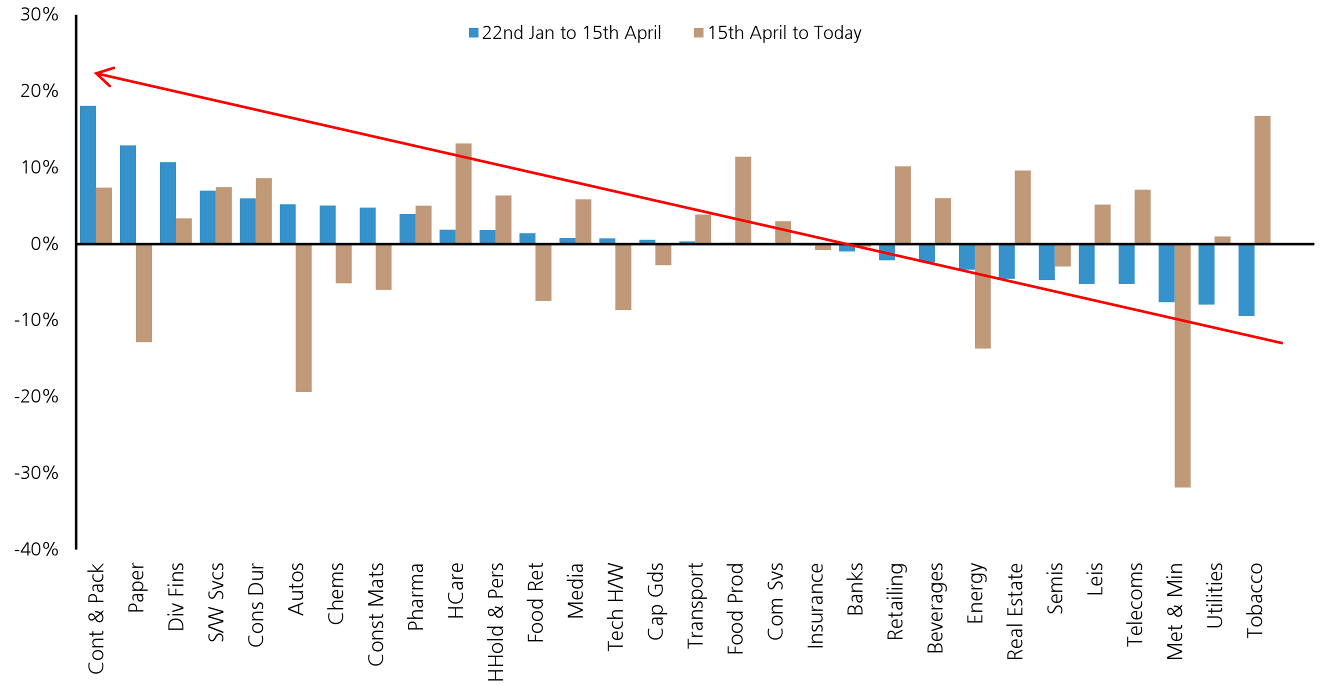
However, we can break the post-QE period down into two distinct phases: the run up to the market peak in mid-April and the performance in the correction following that. Initially, the sectors behaved in a typical "post-QE" fashion with the vast majority of cyclicals outperforming and Utilities, Telcos and Tobacco underperforming. Given the level of cyclicals relative to defensives in terms of performance, valuations and stage in the earnings cycle, we would expect an extension of QE to lead to cyclicals outperforming.

All the initial gains in the run up to mid-April have been unwound

A further aggressive easing by the ECB would likely cause a rotation into equities, cyclicals and value

If we were to see a sharp weakening in the Euro as a result of ECB policy action, that would likely give some boost to the overseas earners. However, after the Euro trade-weighted was down the most in c.20 years in Q2, we suspect the peak of the sweet spot for FX support now lies behind. Additionally, we see little improvement in the macro data in Emerging Markets and the Eurozone domestic recovery theme is still our favoured play. *For more details see:* **European Equity Strategy - Sector Score-Card: More cyclical, more domestic**, 16 September 2015.

Figure 12: European Sector relative performance: (1) Start of QE to market peak, (2) Market peak to now



Source: Thomson Datastream, UBS

Countries: A further easing by the ECB is likely to favour Eurozone countries. Our top picks are Spain, Italy and Portugal where we see the biggest potential for earnings to bounce back with profits c.40-65% below their 2007 peak. We also favour France. We are neutral on the two large non-Eurozone markets – the UK and Switzerland. Sweden, Denmark and Holland make up our least preferred countries.

For more details please see: **Macro Keys - Country picks: Periphery drives capex revival**, 21 September 2015.

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