MONEX

ECB is set to recharge batteries once again

1st June 2020

The ECB is widely expected to bring further action in its next policy meeting on June 4th. Consensus among analysts and investor surveys remains supportive of an extra €500bn increase to the Pandemic Assets Purchasing Program (PEPP), after the ECB failed to meet similar expectations in the previous meeting " which were partly eased by the introduction of the new PELTROs scheme.

In the April meeting, the ECB reinforced its readiness to increase the size and flexibility of the €750bn PEPP launched in March. This time around, the bank faces higher pressure on delivering on such promises as per a number of reasons:

- In the first two months of the program, the ECB has already purchased more than €180bn in public debt off the initial €750bn amount targeted by year-end. At this pace, the programme is set to run out of firepower by October, leaving an empty gap for the last quarter of the year. The ECB could certainly wait to fill its PEPP tank at a further meeting when the state of the eurozone economy is more visible. However, this risks unnecessary speculation about a potential draining of resources, leading to a tightening in financial conditions. Even as there is no immediate need for an increase in the program size in terms of current funds demanded, pre-emptively tackling such speculation would argue for a June decision.
- Raising the overall size of PEPP at this early stage will also help ease concerns on the highly observed deviation from the capital key bounding the medium-term horizon of the program. Although there is no available data on the breakdown of the PEPP at a country-level, capital key deviations from PSPP likely offer a lower bound benchmark. According to Goldman Sachs estimates, April bond purchases under PSPP skewed away from Germany's share by around 10 percentage points while favouring Italian, Spanish and French shares by 5 to 8 pp. Although those estimates follow even more skewed ones in March (around -20pp for Germany, 17pp for Italy and 3 to 5pp for France and Spain), they broadly hint to a sustained deviation in the months to come. Increasing the overall size of the programme could easily tackle this issue, especially under the careful monitoring by the German Constitutional Court.
- As highly criticised as capital key deviations are now, they are exposed to more serious claims in the future, when the worst effects of the pandemic are passed. In terms of economic impact and legal bounds, they are currently broadly justified but that might be less of a case in the near future.
- Finally, tapering the bond market will have a solid signalling message. It will clearly state that the ECB stands behind the eurozone economy while the European Commission attempts to strike an ambitious fiscal plan.

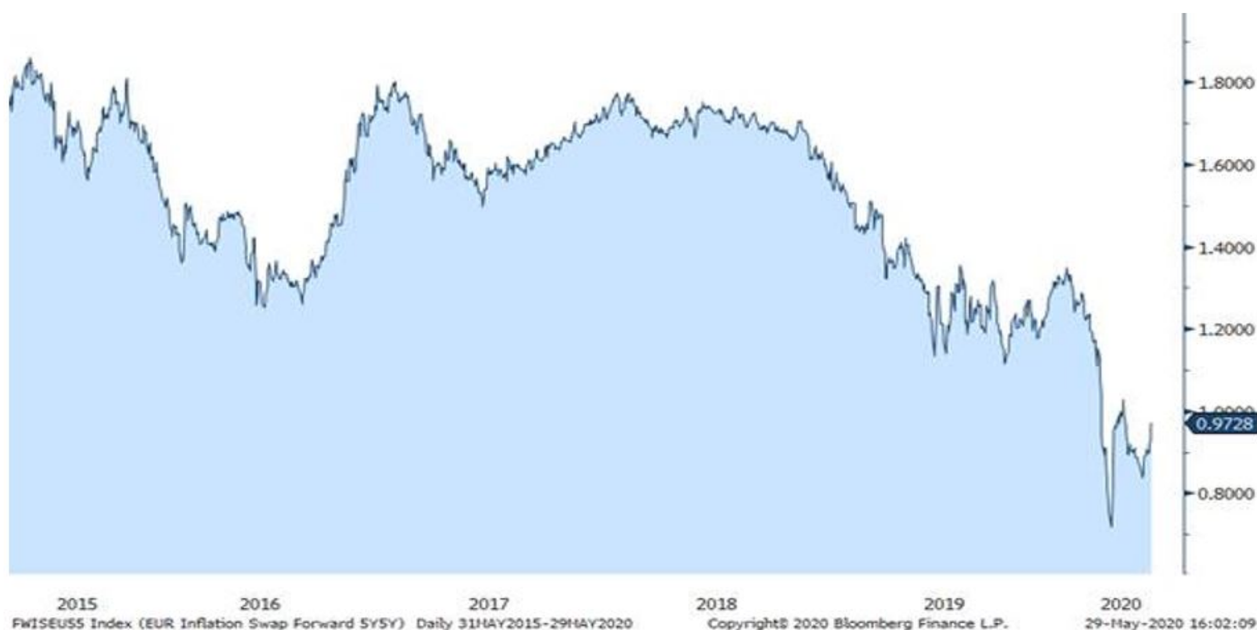
Other topics await the ECB meeting and relate to the updated macroeconomic projections and a potential reference to whether the so-called fallen-angels will be included in ECB's portfolio. Even under broad uncertainty

around the current climate, fresh projections might aid the ECB to reinforce the need of a larger PEPP size.

> Recent comments from member staff indicate that the eurozone is forecast to shrink by 8% to 12% in 2020, in line with the institutions worst scenarios.

Inflation projections will also catch attention after April's meeting minutes revealed some warnings over potential medium-term inflation pressures from supply disruptions, weaker market competition, and changes to supply chains; a notion that could get watered down by a higher-than-expected demand gap. As per the inclusion of junk-rated bonds as part of the purchase programs, mirroring moves from the Fed, the bar seems still high. The main reasons behind this argument rest on the fact that fallen-angels have already been included in the collateral pool, while the topic has remained broadly muted in further ECB communication. Overall, the single currency shall take this news at least with some minor relief; given that ECB's performance help reassures markets on strong monetary support.

Forward Inflation Swap pricing suggests it's excellent timing for the ECB to provide an extra push to slowly awakening inflation expectations



WILL RBA SOFTEN ITS OPPOSITION TO NEGATIVE RATES?

The Aussie dollar has been one of the best performers against USD so far in May, helped along by improving risk appetite and a relatively well-contained domestic macro outbreak. Amid intense speculation that major central

banks such as the Bank of England, Federal Reserve, and Reserve Bank of New Zealand would implement negative rates in response to flagging domestic macro conditions, markets remained unconcerned with the prospect of the RBA following suit. Governor Philip Lowe has been fairly consistent in reiterating opposition to negative rates, twice calling them "extraordinarily" unlikely in Australia, including in a recent webinar.

> Australia's relatively favorable domestic macro conditions suggest the RBA will have little reason to soften its opposition to negative rates at next week's meeting, and rates are likely to remain unchanged.

Given encouraging recent signs from the labour market, it is possible the central bank may even signal that the Q2 shock may be less severe than previously expected.

A small domestic outbreak and effective containment measures meant that the country was able to announce a plan to leave lockdown relatively early.

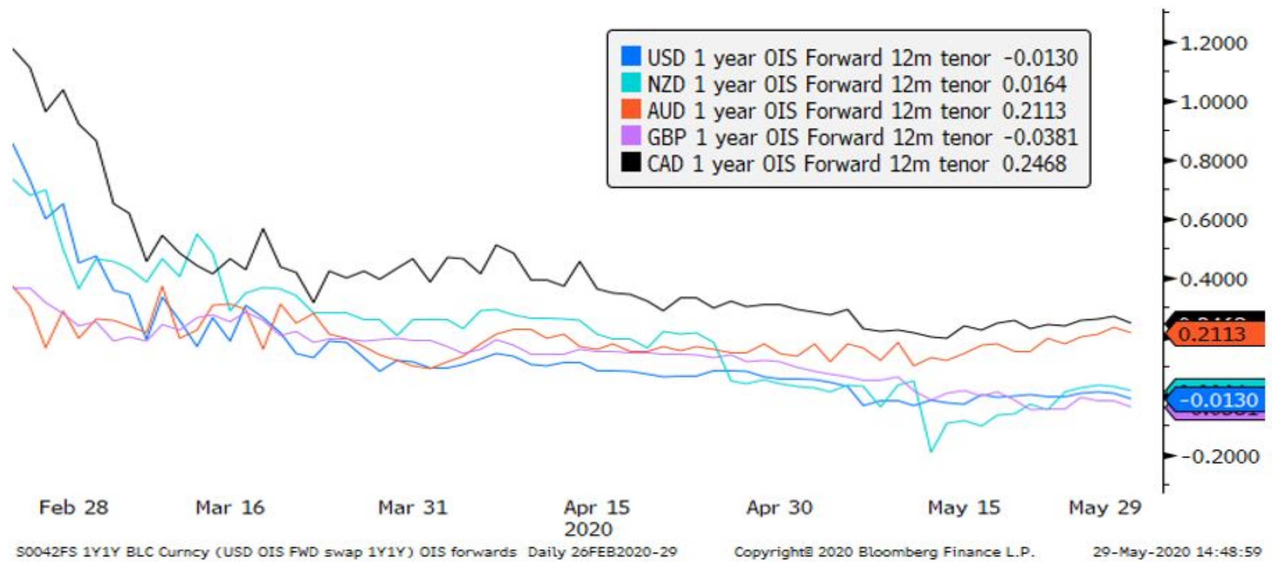
As a result, although the economy will contract sharply in Q2, with gross domestic product expected to fall by around 10%, the shock may end up looking mild compared to peer economies. The relatively short duration of full lockdown measures in Australia and the Government's job subsidy program both offer some reason to hope that the shock to the labour market may be already over.

> Official unemployment data suggest that the shock to employment was historically deep: 594,000 jobs or roughly 5% of total employment were lost in April.

However, experimental weekly payrolls data suggest that the rate of job losses slowed in the first two weeks of May, when total jobs were reported to have declined only 0.2%. Sectors such as retail and hospitality, which were the hardest hit by initial lockdown measures, even registered increases in employment. The experimental data from the Australian Bureau of Statistics must be taken with a large grain of salt, particularly given the highly volatile nature of the labour market and economy as a whole. But taken in the context of Australia's benign domestic virus situation and relatively early easing of lockdown measures, they are at least encouraging.

Forward pricing of overnight index swaps suggests that markets have taken RBA opposition to negative rates to heart. When major central banks were softening positions on negative rates in May, forward pricing of AUD OIS remained stable.

OIS pricing reflects RBA aversion to negative rates



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