Market Expectations Central Bank Policy

Main indicators and recent developments

Money Market Contact Group
European Central Bank

3 December 2018
Agenda

- GDP Growth in the Eurozone
- Headline and Core Inflation
- Market expectations for the first rate hike
- TLTRO talk
- APP reinvestments
- Forward Guidance: some recent quotes
- Bond and FX (swap) markets
Real GDP Growth: a growth dip after the 2017 recovery

- Contrary to continued growth in the US, growth in the Eurozone decelerated to 2.1% in Q2 2018.
- In France and Germany, economic growth has weakened from 2.8% at the end of 2017 to respectively 1.7% and 1.9%.
- Events like US tariffs, Brexit and the Italian budget discussions are not helping the matter.
- ECB growth forecasts (Q4)

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<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>LT</th>
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<tbody>
<tr>
<td>Real GDP</td>
<td>2.0</td>
<td>1.8</td>
<td>1.6</td>
<td>1.6</td>
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Source: Belfius research
GDP Growth: trade no longer contributed in H1 2018

- In 2017 the recovery was based on an increase of net trade.
- In 2018 this growth pillar has disappeared and was temporarily replaced by an inventory increase and investments but this is not sustainable in the longer end.
- We see a bigger contribution from internal consumption in H2 2018 and 2019, in line with the trend of 2016/17.

Euro area contributions to quarterly GDP

Source: Thomson Reuters Datastream / Fathom Consulting
Headline inflation in the Eurozone has increased towards 2% but Core inflation remains rather stable at or around 1%.

There is no urgency for the ECB to increase interest rates but the headline inflation increase could weigh on consumers’ purchasing power.

ECB Inflation forecasts (Q4)

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<tr>
<td>HICP</td>
<td>1.7</td>
<td>1.7</td>
<td>1.7</td>
<td>1.9</td>
</tr>
<tr>
<td>HICP Core</td>
<td>1.1</td>
<td>1.4</td>
<td>1.7</td>
<td>1.8</td>
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Low consumer inflation but strong asset price inflation

Real yearly growth in house prices (%)

- In some countries, low interest rates have translated into an exaggerated year-on-year increase in real estate prices.

Source: Belfius research
Inflation: Improving labour markets a reason for optimism

- A stronger labour market makes more jobs hard-to-fill and as such creating a bigger risk for wage inflation, like we have seen in the US.

- There is still a big divergence between labour markets on both sides of the Atlantic and certainly between countries in the Eurozone.

- ECB U-rate forecast (Q4)

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<tr>
<td>U-Rate</td>
<td>8.2</td>
<td>7.8</td>
<td>7.5</td>
<td>7.5</td>
</tr>
</tbody>
</table>

Source: Thomson Reuters Datstream / Fathom Consulting
Monetary policy still accommodative

- Negative real interest rates were necessary to ward off deflationary risks earlier in this decade.
- The surge in headline inflation made real short term interest rates reach a new bottom.
- After the summer 2019, the ECB is widely expected to gradually normalize short term interest rates.
Monetary policy expectations in the Eonia market

- Since last MMCG the first rate hike has been **postponed** from September 2019 to December 2019.

Source: Belfius research
Monetary policy expectations: (new) T-LTRO talk

- T-LTRO outstanding of € 725 Bn.
- First maturity of € 385 Bn in June 2020.
- From June 2019, this might cause some reason for concern because of NSFR reasons.
- + avoid cliff effect and panic in capital markets
- + compensate hawkish measures like end of APP
- + decrease market stress around Italy
- - contradiction with normalization process
- - stigma could come back, depending on conditions
- How: 2 years? Fixed/Floating? Rate? Repayments?
- Timing of announcement: important for funding plan and future LT issuance of banks.

Source: Belfius research
Monetary policy expectations: APP reinvestments
Monetary policy expectations: Forward Guidance

- 28/11 Lane says rate increase dependent on what data will be like in H2 2019
- 28/11 Lane says important not to be overly-dramatic about slowdown in Euro zone growth
- 26/11 Draghi says GC continues to anticipate that net Asset Purchases will come to an end in December.
- 26/11 Draghi says a gradual slowdown is normal as expansions mature and growth converges towards its long-run potential.
- 26/11 Draghi says expects headline inflation to decline in line with oil price fall.
- 26/11 Praet says will have to clarify what ECB means by reinvesting for an extended period of time.
- 26/11 Praet says downside risks have increased noticeably; significant monetary policy stimulus still needed.
- 22/11 Praet says premature to decide on a new TLTRO now.
- 20/11 Weidmann says policy normalization will take several years, ending QE only first step.
- 20/11 Nowotny says sees no reason to deviate from ECB growth forecast.
- 19/11 Villeroy says end of net asset purchases will not mean the end of our monetary stimulus, far from it.
- 16/11 Draghi says labor market is already showing signs of tightness, pass-through to prices relatively muted.
- 16/11 Draghi says we expect the expansion to continue in the coming years.
- 16/11 Draghi says forward guidance has been effective in anchoring expectations about the future path of interest rates and preventing an undue tightening.
- 15/11 Knot says at this point impact of slowdown not enough to change outlook.
- 15/11 Weidmann says inflation in Euro zone now broadly in line with price stability
- 15/11 Weidmann says monetary policy room for manoeuvre likely to be limited in a future economic downturn.
Bond Markets: all eyes on Italy
FX swap markets preparing for Year End volatility
Currency Markets: a stronger Dollar
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