Daily Note

ECB DOVES FLYING HIGH

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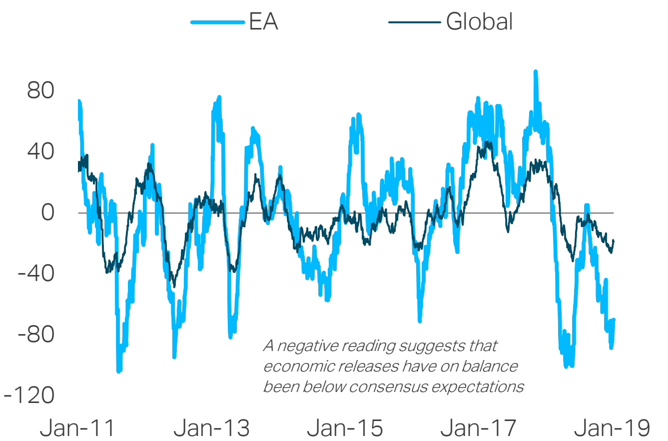
- **ECB acknowledges that risks to growth have moved to the downside**
- **This is a key step towards new (T)LTROs, which could be announced in March**
- **Draghi may also make the forward guidance on interest rates more dovish**
- **We expect further downgrades to ECB – and consensus – forecasts for EA growth**

Risks to growth no longer balanced. The European Central Bank (ECB) left policy unchanged at yesterday's meeting, as was widely expected. What did change, however, was the assessment by the Governing Council (GC) of the balance of risks to euro area (EA) growth, which it now judges to be tilted to the downside. During the press conference following the meeting, ECB President, Mario Draghi appeared to be setting the stage for upcoming policy changes.

March meeting shaping up as important. The revised risk assessment is another step towards the announcement of some form of (targeted) longer-term refinancing operations (TLTROs), which could happen as early as the next policy-setting meeting on March 7, when the next round of staff macroeconomic projections will be published. We expect the growth outlook to be downgraded again and the ECB could also make its forward guidance on interest rate more dovish. The GC expects the key interest rates to remain at their present levels at least through the summer of 2019. But markets have already pushed out expectations of the first hike to mid-2020. Draghi reiterated the rate forward guidance is both date and state contingent and that if the growth slowdown persists, the ECB will validate the market pricing.

EA negative data surprises surge

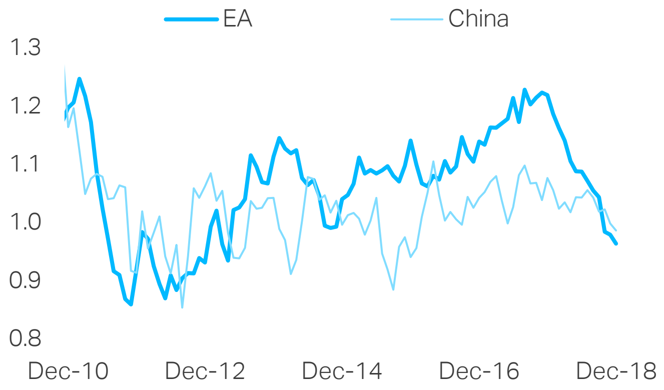
Citi Economic Surprise Index



Source: Citigroup, Bloomberg, TS Lombard

EA manufacturing in a recession; more pain ahead

Markit manufacturing PMI: Orders to inventory ratio



Source: Markit, Datastream, TS Lombard

Different contingencies and elements. There was a consensus among GC members that economic momentum has weakened in the EA. They also agreed on the causes of the slowdown, including protectionism and a pullback in Chinese growth. But there was no unanimity about the duration of the slump. Should it persist, Draghi said that 'we will consider different contingencies and elements'. He did not elaborate.

TLTROs no panacea. We have been making the case that some form of (T)LTROs is crucial. In their absence, Italian banks in particular will face a significant liquidity squeeze as loans made by the ECB under earlier TLTROs approach maturity. The first set of repayments is due in June 2020. But under new Basel bank regulations, lenders will start to feel the pressure from mid-2019 because the risk weighting of the loans will increase in the final year of their life. Draghi emphasised that TLTROs have been very effective in the transmission of monetary policy in the euro area. (T)LTROs do not resolve underlying faults at banks, but we think they can postpone the looming liquidity squeeze, especially at Italian lenders.

EA data disappointments exceed global data misses. Global growth slowed abruptly last year due to mounting protectionism and FOMC policy tightening. But EA data have been particularly weak. The Citigroup surprise index shows that the EA has generally had more data disappointments than the rest of the world. Germany may have just about escaped a technical recession last quarter. But not Italy: according to the Bank of Italy, the economy shrank in the last three months of 2018 for the second consecutive quarter.

EA manufacturing in recession with more pain ahead. Crucially, manufacturing – one of the main engines of EA growth – ended the year in recession. Temporary factors, including protests in France and the drag from new emission-testing standards which have hurt the auto sector, may have exacerbated the sector's troubles. But anyone expecting a swift bounce as those factors fade is set to be disappointed. The inventory overhang is still large, especially in Germany. The deflationary impulse from China will further hurt EA output throughout H1. Competitiveness pressures have eased but could resurface should Beijing fail to adequately stimulate the Chinese economy, pushing it towards using the yuan's exchange rate as a policy tool again. Global demand remains soggy.

The flash EA manufacturing PMI for January released yesterday dropped to 50.5 from 51.4 in December and the German PMI fell to 49.9, signalling a month-on-month contraction. New factory orders continue to fall, led by declining export demand. The backlog of work is also shrinking as firms meet previous orders to keep up production. And still, the inventories-to-orders ratio is on the rise.

Expect more downward revisions to ECB and consensus forecasts. The ECB's current growth forecasts of 1.7% for this year and 2020 are too optimistic. The central bank will most likely scale them back again in March. Analysts surveyed by Bloomberg this month have trimmed their 2019 growth estimates to 1.5%. Last May they were projecting 2.0%. We see room for further downgrades to these forecasts. EA growth could be just above 1% this year.

Draghi is caught between a rock and a hard place. With the eurozone economy slowing sharply and inflation well-below the ECB mandate, the central bank's QE-exit was badly-timed. But QE in its current form has probably run its course (the ECB has run out of assets to buy) so policies such as TLTROs and a more dovish forward guidance are the path of least resistance. Their impact however will be muted. In the absence of a meaningful fiscal boost the ECB faces an extremely difficult balancing act.