

## ECB MEETING: WHEN DOVES CRY

The ECB gets surprisingly gloomy on growth and inflation and shifts to softer monetary policy immediately too.

Since the financial crisis, the unwritten rule has been that bad economic news was good news for investors, as central-bank taps likely would be opened. And if a central bank talked more dovishly than expected in a meeting, the markets were quick to react and party.

For almost 1.5 hours on Thursday, European equity investors thought they had a party lined up. The Dax and Stoxx 600 made upward moves as soon as the European Central Bank's (ECB) press release was published. But the fizz evaporated during the press conference and the markets even turned negative. This was all the more remarkable for the Dax. The euro fell by over one percent against the dollar and traded briefly below the 1.12 level, normally a catalyst for the export-oriented Dax.

The bond markets also reacted clearly. By the end of the day, the already poor yield on 10-year German government bonds had halved to 0.06%. Nine-year bonds are already yielding negatively again and we do not rule out another temporary slide of 10-year-bonds into negative territory. Ulrike Kastens, senior economist at DWS, summed up the market response: "This meeting really surprised us. The ECB is much more concerned about Europe's economy than anyone expected. How seriously investors take the ECB's concerns is shown by the market reactions, which were negative despite the more dovish tone."

### THE ECB'S DECISIONS IN DETAIL

The ECB surprise was not confined to its pessimistic economic outlook. It also came up with some unexpected medicine: highly accommodative monetary-policy measures. The package announced on Thursday contains three important messages.

- Gross domestic product (GDP) growth expectations have been revised significantly downwards, especially for 2019. The ECB now expects economic growth of 1.1% in 2019 (from a previous forecast of 1.6%), 1.6% in 2020 and 1.5% in 2021, with risks remaining negative, particularly due to ongoing uncertainty (such as trade conflict). This is remarkable because in the past the ECB has typically spoken of balanced risks after it had engaged in monetary measures. It was more pessimistic this time because of the high degree of uncertainty. In addition, the overall forecast for inflation has been

revised downwards. For 2019 the inflation rate is expected to rise to 1.2%, for 2020 to 1.5% and for 2021 to only 1.6%. The ECB remains confident that higher wages will translate into higher prices, but that this will take longer than expected. And so for now the inflation target of "below but close to 2.0%" appears out of reach.

- Given the growth and inflation weakness it foresees, the ECB also changed its interest-rate forecast on Thursday, implying no interest-rate hikes in 2019.
- What the ECB came up with was a new round of targeted longer-term refinancing operations (TLTROs). They should ensure continued favorable liquidity. The new series of TLTROs III will be launched in September 2019 with the last ones to be offered in March 2021. All have a maturity of two years and are linked to the main refinancing rate, which means that the last one will mature in 2023. A further surprise is that the details will not be announced until later.

### CONCLUSIONS AND IMPLICATIONS FOR OUR OUTLOOK

The central bank's weeping doves have surprised the markets. The ECB has reduced its forecasts, announced initial details on TLTROs and made its monetary policy more accommodating than expected. However, the drastic reduction in growth forecasts and the further assessment that economic opportunities and risks look negative means the ECB still remains concerned about the Eurozone economy. Its growth estimates are now slightly lower than ours (2019: 1.3%, 2020: 1.4%). Nevertheless, the ECB appears to share our view that the probability of a recession is very low, and that renewed deflation is unlikely, too.

The ECB's new stance confirms our recently reduced forecasts for Bund yields. For 10-year maturities, we reduced them at the end of February from 0.60% to 0.30% for the 12-month period ahead. Our euro-dollar forecast of 1.15 euro per dollar to March 2020 remains the same; when we made it we considered that some short-term euro weakness was probable.

Yesterday's decision is likely to extend the period of suffering for European banks. As a result of the ECB's announcement not to raise interest rates before 2020, no noticeable improvements in banks' net interest income is likely to occur until 2021.

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## GLOSSARY

### Bunds

**Bunds** is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

### Central bank

A **central bank** manages a state's currency, money supply and interest rates.

### Dax

The **Dax** is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

### Deflation

**Deflation** is a sustained decrease in the general price level of goods and services.

### Euro (EUR)

The **euro (EUR)** is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

### European Central Bank (ECB)

The **European Central Bank (ECB)** is the central bank for the Eurozone.

### Eurozone

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

### Financial crisis

The **financial crisis** refers to the period of market turmoil that started in 2007 and worsened sharply in 2008 with the collapse of Lehman Brothers.

### Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

### Inflation

**Inflation** is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

### Monetary policy

**Monetary policy** focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

### Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

### Refinancing

**Refinancing** refers to the replacement of an existing financial obligation with a new obligation.

### Stoxx Europe 600

The **Stoxx Europe 600** is an index representing the performance of 600 listed companies across 18 European countries.

### Targeted longer-term refinancing operations (TLTROs)

**Targeted longer-term refinancing operations (TLTROs)** refer to the ECB's providing of financing to Eurozone banks.

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