

MACRO MARKETS DAILY

Economic data today

- **US June Housing Starts** (exp. 6.2% MoM, last -5.5% MoM) and **Building Permits** (exp. 2.7% MoM, last -4.9% MoM). After two months of negative performance, we expect building permits to recover some ground in June. In May, activity in the West (-12.8% MoM in May) and the Midwest (-9.9% MoM) was very weak, and was modest in the South after a sharp 7.1% MoM decline in April. Housing starts have also been very negative in the last three months, with annual growth actually moving into negative territory in the last two months (-0.7% in April and -2.4% in May). We could see a rebound in June, but volatility in the sector could continue in the coming months.

Rates Strategy

- **EUR Govies:** A stronger UST (fueled by news overnight about the new US administration's difficulties in drumming up the necessary support among some Republican senators to pass its replacement of Obamacare) helped EUR govies maintain the healthy tone in yesterday's session.
- The 10y Bund richened another 5bp (so that it is now trading at 0.56%), while risk premia continued to tighten further, with Spain leading the movement in the morning (when its spread over Germany contracted by more than 3bp), but all periphery govies finally closing 1-2bp tighter (with the 10y SPGB below the 100bp mark for the first time since October).
- EUR investors should be in wait-and-see mode today, **waiting for the outcome of the ECB meeting tomorrow** (which we expect to provide few changes –and, hopefully, nothing too meaningful– yet, see our [ECB meeting preview on page 2](#)). As a result, market directionality today is likely to be explained by developments in the US or even the UK
- **UK supply:** The DMO will auction £2.75bn nominal of a new 0.75% July 2023 gilt this morning, with a DV01 of around £1.6mn. Last year's new 5y gilt had a weak start, firmed up after its second tap and has done well recently. We see a ~2bp new issue discount as appropriate, based on that example and previous ones. That would translate into it being attractive at a 5bp spread over the existing 2.25% Sep'23s, itself a gilt that we find cheap on RV (e.g. as a 0H 22s/23s/2 25s [fly](#)). Gilt yields in general remain at their highest since February and we expect them to rally over the summer, although we see more scope for performance around 10-12y than the 5y area, where ASW are still very wide by historical standards, even after some tightening in the recent sell-off. Please see our [Auction Preview](#) published Monday for more details.

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FX Strategy

- The **USD Index** strengthened overnight, as the focus on faltering healthcare reforms in the US started to give way to the prospect the ECB may look to contain expectations of tighter monetary policy at tomorrow's meeting. Indeed, despite EUR/USD reaching a 12-month high yesterday, at 1.1583, the pair slipped back to 1.1530 overnight and may struggle to reverse this decline today.
- **GBP/USD** began the week at above 1.31, but fell yesterday, after UK inflation data for June came in below the consensus forecast, weighing on expectations that the BoE's recently more hawkish tone is likely to continue. Despite the firmer USD overnight, GBP/USD has strengthened a little this morning, to sit just below 1.3050.
- **USD/JPY** has been on a downwards trend since the start of last week, but managed to hold at above 112 overnight, helped by the stronger USD and firmer Asian equities. Tonight, the JPY focus will switch to the BoJ, which takes its latest decision on monetary policy. As has been the case in recent months, there is little expectation of anything other than additional dovish rhetoric from the Policy Board. We continue to expect the Bank to maintain an expansive monetary policy throughout H2-17.
- The Australian Leading Index slipped overnight, but iron ore prices jumped by 3%, rising to their highest since mid-April and helping the AUD hold on to its recent gains. Indeed, **AUD/USD** rose to just below 0.7950 on Tuesday, rallying after the RBA minutes suggested the Bank continued to see the Neutral Cash Rate at around 3.5% (1.5% currently). The pair has now gained c.5% in less than two weeks, though, representing a sharp move even for the AUD. Hence, with the unemployment rate expected to rise tonight, the AUD may now struggle for further short-term upside, and we consider a small reversal in the coming days as more likely than additional gains.

ECB meeting preview: Too early to remove the easing bias?

- ✓ Since late last year, ECB members have desperately been trying to find the smoothest way to start the normalization of the massive monetary policy easing. After already having clarified, in June, that official rates will not be reduced again in this cycle, in coming weeks they will have to do the same with the ECB's bond purchase program, paving the way for a gradual reduction in these purchases in 1H18.

- ✓ Yet, the lack of reaction by core inflation (or negotiated wages) to a much healthier macro environment and the (mostly foreign-driven) sharp EUR appreciation are certainly complicating the ECB's exit strategy.
- ✓ We think the ECB could make another –relatively minor– tweak to its message to the markets in its meeting tomorrow, leaving the bulk of the details on its tapering strategy for the last three meetings of the year.

Facts:

The Eurozone economy is performing very well (not only in surveys, but also real activity data) with the labour market following that trend, but that is not the case with inflation, which is being dragged down by structural headwinds and a lack of wage pressure.

On a related note, although to a large extent also due to foreign reasons (the aftermath of political events in the UK and the US in 2H16), the EUR exchange rate has appreciated significantly in recent months (+4% in NEER and +9% vs. the USD YTD), while oil prices remain in the lower end of their \$42-54/bbl range.

- As a result, the ECB is now slightly further away from meeting its only (inflation) target, having recently reduced its long-term inflation forecast (1.6% for 2019). Yet, we believe that the ECB doesn't want to be hostage to its own macro projections, given the very accommodative monetary conditions. And that was probably behind Draghi's words in Sintra (27/6), where he reiterated that *"deflationary forces have been replaced by reflationary ones"*, while implying that stopping bond purchases is not the same as tightening (*"the ECB can accompany the recovery by adjusting the parameters of its policy instruments"*), especially as the ECB has done much more than initially expected, eg:
 - Depo Rate @ -40bp (vs 0bp originally)
 - Bond purchases will finally reach c.€2.4trn (vs. the €1.1trn in the original plans)
 - TLTROs @ €750bn, larger-than-expected (very attractive LT) funding
 - Excess liquidity @ c.€1.7trn (from just €175mn when the QE started)

The ECB is widely expected to start withdrawing its easing bias (announcing a gradual reduction in bond purchases) before the end of 2017. But the main issue we see is **when and how** the Bank communicates this without *shooting itself in the foot*, given the tightening in financial conditions any increase in rates / further EUR



appreciation would cause (with the obvious implications for its inflation target).

The gradual shift in its message already started in June, when the ECB removed the possibility of further cuts (deleting “or lower” from the statement), but kept “asset purchases could be extended, in size or duration”.

- **Expected changes in the July meeting:**

Not that many and, hopefully, nothing too meaningful (EUR >1.15\$ as we write). We expect the statement to keep emphasizing how well the macro is doing and that, although inflation is not following the recovery, deflation is not a real danger anymore.

The key words in the statement are now: “the ECB stands ready to increase the programme in terms of size and/or duration”. That could be modified, especially the “size” aspect –i.e., implying that purchases will not increase above €60bn/month, while any tapering in 1H18 could be considered “duration” lengthening in the program (so they could keep this bit). But, despite any possible hints, we doubt these words would be removed altogether yet, given the possible large market ramifications and the seasonal decline in an already poor liquidity environment. In fact, the ECB should then be less worried about another upward leg in rates than in FX, but that would be very complicated to achieve.

- **See you in September**

If the EUR keeps on appreciating (we have been EUR bulls for months, but think it could take a break at this level) and/or the oil price keeps on falling, the ECB will have a hard time pre-announcing the end of QE when it is even further from achieving its inflation target. Nevertheless, it cannot continue buying bonds forever (particularly considering a potential scarcity problem).

We continue to believe that, in September, the ECB will pre-announce that it is planning to wind down its bond purchases in 2018, although it might not provide all the specifics at that stage. Rather, we think the tapering details could be provided at the October or even December meetings.

- **Tapering: When & how ?**

We continue to believe (see our [Macro, Rates & FX 2017 Year Ahead report](#)) that the ECB will start tapering in January 2018 and that the aim will be to scale back these purchases by €10bn per month. Our ‘only’ doubt (FX dependent) is whether Draghi will pre-commit to such a reduction pace (i.e., +€150bn in extra purchases in 1H18) or whether this reduction will have to be sanctioned, à-la-Fed, at every ECB meeting (+€210bn between January and July 2018). According to our numbers, there should not be any scarcity problem in the main countries with these QE end dates.

So...

- ✓ ... Given the major market reaction to Draghi’s comments in Sintra three weeks ago (EUR +1 figure and largest UST sell-off in 2017) and with no mounting inflationary pressures building up, we believe the ECB should try to avoid surprising on the hawkish side again this month, which would tighten financial conditions further.
- ✓ That said, the healthy macro outlook remains fully consistent with a gradual withdrawal of the stimulus in the months ahead, and we expect a smooth/gradual tapering to start in January 2018.
- ✓ We expect the ECB to be more explicit about this in its September meeting, with a clearer message indicating such a possibility. But it might still be too soon (risky) for the ECB to pre-commit to any such plans right now.

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