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## Draghi signals slow exit

**ECB View: Focus switches from inflation to economic growth** – In a speech at the ECB Forum on Central Banking in Sintra earlier today, ECB President Draghi struck a less dovish tone than at the June press conference. He signalled that the central bank will move towards tapering asset purchases, but at a slow pace. He set out three key points. The first is that ‘all the signs now point to a strengthening and broadening recovery in the euro area. Deflationary forces have been replaced by reflationary ones’. Second, while ‘there are still factors that are weighing on the path of inflation, at present they are mainly temporary factors that typically the central bank can look through’. The ECB President attributed soft inflation partly due to increases in labour supply, which reflected a combination of a strengthening economy and labour market reforms. Third, ‘as the economy picks up we will need to be gradual when adjusting our policy parameters, so as to ensure that our stimulus accompanies the recovery amid the lingering uncertainties’. By playing down – for the first time – subdued current inflation, and focusing more on growth as a trigger for less accommodative monetary policy, Mr Draghi seems to be gradually preparing the path towards a tapering of asset purchases next year. At the same time, he is emphasising that the process will be very slow. Overall, following this speech, we are more confident in our call that the ECB will start to taper its asset purchases from the start of next year onwards. However, it also raises the risk that the process will be somewhat slower than our base case. Our central view is that tapering will start in January 2018 and that the programme will end completely by June, with purchases being tapered by EUR 10 bn per month. (Nick Kounis)

**Eurozone government bonds: Markets start to price in QE taper** – In reaction to the less dovish tone by ECB president Draghi, the market has started to price in the gradual exit of the ECB’s QE programme. In a nutshell, the market was caught completely off guard by Mr Draghi. In an instant, the yield of 10 year German government bonds soared by 9bps to over 0.30%, the highest level since the end of May. Also yields of short dated bonds climbed and even reached the highest level since a year. Since yields of German longer dated bonds jumped higher than short dated bonds, the bond curve steepened, reversing the recent flattening trend. Furthermore, risk sentiment deteriorated as country yield spreads widened. In particular, the yield difference between Italian and German 10 year bonds increased, although at the end of the day this spread still only widened modestly by 3bps. Finally, pricing in Eonia derivatives showed that market expectations of future deposit rate hikes have built. The market has now fully priced in a deposit rate hike of 10bps during the second half of 2018. This implies that, while assuming the ECB won’t hike rates before the end of tapering, the market has started to believe that the programme would end completely before the start of second half of 2018. Going forward, we expect that due to the tapering of the QE programme (see above), the yield of 10 year German government bonds will increase further, to 0.80% at

the end of the year. In addition, we expect that risk sentiment will deteriorate and judge that the spread widening of peripheral markets has only begun. We expect wider peripheral spreads at the end of this year, with Italian spreads being the most vulnerable for upward pressure. We continue to forecast the spread between 10 year Italian and German bonds to climb to 240bps at the end of the year. (Kim Liu)

**Global FX: EUR/USD up move gaining momentum** – ECB President Draghi's comments this morning triggered a rise in expectations that the ECB may reduce monetary stimulus earlier than expected. This has resulted in a rise in German government bond yields versus their US counterparts. Currently, the 10y government bond yield spread between Germany and the US is the dominant driver for EUR/USD. This spread has narrowed to below our end of year forecast of 190bp (US – Germany). Moreover, the net long euro positions in the futures market are relatively large. Do these factors mean that the EUR/USD move will run out of steam? Not necessarily. For this to happen, Fed speakers (such as Chair Yellen this evening) need to successfully convince the market that the Fed will continue to hike interest rates as signalled by the “dots” plot. Currently, financial markets are pricing in a probability of roughly 50% for one 25bp more rate hike this year and another 25bp next year. So the gap between the Fed’s “dots” plot and market expectations is substantial. Another crucial factor for the US dollar to recover versus the euro is that US economic data start to surprise on the upside. If the Fed is not successful in convincing financial markets and US economic data fail to surprise positively, then the US dollar will remain under pressure versus the euro and versus other currencies. The net speculative long euro positions may be substantial, but they are not that large when compared to the size of the net short euro positions in the past. Finally, it is likely that investors are not positioned for a substantial move higher in EUR/USD from here, because on every occasion in the past, the move ran quickly out of steam. If this time around the EUR/USD rally is gaining momentum, quite some investors are wrong-footed and this could result in an acceleration of the up move. (Georgette Boele)

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