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ECB Preview – Scenarios and market reaction

The ECB has signalled that, at this week's meeting, it will most likely set out the outlook for its QE programme beyond December 2017 (though some details could follow later). What it will decide is uncertain. Officials seem to be considering a trade-off between the future size and duration of the programme. Below we sketch out possible scenarios and our view of the likely market reaction. Our views are summarised in the table.

ECB QE Scenarios	Market reaction	Schatz yield	Bund yield	10y ASW	10y DE - IT	EUR / USD
Taper @ EUR 10bn	Tantrum	↑↑↑	↑↑↑	↓↓↓	↑↑↑	↑↑↑
6 Month @ EUR 20bn	Very bearish	↑↑	↑↑	↓↓	↑↑	↑↑
6 Month @ EUR 40bn	Mild bearish	↑	↑	↓	↑	↑
9 Month @ EUR 30bn	Neutral / Mild bullish	≠	≠	≠	≠	≠
12 Month @ EUR 30bn	Bullish	↓↓	↓	↑	↓	↓
Open ended @ EUR 40bn	Very bullish	↓↓↓	↓↓	↑↑	↓↓	↓↓

Source: ABN AMRO Group Economics

Base case: EUR 30bn for 9-months

Our base case is that QE will be extended next year, but at a slower pace. We expect the size of monthly asset purchases to drop to EUR 30bn from January onwards, with the programme extended through to September 2018. This would reduce the degree of stimulus given the strengthening economic recovery and limits to the scale of the QE programme given that the ECB wants to stick to the issuer limit. On the other hand, given still subdued underlying inflation and the strength of the euro over recent months, the ECB will choose to reduce accommodation very slowly. This will be designed to prevent a significant tightening of financial conditions, which could further slow the expected progress of inflation towards the ECB's goal over the medium term.

We expect a number of other announcements to try and calm markets. First, there will be an emphasis on the scale of reinvestments as well as ongoing net asset purchases. We estimate that next year, re-investments could total EUR 15-20bn per month, leaving gross purchases at EUR45-50bn. Second, the ECB could signal that the slowdown in QE will be borne mostly by the PSPP, while the corporate bond and covered bond purchases will be maintained closer to current levels. Finally, the current forward guidance will be maintained, leaving open the possibility of a further extension of QE and stressing that interest rates will be maintained at current levels well past the time when the QE programme ends.

We think the market impact of such an announcement would be relatively limited. The market consensus now appears to be broadly for 9 months at EUR 30bn. If anything, the additional elements we expect (such as the unchanged forward guidance) could be relatively bullish for bond markets.

Alternative extensions

As a rule, we think shorter extensions (at 6-months) would tend to trigger a negative market reaction. There would likely be some steepening in core curves , tighter swap spreads and widening in credit and country spreads, with the biggest impact on Italian sovereign bonds. We would also see further euro strength. This is because a 6-month scenario could ignite earlier rate hike expectations, as well as speculation that the programme could end sooner. This would change only if the ECB strengthened its forward guidance to explicitly suggest that interest rates would not go up until 2019 in any case. A longer extension (12-months), would by the same token, have a positive impact on financial markets, even if the monthly net purchase amount was relatively modest.

Taper with pre-defined end date

An alternative scenario would be a real taper with a communicated QE end date. This means that the ECB would set out a slowdown in net purchases and specify a specific end date. For instance, the ECB could signal a drop in net asset purchases of EUR 10 bn per month from January onwards. The programme would end in June 2018. Markets would know for sure that the end of QE was in sight. There would also be a risk that markets start to build up expectations for rate hikes in the second half of next year. The market reaction would most likely be negative, with a sharper steepening in core curves and widening in credit and country spreads, with again Italy most vulnerable. The euro would likely surge.

Open ended

A final scenario would be that the ECB announced open ended QE with no pre-set guidance. For instance, it could say that net asset purchases would total EUR 40bn per month until there is a clear upward trend in underlying inflationary pressures. It would have a powerful impact on expectations both about future QE and on the period in which interest rates would remain low. We therefore think that the market impact would be bullish. There would be some flattening in core curves and decline in credit and country spreads, as well as euro weakness. However, volatility around meetings and economic reports would increase. Furthermore, given limits to the QE programme, such a commitment could be difficult to execute. Finally, the more hawkish members of the Governing Council would resist such a course of action strongly.

Likelihood of different scenarios

We would attach a very high likelihood to an extension scenario (80-85%) rather than a taper (10-15%) or an open-ended programme (5%). Judging the exact size and duration of the extension is more tricky, though we think a 9-month (or more) extension is the most likely.