ECB to disappoint. Lagarde expects fiscal policy to do the lifting.

I’ve been of the view, like so many other investors, that the would be dovish and a) launch LTRO early, b) cut rates, and c) do some form of QE (the market thinks outright QE, I thought unconstrained LTRO.)

This view has led me to be long EUR duration from Bunds to Italian and Portuguese treasuries. I have also been long Euro IG credit duration due to the steepness of the credit term structure. This was a over a year ago. It has been a good trade.

The past month has seen in acceleration in these trades. My view, however, has now changed. The European economy has been weak, victim in no small part, of the trade war raging between America and the rest of the world. Economic data suggests the ECB has to be dovish and increase its reflationary efforts. The TLTRO and LTRO calls are based on the details of what the ECB can or cannot do. QE is needed once again but the dearth of German ISINs and the need to buy more peripheral debt is constrained by teh ECB’s need to buy pro rata to its capital key. Repo operations allow the ECB to facilitate private commercial banks to do the buying on its behalf, without these inconvenient limitations.

The risk to the trade has always been political. The end of the Draghi term at the end of this October and the beginning of Lagarde’s leadership of the ECB is a risk.

Christine Lagarde is a consensus builder and communicator. She leans towards dovishness but is likely to be a moderator rather than a leader of the ECB’s policy committee.

On September 4, Lagarde called for European governments to do more in fiscal policy to boost Eurozone growth. While Lagarde is a supporter of monetary accommodation, it was a signal that she at least is listening to the views of the hawks, or that she thinks that further monetary accommodation will have limited impact with rates already through the zero floor. I expect that Draghi may announce another round of QE but a moderate one, (not more than 25 billion EUR of net purchases a month,), disappointing the market’s expectations of further blank check accommodation, or he may simply do nothing but talk, and hand the baton to Lagarde. Lagarde’s September 4 statement is a signal that she will be more circumspect and may demand that member states’ treasuries pick up the slack instead of leaving it to monetary policy.

If so, the impact on rates markets will be negative. Expect curves to steepen and rates to back up.