What will the ECB do March 10, 2016

The Eurozone economy has weakened in 2016 slipping into deflation with both manufacturing and services PMIs turning south in January and February. After disappointing the market in December 2015 with a mere 6 month extension of the existing QE the ECB will be expected to do more to spur demand and head off deflation.

The market will expect the following:

1. 20 basis point rate cut to take the deposit rate to -0.5%.
2. Additional 10 billion EUR monthly budget for bond purchases.
3. Program extension from Mar 2017 to Sep 2017
4. Additional TLTRO

What might not be effective:

1. A rate cut is not likely to be effective. The problem is not willingness to lend but willingness to borrow. Banks will not be able to pass on the lower rates while incurring costs on their reserves on deposit. They might well raise interest rates to make up for the additional costs.
2. The bond purchases are allocated according to the capital key which means 25.6% of the budget goes to German bunds, 20.1% to OATs, 17.5% to Italian bonds and 12.6% to Spanish bonds. Deflation is worst in Italy, Spain and France. Germany has zero price growth. The money is not going to where it is needed most.
3. TLRO take up has been disappointing.
4. Most of what the ECB can do, the market expects the ECB to do. There is no latitude for shock and awe left.

What might the ECB do to surprise the market?

1. Moving away from the capital key and allocating the budget to the countries which need stimulus most and trying to bring rate convergence between countries'

   bond yields could be more effective and would be taken positively by the market.
2. Currently the ECB buys 8% of the budgeted bond purchases, while the National Central Banks buy a further 12% under a risk sharing program. The other 80% is not commingled and each NCB bears the default risk of their own government's bonds. The ECB could make all purchases risk-shared. This would pull peripheral and core spreads together bringing down interest rates in Italy, Spain and Portugal.
3. Removing limits on buying debt yielding less than the deposit rate. If the ECB cuts rates by 20 basis points, this point would be academic.

What might get in the way?

1. On Feb 25, 2016, Jens Weidmann, President of the Bundesbank, argued that his Eurozone counterparts are putting too much emphasis on recent weak data. The Bundesbank's own prognosis for the Eurozone economy was less gloomy. This could be a signal that the Bundesbank, the largest capital contributor to the ECB, is unwilling to do more.
2. Draghi himself might decide that doing more of the same is not rational given that the initial program has not been effective. As long as the ECB was strenuously fighting deflation, governments would be less inclined to pursue fundamental reform.

Speculation.

1. If the ECB simply meets market expectations, it is likely the market will be disappointed.
2. The ECB has little room to surprise the market since the market is expecting a lot.
3. Draghi may, if he so chooses, openly speculate about going off the capital key, or commingling the NCB's risk, to present the Bundesbank a fait accompli at the Apr 21 meeting.

Trades:

1. The EUR is fundamentally weak, recent strength being related to the risk of a disappointing ECB announcement. The EUR remains a good short, however, the degree of uncertainty surrounding the Mar 10 ECB meeting recommends moderating this exposure.
2. Under TARGET2, countries are essentially risk-shared and as such peripheral bonds should trade tighter to German and French government bonds. Convergence trades are still rational. Again the uncertainty around the possible outcomes leads us to defer this trade until we have more visibility.