Busy Thursday

71 – 7 December 2020

Key points

- This Thursday could be a key moment for Europe, with the ECB meeting and the beginning of the European council. We could get a positive surprise on the time extension of PEPP, but the constraints on the "top-up" are significant. There is some tentative progress on the "rule of law" spat but hurdles abound. The Council meeting could bring about the denouement of the Brexit saga.

This Thursday could be an important day in Europe. The ECB has telegraphed another much-awaited layer of monetary accommodation, designed essentially to create financial space for accommodative fiscal policies across member states. The same day, the European Council will start. While these items are not on the official agenda, it is highly likely that this meeting will provide another occasion to try to unlock the "rule of law" spat, while we would not be surprised if this could bring about the denouement of the Brexit negotiations.

Our baseline for the ECB announcements is that PEPP will be raised by another EUR400bn and extended to December 2021, with strong pledges to do more and longer if needed to "preserve market conditions". Given the recent "noises from Frankfurt" reported by Bloomberg, we see a strong risk the Governing Council will opt for a straightforward extension to June 2022, but we don't think the quantum of purchases can significantly exceed EUR500bn and keep some powder dry. Indeed, although PEPP is the ECB's most flexible quantitative easing instrument, we think it is still bound by keeping the central bank's overall holding of any sovereign eligible debt below 50%. Exact quantifications are difficult, but beyond EUR600bn for the top-up to PEPP, the ECB would be sailing very close to the wind. The ECB is doing a great job at delivering the top of what it can, given its constraints. Yet, thorny questions will remain. How healthy can it be that by the time the pandemic crisis ends, there would be no additional accommodation capacity left to speak of?
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Will governments be able to take advantage of the monetary stimulus? We have seen tentative progress towards a more conciliatory approach from Poland, but Hungary still seems far from the compromise needed to unlock the Next Generation programme. Conversely, in the US, some more tangible progress is underway. A group of 10 Senators from the two parties is proposing a package of more than USD 900bn (c.5% of GDP). This is not the first effort of this nature, but this time it is being backed by President-elect Biden and the leader of the Democrats in the Senate. A demonstration of bipartisanship in December already would be a strong illustration that the ultra-confrontational Trump era is drawing to a close.

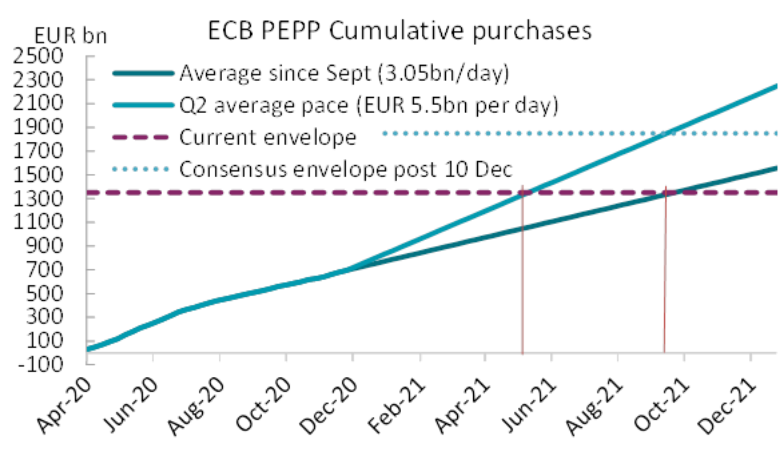
Calibrating the recalibration

The consensus around the role of monetary policy in our current predicament is quite strong at the ECB board. Fabio Panetta was the first to acknowledge that creating space for the fiscal stimulus is the most efficient transmission channel for monetary policy in the current configuration. Christine Lagarde made it a central tenet of her "big speech" at the central bank's annual conference. With Yves Mersch on the way out it is unclear who is the standard bearer of the hawkish persuasion at the board, but it was still telling to hear Isabel Schnabel espouse the same view last week, albeit in a slightly elusive way. She explicitly acknowledged the complementarity of monetary and fiscal policy, and somewhere else in the interview she highlighted the need to keep financial conditions favourable, but without linking the two notions together explicitly. Still, the message is clear: the ECB is engaged in a form of "yield control". Schnabel took pains to explain the central bank was far from setting a quantitative target on the level of interest rates (even if she did not dismiss the option out of hand), but "preserving financial conditions" – the expression she used – probably constitutes a fine definition of implicit, of "soft" yield control.

How can we calibrate the amount of central bank purchases which will keep market interest rates within an acceptable range? With traditional, explicit yield control, the central bank doesn't need to: the quantum of purchases is whatever is needed to hit the targeted market interest rate, depending on market conditions. The ECB cannot rely on the same mechanism because investors are aware of the central bank's limits – a key difference with the Bank of Japan which is facing no political or legal constraint to its engagement on the sovereign bond market - but it has been very good at making the best of them.

The power of the Pandemic Emergency Purchase Programme lies in its flexibility relative to some of those limits: purchases of sovereign paper can exceed 30% of the issuer's marketable debt, and the ECB can take liberties with the ECB's capital key to apportion its operations across issuers. Investors operate on the basis of a double uncertainty: since the ECB is not committed to a precise level of interest rates – and monitor several national curves at the same time – investors are never sure when and where the ECB will suddenly intervene "en masse". **There is a hard limit though: in our understanding the central bank is still bound by the European Court of Justice which has endorsed quantitative easing partly because the ECB would hold only a minority of each sovereign's debt**. 50% is a real constraint. It is just that at least at the beginning of the programme -while there is still quite some space before hitting 50% - investors willing to test the ECB's resolve would need to stomach a deluge of unpredictable interventions. Ultimately, since the middle of the summer the ECB has been able control the market with limited actual purchases.

Exhibit 1 – How to push the envelope?



Source: ECB, AXA IM Research, December 2020

This makes predicting the next phase of PEPP quite circular. **Most economists/strategists we follow extrapolate from a past level of purchases which was consistent with favourable and stable financial conditions and simply prolong this along the time horizon over which they think the ECB will need to maintain "emergency support".** This is inherently imprecise. We offer an illustration of this in Exhibit 1. On average since September the ECB has been buying EUR15.3 bn per week, amid remarkably benign market conditions. Under this scenario, to prolong PEPP until the end of 2021

from June, a “top-up” of c. EUR250bn would be enough (to EUR 1600bn). But the second pandemic wave is likely to make governments’ debt issuance even higher next year, while obviously the longer the programme lasts, the higher the chances incidents” – e.g. political instability – would trigger bond market pressure forcing the ECB into re-upping its purchase quantum. During the challenging second quarter of 2020, the ECB was spending 27.5bn a week. This would require a EUR900bn top up. Market consensus for this week’s announcement is close to the median of these two estimates, at EUR500bn, below the ECB’s previous move on PEPP (the 6-month extension with a 600bn top up announced in June). **There is in our view a good reason why expectations for the top-up should not exceed the median too much: the “hard limit” of 50% is now within sight**.

Then again, precise figures are hard to come by. To start with, we don’t know exactly know how close the ECB already is from holding 50% of German eligible public debt, while the quantum of eligible securities is rising because of the mounting public deficits. We also need to consider the fact that on top of the emergency purchases, the central bank continues to buy government bonds under the “ordinary” quantitative programme, the Asset Purchase Programme (APP). According to Sophia Selim at Bank of America Merrill Lynch, the remaining space for PEPP in 2021, assuming the ECB does want to deviate too far from the capital key, is in a range of EUR650bn to EUR 880bn, depending on the size of the German deficit next year. In other words, under these constraints **the ECB in any case would not have the capacity to provide the quantum of support to the bond market that it offered in Q2.**

There could be a trade-off between “quantum” and “time”. **Last week Bloomberg reported that many Governing Council members were ready to support a 12-month extension until June 2022**. In her interview last week Isabel Schnabel did not confirm it but did not dismiss this out of hand either. This may seem odd to push the notion of “emergency” so long, since the good news on the vaccines make it now very likely that at the end of 2021 at the latest sanitary conditions in the Euro area will be permanently restored. However, **we think there would be value in providing such further visibility to the market.** Indeed, the end of PEPP will raise thorny issues for governments. Thanks to its flexibility – and absence of conditionality – PEPP is the ultimate “umbrella” for active public finances. Even if the ECB maintains a decent quantum of buying with the APP programme after folding PEPP, the risks of market pressure on the most fragile member states will be significant. The longer governments can “cash in” the recovery of the second half of 2021 to shore up their finances through the operation of automatic stabilisers before losing the protection of PEPP, the better.

But the issue then shifts again on the quantum. At first glance, the size of PEPP should be proportional to its length. Governments will still be in deficit in 2022 and will maintain a substantial pace of issuance which could and should be “lapped up” by the ECB. A problem though is that, **if the ECB is already close to holding 50% of German debt at the end of 2021, then the additional German issuance in the first half of 2022 will not substantially raise the “buying space” for PEPP after what is going to be taken by “ordinary QE”.** The call by Morgan Stanley economists (a 600bn top up with an extension of PEPP to June 2022) is in our view at the top end of what can be expected.

For our part, we think the ECB would find itself in the “least problematic position” by announcing a floor in terms of purchases quantum and timeline, while insisting on the possibility to do more on both, so as to preserve as much “dry powder” as possible. In our baseline, the ECB would announce EUR400bn *at least* until *at least* the end of 2021, but with a strong pledge to do more should this be needed to “preserve financial conditions”. Given last week’s “noises from Frankfurt”, the risk that they would shift to June 2022 has risen significantly, but in this case, we would not expect the purchasing quantum to exceed EUR500bn, with again some pledge to buy more if needed.

Beyond PEPP, the ECB is highly likely to continue easing conditions for banks, by extending the discount window of the Targeted Long Term Repurchase Operations until at least the end of 2021, adding some tenders. Further alleviation of the cost to banks of the negative interest rates would be produced by tweaking tiering rules so that a higher share of banks’ excess reserves – further boosted by more generous TLTROS – would be exempt of the negative deposit rate “tax”.

We continue to think the ECB is doing a great job at delivering the top of what it can, given its constraints, but we should not be under any illusion about the central bank’s remaining capacity. The good news on the vaccine should be a massive source of relief for the Governing Council, since it is plausible this week’s push will be the last “big effort”

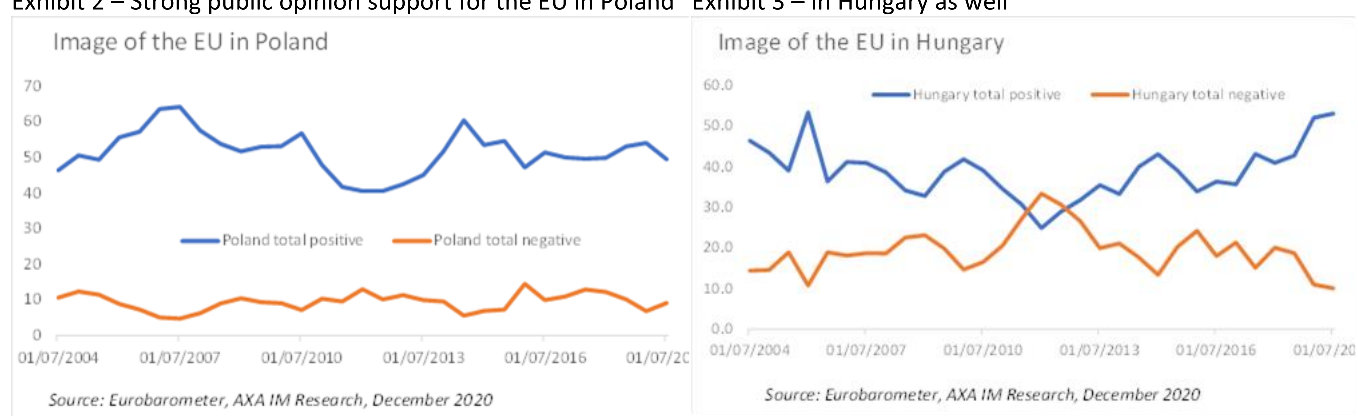
requested from them before the end of the pandemic. Yet, thorny questions will remain. **How healthy can it be that by the time the pandemic crisis ends, there would be no additional accommodation capacity left to speak of, at least within the current constraints weighing on the ECB?** The Governing Council will pray for a very uneventful recovery post-pandemic.

"Thursday doesn't even start"

Central banks are doing everything they can to create space for fiscal policy. It remains to be seen whether this capacity will be effectively used. Looking at the current fiscal plans released by the main Euro area countries, the range for the additional discretionary fiscal push in 2021 is in a range of 1 to 2% of GDP – the main exception being Italy, slightly north of 3%. On average, this would be lower than the smallest possible fiscal stimulus on the US side (USD 500bn, 2.5% of GDP, which is still officially the red line of the Republican Senators – more on this in the next section). We suspect that some of this hesitation may have to do with the lingering doubts surrounding the Next Generation EU initiative. From this point of view, the EU Council meeting this Thursday could be a key moment.

We have seen some movements on the "rule of law" spat last week. We had mentioned earlier in Macrocast the possibility that the unified front between Budapest and Warsaw would crack given their different geopolitical stances. It might be happening, although it is taking a microscope to see this. Polish Vice Prime Minister Gowin acknowledged that failing to agree on the multi-annual financial framework, and hence the impossibility to disburse on new spending projects, would hurt. To quote his words exactly, "*a provisional budget will be unfavourable to Poland and to the 26 other member states*" adding that "a *compromise is possible*". He went as far as to describe what could constitute a deal: a binding declaration unanimously approved by the EU Council clarifying how the "rule of law" sanction system would be enforced. This would open an interesting avenue, since the framework itself would not change, reducing the risk of yet another conflict with the European Parliament, which considers it has compromised enough already on this. It is only a tentative move though, since the Polish government released on Friday a statement according to which it "*maintains its position in its entirety*". Gowin, who is a moderate, may not reflect the consensus position of the Polish cabinet.

Exhibit 2 – Strong public opinion support for the EU in Poland Exhibit 3 – In Hungary as well



We are even further from this in Hungary. In an interview the following day of Gowin's statement, Prime Minister Orban expressed the view that the declaration approach would be "unworkable". He seems to be ready to take his collision with Brussels to the next level. Commenting on the UK's decision to authorize even before the US authorities the two vaccines by Pfizer and Moderna, he opined that "outside the EU countries can move faster" – which is factually wrong since the EU's rules explicitly allow member states to grant emergency licenses without waiting for the decision of the European Medicines Agency, which can be seen as an allusion to the fact that Hungary itself could contemplate leaving. We don't think this is a likely avenue for Orban, beyond the financial cost of forfeiting the structural funds, given the strong attachment of Hungarian public opinion to the EU, in contrast with the situation which prevailed in the UK before Brexit (a similar picture emerges for Poland, see Exhibit 2 and 3) even if the low frequency of the Eurobarometer poll does not allow to check how the current spat is influencing public opinion. However, for now, it is not obvious that this Thursday's meeting will unlock the situation.

The European Council won't be able to focus on the East only. Strong winds continue to blow from the West as well. We are approaching pantomime season in the UK and we are tempted to read the ups and downs of the "deal negotiation saga" as a succession of set pieces building to a last minute denouement – possibly on Thursday's European Council and our baseline remains that if everyone is rational – which may well be a strong assumption – a very mediocre Free Trade Agreement will be signed within the next few days. Still, the chances of a failure remain uncomfortably high.

British Conservative Prime Ministers, one after the other, and irrespective of their own attitude towards the European Union, discover that there is a wing of their party which will never be satisfied by any type of deal with the EU entailing the slightest form of compromise on sovereignty. Those "ultras" keep moving the goalposts on what form of Brexit would satisfy them (they campaigned in 2016 on the idea that the UK would remain in the single market, which they now consider as the mother of sovereignty infringement). **The ultra-Euro-sceptics were at least indirectly responsible for the demise of ALL conservative Prime Ministers since John Major in 1997. Boris Johnson seems intent to avoid this fate.**

He has more than enough votes in parliament to get an FTA approved on the UK side even with a sizeable rebellion in his camp (the opposition leadership, although it is dealing with internal dissent, will lend him the necessary votes). But the extreme Brexiteers could launch a challenge on his leadership if he fails to snatch from Brussels a deal with significant concessions on fishing and/or regulatory alignment. Given his weak standing in the polls and among all segments of the Tory party at the moment, Boris Johnson may not be inclined to take that risk. Going for "no deal" to appease his ultras would not buy him much time though. In a "no deal" outcome, the sum of political hurdles Johnson would need to overcome would be staggering: the fallout of "no deal" would compound the impact of the second pandemic wave on the economy, while stoking tension in Scotland and Northern Ireland. Rational calculus would normally have Johnson take the risk of a showdown with the Brexiteers now. If he survives the next few weeks after bringing back an FTA, his chances to enjoy four "OK years" before the next elections would be higher. But this politician's mettle has never really been tested.

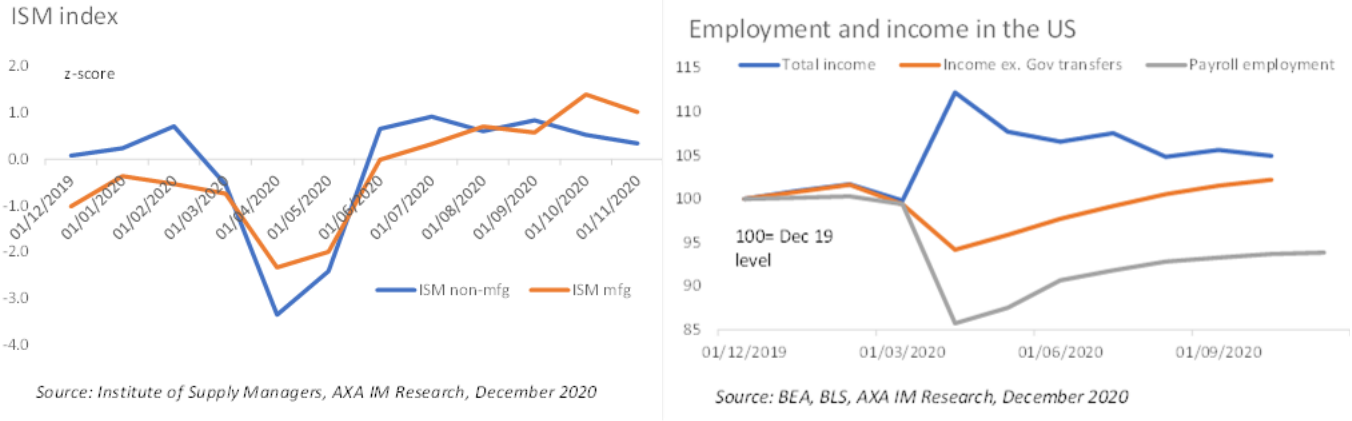
US: the return of the centrist knights

Meanwhile, the data flow confirms that the US strong "acquired speed" on the restoration of business conditions is fading as the second wave of the pandemic continues to gain power (it seems the peak in infection has not yet been reached judging by positivity rates) forcing more and more states to implement restrictive measures**. Google mobility reports have started to head south for the US as well, losing c.10 percentage points in one week. Traditional macro indicators are starting to soften as well**. The levels of the surveys remain higher than in Europe – the ISM index is still above its long-term average in both the manufacturing and the non-manufacturing sector (see Exhibit 4), but the deterioration is now visible.

The weakness in the labour market which we have been tracking for some time in the weekly jobless claims was confirmed last Friday in the payroll data for November which came out very soft at 245k versus 460K expected, down from 610K in October. The pattern we had been worried about since the end of the summer seems to be materializing: total household income is falling back from the heights of the spring, as the contribution of government transfers is disappearing (see Exhibit 5). Underlying income has been recovering, but this is unlikely to continue as job creation is losing steam.

Exhibit 4 – US business surveys losing their shine

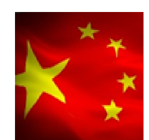
Exhibit 5 – Softly softly goes the US labour market



Source: Institute of Supply Managers, AXA IM Research, December 2020

Source: BEA, BLS, AXA IM Research, December 2020

The equity market has barely taken notice, as the confirmation of challenging cyclical conditions is raising the probability of a fiscal stimulus package. We described two weeks ago in Macrocast how even the Republicans' red line at USD 500bn would still provide some decent short-term relief by prolonging the emergency federal unemployment benefits schemes and avoiding an ill-timed fiscal tightening by local authorities. We may get more. A bi-partisan group of 10 Senators is proposing to add to these two key items nearly USD300bn for small businesses – key to get the Republican base on board – as well as some specific additional schemes for sectors such as air transport. The total package would exceed USD900bn (c.5% of GDP), very close to the assumption we used to build our 2021 forecast for US GDP growth. It's not the first centrist proposal to come out, but the new development is that President-elect Biden has publicly supported it (as a "down payment" towards his more ambitious plans) as well as the leader of the Democrats in the Senate. The end of this week is the deadline for "continuing resolution" which would avoid a shutdown of the administration. Such resolution itself is hardly in doubt, but the fiscal package could be tagged to it. A demonstration of bipartisanship in December already would be a strong illustration that the ultra-confrontational Trump era is drawing to a close.

Country/Region	What we focused on last week	What we will focus on this week
	• Payrolls rose by 245k, far short of consensus. Jobless at 6.7% on lower participation. • ISM manu and non-mfg Nov indices fell • Beige Bk “little or no growth” in several areas • Stimulus talks resumed around new bipartisan proposal of $908bn • States tightened restrictions as virus set new daily highs	• US CPI inflation for November expected to soften to 1.1% headline, 1.5% core • US jobless initial and continuing claims to see latest developments • New cases peaking after increased restrictions
	• German federal and regional governments agree to extend lockdown light to January 10 • German factory orders and VDA car production were solid, echoing strong PMIs • France INSEE sees activity 8% below normal in December, with Q4 down 4.5%qoq • Spain approved its first budget since 2018, with the coalition relying on regional parties	• ECB recalibration to include 1) PEPP extension in time (at least end-21) and size (at least EUR400bn); 2) longer TLTRO discount period (at least end 21) and new tenders; 3) increase in the tiering multiplier • EU summit to focus on the EU budget • German industrial production to show further momentum in October
	• UK medical authority approves Pfizer vaccine • UK lockdown eases, PM Johnson sees Tory rebellion on Tier system that replaces it • Mortgage approvals and house price gains illustrate buoyant housing activity • Chancellor Sunak discusses tax hike possibility, PM business tax cuts	• UK-EU trade deal likely announced or not after this weekend. We expect a deal • UK GDP for October, we forecast output to dip in Oct, consensus +0.4% m/m • BoE Financial Stability Report published • BRC retail sales monitor for Nov to gauge impact of lockdown
	• Oct industrial production rose by 3.8%mom but remains at -3.9% of Oc in Oct 2019 level • Unemployment rate rose to 3.1% (+0.1ppt) • Nov consumer conf is stable while services PMI is up to 47.8. We anticipate a decline as they don’t include recent restrictions yet	• Dec Reuters Tankan manufacturer index should be confronted by further restrictions • November bank lending should remain pretty high on year-on-year basis • Q4 business survey index is likely to highlight delayed recovery in investment
	• Multi-year high PMIs suggest continued solid expansion in manufacturing and services sector activities	• Strong gains in PMI export order foreshadow firm gains in export growth • CPI inflation is expected to ease further due to falling pork prices, while PPI deflation should wane
	• NBP on hold (0.10%), QE maintained • Asia export monitor points to steady recovery. Resilient Korean Nov. export growth 4%yoy • November PMIs suggest continued strength, with most economies showing expansion • Q3 GDP in Brazil +7.7%qoq with strong rebound in domestic demand thanks to policy support	• Central bank meetings: Brazil, Chile and Peru expected on hold • Mexico CPI (Nov) could be back within the central bank target range from above 4% • South Africa Q3 GDP release

Upcoming events

US :	Tue: Non-farm productivity (Q3, final); Wed: JOLTS job openings (Oct), Wholesale inventories (final, Oct); Thu: CPI (Nov); Fri: PPI (Nov), Michigan cons sent (prel., Dec)
Euro Area:	Tue: EA GDP (final, Q3), Ge ZEW survey (Dec); Wed: Ge CA, TB (Oct), Sp IP (Oct); Thu: ECB announcement, EU Council meeting, Fr IP (Oct); Fri: Ge, Sp HICP (final, Nov), Ge CPI (final, Nov)
UK:	Mon: Halifax housr price monitor (Oct); Tue: BRC Retail Sales Monitor (Nov); Thu: RICS Hoursing survey (Nov), Monthly GDP (Oct); Fri: BoE publishes Financial Stability Report
Japan:	Mon: Leading index (prel., Oct), GDP (final, Oct), CA (Oct), TB (Oct); Tue: Economy Watchers Survey (Nov), Private ‘core’ machinery orders (Nov)
China:	Mon: FX reserves (Nov), TB (Nov), Exports (Nov), Imports (Nov); Wed: CPI (Nov), PPI (Nov)

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