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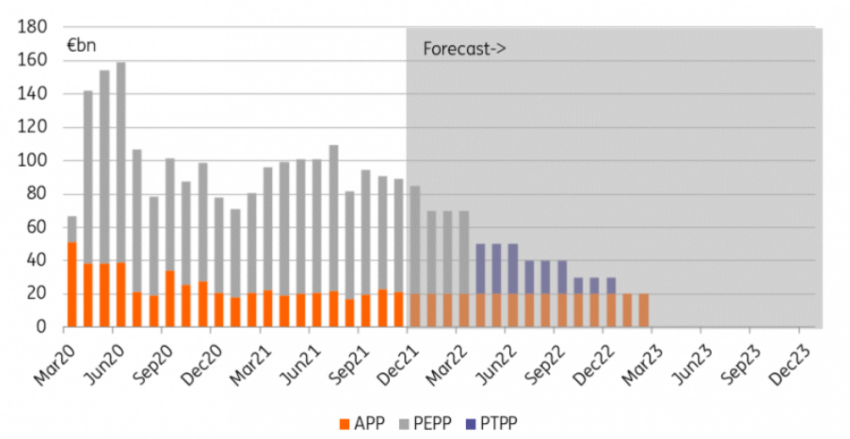
Rates: Our favourite ECB QE programme

At its December meeting, the European Central Bank is likely to decide on how to transition away from quantitative easing. The answer is probably by announcing more QE, temporarily. We argue it should retain as much optionality as possible. This is near-term dovish for rates, but paves the way to tightening

QE decision at the forefront of this week's meeting

It is difficult to keep track of the number of speeches and anonymous 'sources stories' leading up to this week's ECB meeting. One thing is certain, there have been many, and they only slightly narrowed down the range of potential outcomes. On the one hand, we feel reasonably confident in saying that the Pandemic Emergency Purchase Programme will not receive a boost in size, and that a decision on the Targeted Longer-Term Refinancing Operations will probably have to wait until the new year. On the other hand, we are faced with no less than three options regarding the future of the ECB's quantitative easing, provided this decision isn't also delayed until the new year due to the Covid-19 uncertainty.

We expect a new QE package to be deployed next year



Source: ECB, ING

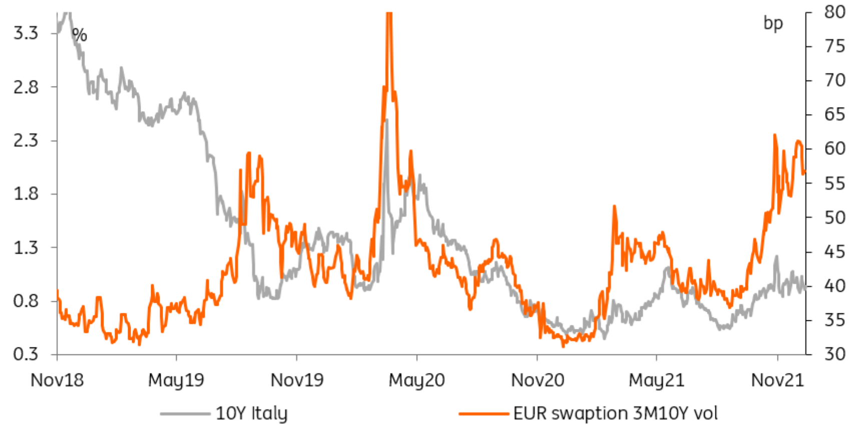
On the future of QE after PEPP's scheduled end in March 2022, three options emerge. From the most hawkish to the most dovish they are:

1. Allow PEPP's unused firepower (eg €100bn) to be spent flexibly over the course of 2022. This option could come with increased flexibility to reinvest the proceeds of existing PEPP holdings. This is the option most likely favoured by the hawks.
2. Boost the Asset Purchase Programme by either a fixed amount to be spent throughout 2022 (eg €200bn), or by adding a fixed amount of monthly purchases for the rest of the year (eg €20bn per month on top of the existing €20bn). This seems to be the market consensus.
3. Introduce a temporary programme sharing PEPP's flexibility but with a separate envelope (eg €300bn) to be spent in 2022. This is our favoured option.

Flexibility matters more than ever

Euro for euro, options one and three should have roughly the same market impact due to their equivalent flexibility, but the ECB has the possibility to give option three more firepower than option one as it has pretty much ruled out boosting the PEPP itself. This is one reason why we think option three is the most likely, and indeed the best to muffle market volatility ahead of the upcoming tightening cycle.

Containing rates volatility and peripheral yields will be key as the ECB tightens



Source: Refinitiv, ING

Boosting the APP is an inferior strategy in our view

Boosting the APP, option two, is an inferior strategy in our view as this programme is hindered by less flexible rules, and is therefore less well equipped to deal with temporary spikes in spreads. Worse still, if the ECB commits to fixed monthly amounts, it will set itself up for another difficult communication exercise once this programme needs to be tapered. Despite these drawbacks, this seems (judging from Bloomberg's survey of economists) to be our peers' favourite option. Maybe a case of 'better the devil you know'.

Towards a hawkish QE?

The ECB, and other central banks for that matter, have made it abundantly clear that the range of possible economic outcomes has broadened. As a result, there is a case to be made for leaving the most options available. Flexibility to conduct, and indeed stop, purchases in the event of a prolonged inflation overshoot comes to mind first but there is an even more important element: containing financial fragmentation.

Indeed, should spreads blow out on signs of accelerated tightening, it would put the ECB in a difficult situation: doggedly pursue monetary tightening at the risk of a financial crisis, or prevent financial fragmentation at the risk of losing control over inflation. This creates a dilemma for markets: the most dovish decision in the near term, as far as containing spreads is concerned, should also leave the ECB with the possibility of earlier, and larger hikes.

Even if we're right in calling for an increase in QE firepower, markets should take the hint: tightening is coming.

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