Events Round-Up

NZ: Food prices (m/m%), Aug: 0.7 vs. 1.1 prev.
EC: Industrial production (m/m%), Jul: -0.4 vs. -0.1 exp.
EC: Deposit Facility rate, Aug: -0.5 vs. -0.5 exp.
EC: QE purchase pace, Aug: €20b vs. €30b exp.
US: CPI (y/y%), Aug: 1.7 vs. 1.8 exp.
US: CPI ex food and energy (y/y%), Aug: 2.4 vs. 2.3 exp.
US: Initial jobless claims (k), Sep 7th: 204 vs. 215 exp.

Good Morning

The ECB announced a 10bp rate cut and the resumption of its QE programme from 1st November at its meeting overnight. The EUR and German bond yields initially fell in response, but they quickly reversed course and now both are higher on the day. Market sentiment has been boosted by incrementally more positive news on the US-China trade front, which has boosted equity markets and the CNY, although the NZD is surprisingly lower on the day. The global bond sell-off has extended, despite the ECB's actions.

At the ECB meeting overnight, the central bank announced a 10bp rate cut to the deposit rate, as expected, to -0.5%, and the resumption of its QE programme, at a pace of €20b per month. As widely expected, the rate cut was accompanied by the introduction of a “tiering” system, which exempts a portion of banks’ excess reserves from the negative deposit rate and is aimed at mitigating the negative impact on bank profitability, and hence banks’ willingness to lend. The ECB also made the terms on its TLTRO more generous, lowering the interest rate and extending the maturities from 2 years to 3 years.

While quantum of the QE programme was lower than analyst expectations of €30b per month, the ECB exceeded expectations on the duration, with the ECB statement saying that bond buying would continue until shortly before the ECB starts raising rates; this is effectively the ECB’s version of ‘QE infinity’. There are some technical aspects around QE that don’t appear to have been clarified, such as how the ECB will prolong its programme when its holdings of German bunds hit its self-imposed 33% threshold (which analysts estimate could happen within a year). Either the ECB will need to increase those thresholds or skew its purchases away from the ‘capital key’ (i.e. buying more Italy etc and less Germany going forward). That may be left for incoming President Lagarde, who will conduct a strategic review when she comes in. The ECB has previously bought bonds at an €80b per month pace.

As foreshadowed by speeches and interviews by several ECB Governing Council members in the lead-up to the meeting, there was clear internal opposition to the resumption of QE. According to Bloomberg, the governors of Germany, Holland, Austria France and Estonia, as well as two Executive Board members, opposed the plan, preferring to keep bond buying in reserve in case there were a crisis-like situation in the future. Draghi again called out for governments to do more on the fiscal policy front, saying “there was unanimity...that fiscal policy should become the main policy instrument.”

There had been growing doubts in the lead-up to the meeting that QE might be relaunched at all, and the announcement immediately sent the EUR and European rates lower. The EUR reached a low of 1.0927, near its lowest level since 2017, but it swiftly bounced back and is now trading at 1.1065, 0.5% higher on the day. Likewise, the German 10 year bund yield fell 6bps to -0.64%, but it has had a 12bp round trip and now sits at 0.52%. Positive news on US-China trade (see below), unwinds of speculative positions, and possibly some doubts among market participants around the ECB’s resolve (and ability) to deliver more stimulus – given the internal opposition to QE – explain the reversal in market rates. Encouragingly for the ECB, inflation expectations moved sharply higher, with the 5y5y inflation swap rising 8bps to 1.3%, and long-dated peripheral bond yields fell sharply, with Italy’s 10 year yield falling 10bps to 0.86%.

There have been incrementally more positive reports on US-China trade relations over the past 24 hours that have boosted broader market sentiment. Bloomberg reported that some Trump advisors had discussed offering a limited trade deal to China which would roll back tariffs (i.e. see the September tariffs unwound, with the tariffs planned for October and December not implemented) in exchange for a commitment from China to buy more agricultural goods and strengthen IP protections. The proposed mini-deal had not been run past Trump as yet and CNBC later quoted a senior White House source as saying it was “absolutely not” considering such a measure. Yesterday, Trump announced that the planned tariffs for October 1st would be delayed until the 15th of the month as a goodwill gesture, which the editor of the Global Times said would create “good vibes” for the upcoming trade negotiations.
And China is also reportedly considering whether to increase its purchases of US agricultural goods in the lead-up to the October trade talks as a goodwill gesture on their side. While market participants are naturally sceptical that there will be a ‘grand deal’ anytime soon between the two countries, the trend in relations between the two countries at least appears to be heading in the right direction.

Amidst the round-trip in European rates after the ECB, more positive reports on US-China trade and clear signs that market positioning has been caught wrong-footed, the global bond sell-off has extended. The 10 year Treasury yield has increased 5bps on the day to 1.79%, from a post-ECB low of 1.67%. A stronger than expected US core CPI release, which rose to an annual rate of 2.4%, added further impetus to the move higher in rates. Used car prices, one of the factors that had depressed core inflation earlier in the year, showed another outsized rise on the month, boosting the overall core index. NZ’s 10 year swap rate rose 4bps yesterday to 1.42% and we should expect that move to extend further today given the overnight moves.

The USD is weaker overnight, by 0.2% to 0.3% in index terms, largely reflecting the appreciation in the EUR and other European currencies after the ECB meeting. The risk-on market backdrop, which has seen the S&P500 rise another 0.6% overnight, and rise in Treasury yields has resulted in further gains in USD/JPY, which has moved up to 108.15, its highest level in six weeks.

Surprisingly, the better news on the US-China trade front, which has seen the offshore renminbi (CNH) strengthen by 0.6%, the improvement in market sentiment, and the rise in the EUR hasn’t done anything to help the NZD. The NZD has fallen away from an intraday high of 0.6451 to around 0.64 and it is now 0.2% lower on the day. The AUD is unchanged on the day, at 0.6865, and also hasn’t benefited from the appreciation in the CNH as one would have expected, given the tight correlation between the two currencies since the trade war erupted.

The NZ manufacturing PMI, which fell into contractionary territory last month, is released this morning.

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Coming Up

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<th>Period</th>
<th>Cons.</th>
<th>Prev.</th>
<th>NZT</th>
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<tbody>
<tr>
<td>NZ Manufacturing PMI</td>
<td>Aug</td>
<td>48.2</td>
<td>10:30</td>
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<tr>
<td>US Retail Sales (m/m%)</td>
<td>Aug</td>
<td>0.2</td>
<td>0.7</td>
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<tr>
<td>US Retail Sales Ex Auto and Gas (m/m%)</td>
<td>Aug</td>
<td>0.2</td>
<td>0.9</td>
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<td>US U. of Mich. Sentiment</td>
<td>Sep</td>
<td>90.8</td>
<td>89.8</td>
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Source: Bloomberg, BNZ

www.bnz.co.nz/research
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