UniCredit

Economics Research

The UniCredit Weekly Focus

Economics, FI/FX & Commodities Research
Credit Research
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"Central Bank Easing: The BoE's turn now!"

- This week's data flow was rather mixed, which is neither unusual for turning points, nor does it challenge our above-consensus view on Europe. With a pretty light data calendar next week, the ECB and BoE meetings will attract investors' attention – after the Fed moved center stage late last month with a rather dovish statement, saying it is not inclined to raise key rates until at least late 2014(!), making QE3 anything but less likely.
- Being in the midst of its two 3Y LTROs, the ECB is not expected to announce any significant changes in its policy settings next Thursday. Nevertheless, the Governing Council is confronted with a new dilemma, as Marco Valli argues in our first note: Whereas the financial & macro environment continues to improve, poor loan data and tightened credit standards have led to renewed discussion of a possible credit crunch.
- However, recent signs of a bottoming-out of growth indicators and the ECB's unprecedented unconventional measures will significantly reduce the risk of a credit crunch. We therefore stick to our view that the credit weakening over the course of 2012 will remain manageable. Although retaining its easing bias, Draghi's tone should be slightly more constructive, supporting our expectation of no further rate cuts in 2012.
- The BoE is expected to restock its QE measures by GBP 50bn next Thursday. In his piece, Mauro Marrano identifies the MPC's continuing concerns about the growth outlook as the main rationale behind this – despite recent improvements in business surveys and market sentiment. In addition, falling inflation leaves scope for further asset purchases.
- Price levels are even falling in Switzerland. While being primarily driven by the preceding strong CHF appreciation, the price declines are temporary and therefore not the beginning of a deflationary spiral. Accordingly, Alexander Koch does not expect falling prices to be a harbinger of further SNB policy action.

Editor: Nikolaus Keis, Economist (UniCredit Bank)

The Week in Retrospect

This week's data flow was more mixed when compared to the almost unabated string of positive surprises over the last few weeks. Nevertheless, this is neither unusual ("the road to recovery won't be a one-way street"), nor does it challenge our above-consensus view on the gradual global and European economic recovery at all.

On the bright side, activity and survey data continued to come in above consensus expectations. PMIs surprised on the upside in Italy (up 2.5 pts to a still depressed 46.8 pts), the UK (a jump to well above the 50 threshold), in the US (the ISM figure rose to 54.1) as well as in China and Japan. Global manufacturing output in 1Q12 is therefore likely to post a decent gain after having contracted in 4Q11. But as private consumption appears to have lost some momentum – German retail sales were rather disappointing, while US consumer confidence unexpectedly dropped – the threat of a downward adjustment of inventories is looming, thus limiting the pace of recovery in 1H12. In the US, for example, the accumulation of stocks contributed roughly two thirds to 4Q11 GDP growth, which was reported last Friday to have advanced at its strongest pace since mid-2010 (+2.8% annualized) – underpinning our view of a temporary setback before US growth picks up again by late spring as also indicated by rising incomes, strong core capital goods orders and receding initial jobless claims.

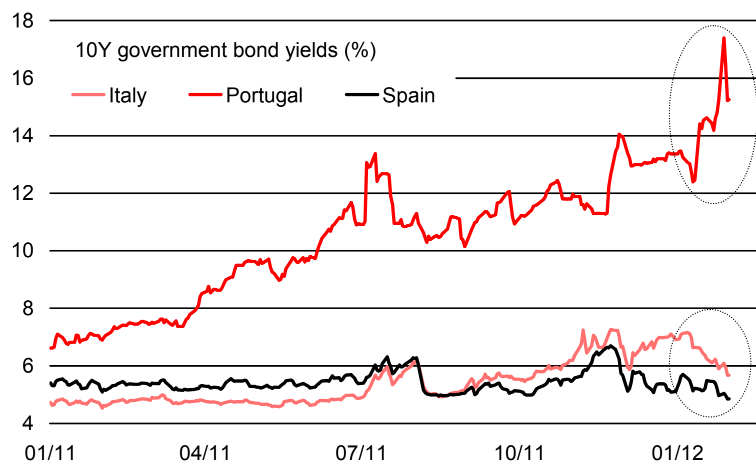
Labor market developments in Europe, by contrast, could not be more divergent. The German labor market continued to power ahead: Employment is currently up by roughly 50,000 per month, job vacancies recorded a record high and the unemployment rate fell back to a renewed post-unification low at 6.7% which, according to our expectations, is likely to fuel EMU recovery further down the road. However, the EMU-wide unemployment rate in December edged up slightly to 10.4%, the highest level in decades, masking huge divergences in both momentum and levels on a country level. Spain's unemployment rate almost hit 23% although the deterioration seems to be moderating. The Greek (lagging) number should have risen to above 20% in the meantime, while the situation is deteriorating in Portugal (13.6%). France and Italy are at least posting single-digit numbers (almost 10% or 9%, respectively). This striking divergence in general and the huge and mostly deteriorating labor market figures in the EMU's periphery in particular remind us of the delicate balancing act politicians face in further consolidating public budgets without jeopardizing economic activity and social coherence.

Another weak spot in Europe is poor monetary development data, which has led to renewed discussion of a possible credit crunch, posing a new dilemma for the central bank, which is already witnessing disproportionally tight financial conditions in those countries undergoing the toughest fiscal adjustment – as Marco Valli argues in the following focus piece. Last Friday's M3 report revealed that EMU-wide bank lending to the private sector plummeted by a widespread, record-high EUR 76bn, taking the yoy rate down to just 1% from 1.7%. And yesterday's ECB Bank Lending Survey (BLS) showed that in 4Q11 banks further tightened credit standards on loans to both non-financial corporations (NFCs) and households, while demand for loans from NFCs declined for the second quarter in a row, albeit to a lesser extent than in 3Q11. While it is always difficult to separate demand and supply-driven factors of rather complex loan developments, the BLS indicates that banks' perception of macroeconomic conditions and borrowers' risk profiles played a greater role than banks' balance-sheet constraints (such as liquidity positions and access to market financing). As we have repeatedly pointed out, it is not bank lending that drives GDP in the eurozone, but rather GDP that drives bank lending. Hence, it should come as no surprise that lending growth is petering out now if one recalls the sharp decline in GDP growth last spring. And while there is certainly the risk that banks may shrink their balance sheets instead of raising new capital to meet EBA requirements, it is far from certain that this will come predominantly from the lending side as opposed to adjustments in other assets, including items held abroad. But despite the risk that supply elements may put downward pressure on credit dynamics, it is likely that the worst of the crisis for the eurozone banking sector is already over.

Recent signs of a bottoming-out of growth indicators and the ECB's unprecedented unconventional measures, either already in place or in the pipeline, significantly reduce the risk of a credit crunch. We therefore stick to our view that the credit weakening over the course of 2012 in the eurozone will remain manageable. In contrast to the ECB's BLS, the Bank of England's (earlier) 4Q11 credit survey did not show much of a further tightening of loan standards (although lending data were pretty weak in December too) nor did the Fed's Senior Loan Officers Survey – at least for domestic banks, indicating that the EMU debt crises has not harmed Anglo-Saxon bank lending behavior much so far.

The recent newsflow on the European debt front gives reason for being cautiously optimistic, although there will be risks and setbacks over the next few weeks and months. The fiscal compact that 25 out of 27 EU leaders signed up to last Monday is a step in a positive direction. The pact includes binding limits on budget deficits and quasi-automatic sanctions on countries that violate deficit and debt limits. Ultimately Chancellor Merkel got what she has been pushing for – maybe at the price of a later agreement on a substantially larger firewall said to have been discussed in informal talks at Davos. Accordingly, the permanent ESM should not displace the EFSF but operate simultaneously, thus almost doubling lending capacity. The third EUR 500bn pillar is expected to be an IMF facility for which EMU countries have already promised EUR 150bn. Meanwhile, it seems that negotiations on a Greek PSI agreement will be concluded soon with yields for the new bonds most probably below 4% (as demanded by the troika) resulting in overall losses for private bondholders of more than 70% on the net present value. The key issue is the commercial creditors' participation ratio – if too low, then the risk of retroactive collective action-clauses increases, which would trigger CDSs. But we continue to expect the deal to be done without triggering CDSs. With an agreement in sight, market participants seem to be refocusing their attention on Portugal, where the fear is of Greek-like losses ahead. Portuguese 10Y yields shot up to almost 18%, their short-term counterparts even higher (see chart) before receding again after a successful 3M and 6M T-Bill auction. Although Portugal's economic position is better than Greece's, and while we cannot rule out some more serious problems further down the road (but not this year), we believe that markets have got ahead of themselves on Portugal.

TARGETING PORTUGAL, WHILE ITALY & SPAIN ARE PROFITING FROM THE ECB'S 3Y LTRO



Source: Bloomberg, UniCredit Research

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Major Data Releases & Economic Events To Look At Next Week

Date	Time (ECB)	Country	Indicator/Event	Period	CIB est.	Consensus (Bloomberg)	Previous
3 - 10 Feb 2012							
Fri, 03 Feb	9:00	TR	Consumer Price Index, CPI (% yoy)	Jan		10.5	10.5
	9:45	IT	Services PMI (index)	Jan	**45.6**	45.4	44.5
	9:50	FR	Services PMI (index)	Jan f	**51.7**	51.7	51.7
	9:55	GE	Services PMI (index)	Jan f		54.5	54.5
	10:00	EMU	Services PMI (index)	Jan f	**50.5**	50.5	50.5
	10:30	UK	Services PMI (index)	Jan	**55**	53.3	54
	11:00	IT	Consumer Price Index, CPI (% yoy)	Jan	**3.2**	3.2	3.3
	11:00	EMU	Retail Sales (volume, % mom)	Dec	**-0.5**	0.3	-0.9
	14:00	SP	Spanish Cabinet Meets; May Announce Bank Overhaul Rules				
	14:30	US	Unemployment Rate (%)	Jan	**8.6**	8.5	8.5
	14:30	US	Non-farm Payrolls (change thousands mom)	Jan	**140**	145	200
	16:00	US	ISM Non-manufacturing (index)	Jan	**53.5**	53.2	53.0
Sun, 05 Feb		FI	Finland Presidential Election (Second Round)				
Mon, 06 Feb		PO	Bank of Portugal Releases Data on Banks				
	9:00	CZ	Industrial Production (% yoy)	Dec	**0.5**	1.0	5.4
	12:00	GE	Industrial Orders (% mom)	Dec			-4.8
	12:59	RU	Consumer Price Index, CPI (% yoy)	Jan			6.1
	14:55	US	Fed's Bullard Speaks on Inflation Targeting in Chicago				
	18:15	US	Fed's Fisher Speaks on Economy in Washington				
Tue, 07 Feb	9:00	HU	Industrial Production (% yoy)	Dec			4.2
	12:00	GE	Industrial Production (% mom)	Dec			-0.6
	21:00	US	Consumer Credit (net change, USD bn)	Dec		7.0	20.4
Wed, 08 Feb	7:45	SZ	Unemployment Rate (%)	Jan			3.1
	8:00	GE	Exports (% mom)	Dec			2.6
	8:00	GE	Imports (% mom)	Dec			-0.1
	8:45	FR	Budget Balance (EUR bn)	Dec			-97.2
	9:00	TR	Industrial Production (% yoy)	Dec			-2.5
	12:00	EU	EU Issues First Alert Mechanism Report on Macro-Imbalances				
	12:59	PL	Central Bank Reference Rate (%)		**4.5**	4.5	4.5
Thu, 09 Feb	2:30	CH	Consumer Price Index, CPI (% yoy)	Jan		4.1	4.1
	10:30	UK	Industrial Production (% mom)	Dec	**0.2**		-0.7
	13:00	**UK**	**Bank of England Repo Rate (%)**		**0.5**	**0.5**	**0.5**
	13:45	**EMU**	**ECB Refi Rate (%)**		**1.0**	**1.0**	**1.0**
Fri, 10 Feb	8:00	GE	Consumer Price Index, CPI (national, % yoy)	Jan			2.0
	8:45	FR	Industrial Production (% mom)	Dec	**-1.5**		1.1
	9:15	**SZ**	**Consumer Price Index, CPI (% yoy)**	**Jan**			**-0.7**
	10:00	IT	Industrial Production (% mom)	Dec	**-0.1**		0.3
	14:30	US	Trade Balance (USD bn)	Dec	**-48.5**	-48.4	-47.8
	15:55	US	University of Michigan Consumer Confidence	Feb	**73.5**	75.0	75.0
	20:00	US	Federal Budget (USD bn)	Jan		-65.0	-86.0

ECB between better sentiment and weaker credit

- The 9 February ECB meeting is unlikely to bring any relevant policy change: we expect the refi rate to remain on hold and no announcement of further unconventional measures. But incoming data indicate that the ECB will be facing tough choices in the coming months.

- The main reason is the increasing divergence between the message of the economic and monetary analysis: while the financial/macro environment is gradually improving, money and credit growth is weakening substantially. This poses a new dilemma for the central bank, which is already witnessing disproportionally tight financial conditions in those countries undergoing the toughest fiscal adjustment.

- In our view, however, positive news outweighs negative news. In the eurozone, lending is mostly a lagging indicator, and the acceleration of the downward trend in credit growth is largely the reflection of the intensification of the sovereign-debt crisis in 2H11. If recent positive signs from financial markets and the real economy are confirmed in the coming months – and we think they will – a credit crunch will most likely be avoided.

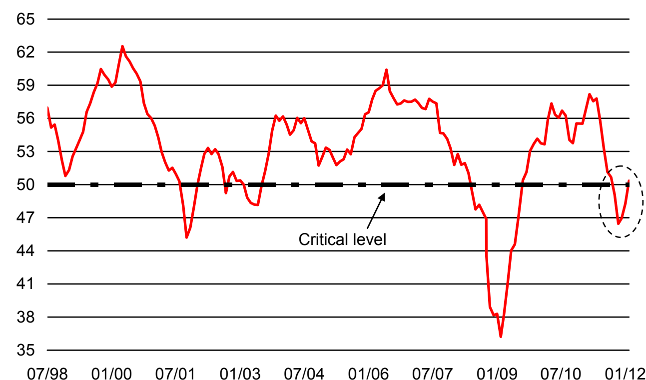
- Accordingly, next week the ECB is bound to retain a clear easing bias, but the overall tone should be slightly more constructive and start providing some support to our view of no further rate cuts in 2012. Our Taylor rule also points in this direction.

Economic and monetary analysis diverge

When the ECB meets on 9 February, the GC will be confronted with a mixed picture. On the one hand, indicators of economic activity suggest that the cyclical low may be behind us (see left chart), and improved sentiment in financial markets bodes well for the sustainability of this moderate recovery in the real economy. On the other hand, credit aggregates are witnessing intensified downward pressure, as shown by the latest set of money/lending data and the further increase in the net tightening of lending standards highlighted by the Bank Lending Survey (BLS) for 4Q11 – see right chart. Overall, the most likely outcome next week is a steady refi rate and no new announcements of unconventional measures. However, the divergence in the economic and monetary analysis puts the ECB in an uncomfortable position, and adds to the other dilemma the central bank has been facing for quite some time: the severe impairment of the monetary policy transmission mechanism and the consequently tighter financial conditions in those countries that are going through the toughest fiscal consolidation.

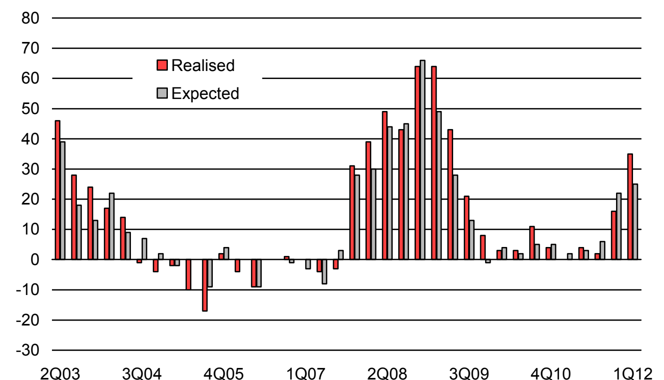
ACTIVITY IS STABILIZING

EMU Composite PMI



AGGRESSIVE TIGHTENING OF LENDING STANDARDS

Net tightening of lending standards of loans to enterprises (NFCs)



Source: ECB, Markit, UniCredit Research

Our Taylor rule is consistent with no more cuts (but downside risks!)

ECB policy – both conventional and unconventional – is the result of the cross-checking of the information arising from the economic and monetary analysis, i.e. the two pillars of the central bank's monetary strategy. When the two analyses send conflicting messages, the ECB's decisions tend to become more difficult. We resort to our Taylor rule to better understand the implications for future policy action of the current and expected trends in economic activity and credit. Note that our own formulation of the Taylor rule is particularly suited to today's environment because it employees lending rather than CPI as an explanatory variable together with a gauge of economic slack.

Taylor rule

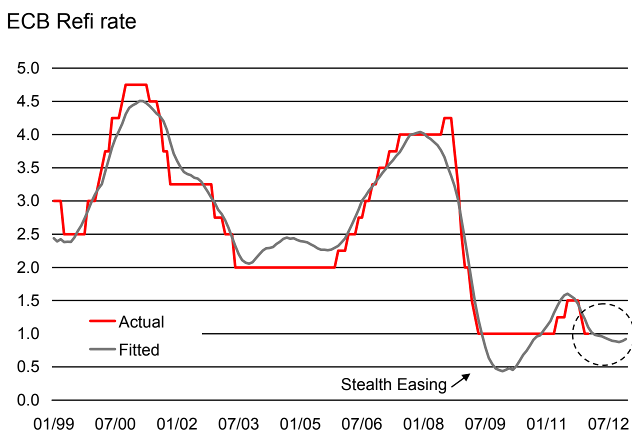
Our Taylor Rule for the euro area brings together the first and the second pillar of the ECB's monetary policy strategy. It provides a real-time monthly estimate of the fair level of the refi rate based on 1) a PMI-based gauge of the output gap as a real-time (unrevised) proxy for the degree of slack in the economy; 2) the yearly growth rate of lending to the private sector. The algorithm is:

$$\textit{Refi Rate}_t = c + \alpha * O_GAP_{t-1} + \beta * LENDING_{t-2} + \varepsilon_t$$

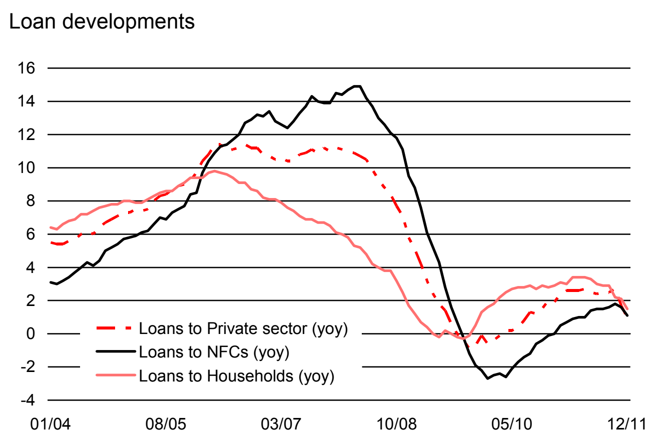
Note that the lags intend to capture the different timing with which information becomes available to the ECB. For example, when setting interest rates at the February meeting, the ECB will have in hand January PMIs and December lending data.

The algorithm shows that in November-December 2011 the ECB moved somewhat preemptively, probably pushed by the particularly acute stage of the crisis and, possibly, a slightly different reaction function under President Draghi. However, the "fair" level of the refi rate has now dropped back in line with the actual refi rate and, based on our forecasts for economic growth and lending, it will bottom out at around 0.80%-0.90% in the course of the year (see left chart). The reason for this further small decline is the widening of the output gap expected in 1H12 – although at an increasingly slower pace – and the projected ongoing deceleration in credit aggregates. This simple exercise shows that, if GDP and lending move in line with our forecasts (on GDP, we are slightly more bullish than the central bank) and the ECB responds mechanistically to them, the refi rate is likely to be left at 1% throughout 2012, with some risk of a 25bp cut. Last month, Draghi suggested that the central bank does not have in mind any specific floor for the policy rate, and is going to be very pragmatic when assessing the need for cutting below 1%.

REFI RATE NOW IN LINE WITH RULE, NO CUTS AHEAD



LENDING SLOWDOWN: MORE TO COME



Source: ECB, Markit, UniCredit Research

Forward-looking vs. backward-looking information

Our rule has proved to be quite accurate in the past, and this time around we see one more reason to follow its policy prescription and stick to our forecast of no rate change. This is the following: recent signs of improvement are recorded in the variables that enter the growth assessment of the economic analysis, which is the most forward-looking part of the introductory statement. In contrast, the deterioration is concentrated in credit growth, which in the eurozone is mostly a backward-looking variable (see left chart). At this stage, credit trends are heavily influenced by the intensification of the debt crisis last summer, which caused a substantial tightening of lending standards and a drop in loan demand. If not properly tackled, this risks starting a vicious cycle. But if recent positive signs on financial markets and the real economy are confirmed in the coming months – and we think they will – the pace of credit deterioration should progressively ease during the course of 2012, a credit crunch will most likely be avoided, and mid-term risks to price stability are going to remain broadly balanced. This is what we expect in greater detail for next week's economic and monetary analysis.

Economic analysis

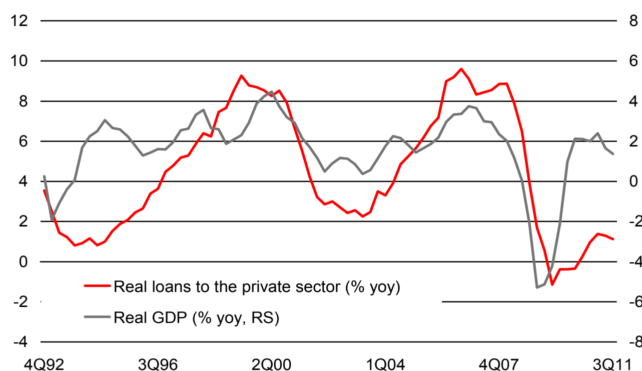
At this stage, the ECB's growth assessment is mostly centered on two elements, as can be inferred from the introductory statement: **1)** developments in financial markets; **2)** trends in growth indicators – we assume mostly business surveys, which are timelier than hard data and therefore more informative for a forward-looking analysis. On both fronts, the intra-meeting newsflow has been quite positive, most likely exceeding the GC's expectations.

1) In the financial market space, tangible signs of relief are now visible across several asset classes, and we think this is largely the effect of the first 3Y LTRO. We expect some of these positive market developments to support economic activity already in the very near term. For example, the acceleration of the downward trend in our Financial Market Index (right chart) on the back of rising equity prices, falling volatility and tighter corporate spreads, signals increasingly favorable growth conditions. Our analysis shows that changes in these financial variables start producing a discernible impact on economic activity with just a short lag.

Financial Market Index (FMI)
The FMI aggregates in one single indicator the signal coming from the financial market variables that display the highest predictive power for GDP growth. These variables are volatility (VDAX), equity prices (DJ Euro Stoxx 50) and corporate spreads (BBB, 5-7Y). Volatility and spread enter the algorithm with a positive sign, equity with a negative sign. The FMI is negatively correlated with economic growth and leads eurozone GDP by one quarter, and the composite PMI and Ifo expectations by one month.

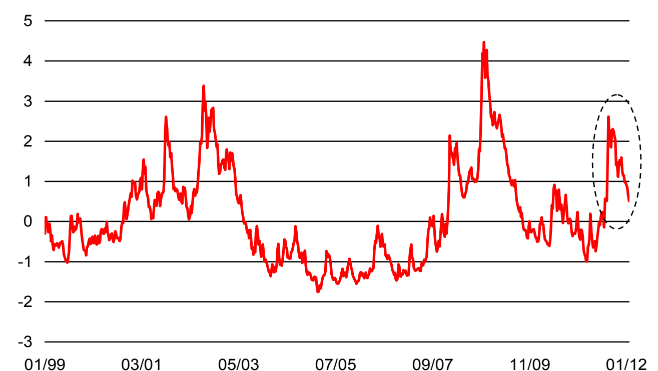
LENDING LAGS GDP

Real Lending vs. Real GDP



FINANCIAL MARKET TENSIONS ARE EASING

Financial Market Index



Source: Bloomberg, ECB, Eurostat, UniCredit Research

Other effects of the 3Y LTRO will probably take more time to feed through to the real economy. This is the case of the drop of funding costs for governments and banks. In Italy and Spain, sovereign spreads have tightened significantly across the whole yield curve, with Italy's long end rallying more than 100bp from early January. Concurrently, also bank funding pressures have eased, with the unsecured debt market showing signs of re-opening, and gauges of subordinated debt risk falling markedly (see left chart). All in all, while long-term liquidity can do little to address public debt sustainability and bank recapitalization needs, it seems to have been very effective in providing insurance against bank refinancing risk. In this respect, the January ECB Bulletin shows a clear correlation between banks' bidding behavior in the 3Y LTRO and their rollover needs. By significantly reducing the risk of a negative feedback loop between the sovereign and the banking sector, the first 3Y LTRO may well have marked a turning point in market sentiment and, probably, the real economy. At the same time, however, the ECB must stand ready to do more to restore similar monetary conditions across the eurozone. In our view, a bolder approach to the SMP remains the most effective way to go.

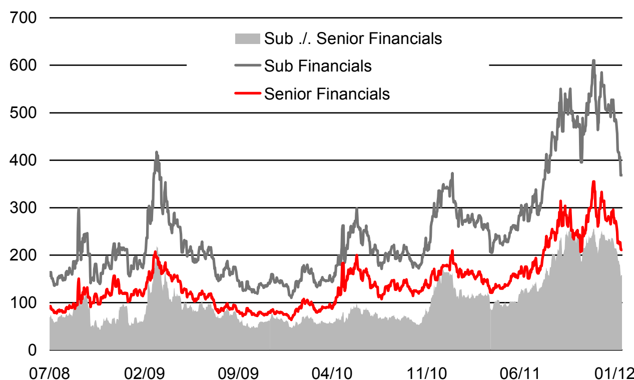
2) On the activity front, the January round of business surveys surprised to the upside. The Markit composite PMI jumped back above 50, the EuroCOIN rose for the first time since May 2011 (although still pointing to slightly negative growth, see right chart), while the Ifo expectations index recorded the third increase in a row, which typically signals a turning point in the German – and therefore also eurozone – business cycle. All this suggests that 4Q11 was probably the GDP trough. In turn, this supports our view that the eurozone may exit contraction territory already in 1Q12, and leaves on track the ECB's December set of GDP forecasts (+0.3% in 2012 and +1.3% in 2013). As the risk of a free-fall in growth indicators declines and the ECB becomes more confident about its GDP central tendency – recent comments by GC members tend in this direction – the next step for the central bank would be to slightly modify the introductory statement to mitigate the "substantial" downside risks to the growth outlook. Barring an unexpected shock, this modest change in rhetoric may already happen next week or in March, when the ECB will release updated macroeconomic projections. The overall tone, however, should definitely remain cautious, as the economy will probably remain anemic for some time, and therefore extremely vulnerable to shocks. Downside growth risks are unlikely to disappear from the introductory statement in the next few months.

Monetary analysis

This is where we expect a more dovish tone, as the ECB will probably acknowledge that past heightened financial market tensions have started to impact the supply of credit. After having held up relatively well in the previous months, lending to the private sector in December 2011 recorded the largest negative flow since the inception of the loan series (EUR -76bn).

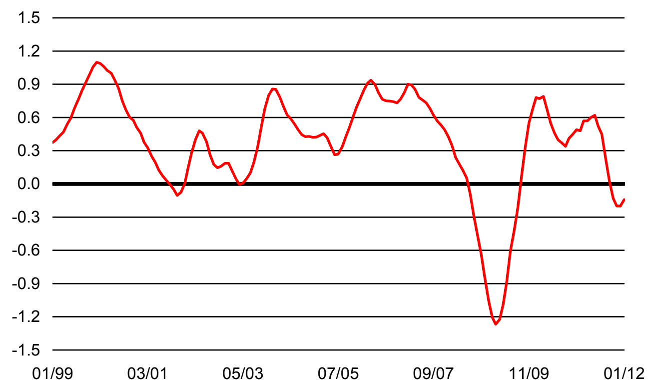
SIGNS OF RELIEF FOR SUBORDINATED BANK DEBT

5Y CDS



€COIN BOTTOMS OUT

EuroCOIN



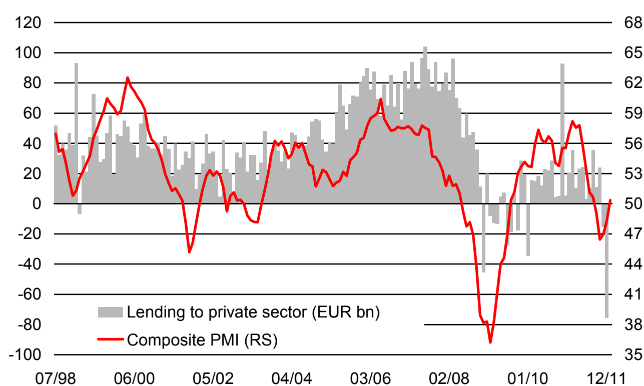
Source: Bloomberg, BoI, UniCredit Research

Monthly data can be very volatile and therefore need to be handled with caution, but this sudden leg down in credit trends deserves close monitoring because, if genuine, weakness would go beyond a pure demand-driven slowdown. This can be easily seen taking business surveys and credit flows in the post-Lehman environment as a term of comparison (see left chart). It emerges clearly that, this time around, the credit deterioration vis-à-vis economic activity is more pronounced compared to early 2009, when most observes – including us – tended to rule out a credit crunch. We think that this will provide the ECB with sufficient evidence to conclude that some supply-side effects are starting to play a role, particularly after the Bank Lending Survey for 4Q11 showed an intensification of the net tightening of credit standards (from the already high level recorded last summer).

However, the expected dovish shift in the monetary analysis needs to be put into context, given that the ECB had preemptively positioned itself for a meaningful credit slowdown involving also some supply-side factors. Since November, introductory statements have explicitly acknowledged the possibility that supply constraints can materialize with a lag. It is therefore highly likely that some of the bold policy response (both conventional and unconventional) of the last few months has been engineered to counter the rising risk of credit rationing. With the second 3Y LTRO to be held at the end of February (and this time banks will take advantage of looser collateral rules), we assume that the ECB will want to assess the response of financial markets, the banking sector and the real economy to the huge stimulus already in place and in the pipeline before delivering additional easing. Recent positive signals from the financial/macro environment mean that the ECB does not have to rush. But there are two other factors that further strengthen the case for a wait-and-see approach. The first one is the Eonia curve, which already trades at a very low level (around 0.35%-0.40%). The second one is pipeline disinflation, which seems to have come to an end. After having recorded a sharp drop from the cyclical highs of March 2011, the European Commission gauge of selling price expectations has now stabilized (see right chart). These signs of bottoming out, at levels significantly above those prevailing at the trough of the 2009 recession, seem to indicate little or no risk of deflation.

SUPPLY-SIDE CREDIT CONSTRAINTS?

Lending vs. Business Surveys



PIPELINE DISINFLATION COMES TO AN END

Core PPI vs. Selling Price Expectations

Source: EC, ECB. Eurostat, Markit, UniCredit Research

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BoE: More QE likely next week

- Next week's MPC decision will be based on the new forecasts, which will be published the week after in the Inflation Report.
- We expect the MPC to announce a further GBP 50bn in asset purchases, which will bring the total stock to GBP 325bn (22% of GDP).
- The main reason for our call is that, despite some recent improvements, the MPC will likely remain concerned about the growth outlook and might thus opt for providing more stimulus to the economy. In addition, falling inflation leaves scope for further asset purchases.
- Regarding the effects on Gilts and sterling, the announcement of additional GBP 50bn will likely have a limited impact on Gilts but it could still cool any GBP-USD rally.

MPC likely to remain concerned about the growth outlook

Next week, MPC members will gather to decide on monetary policy. The asset purchases announced in October (GBP 75bn) will be completed soon and the attention at this meeting will thus focus on whether the MPC will decide to provide more stimulus to the economy. The decision will be based on its updated forecasts, which will provide MPC members with the opportunity to take a fresh in-depth view on the outlook for growth and inflation. Will they announce further purchases? Will they see the need for more stimulus? We think so. Our expectation is for an increase in the stock of purchases by GBP 50bn.

The MPC's fundamental concern during the last few months has been the risk that demand growth will be insufficient to absorb the margin of spare capacity in the economy, causing inflation to fall materially below target in the medium term. Back in November, when the forecasts were last updated, this concern was reflected in the expectation for inflation to fall below target over the forecast horizon as the most likely outcome. This takes into account the asset purchases announced in October (GBP 75bn). At the time, GDP growth was expected to remain below potential during most of 2012, suggesting a widening output gap, with significant downside risks in the near term. While there has been some improvement in the UK growth outlook, with business surveys appearing to have bottomed out, signs of stabilization emerging in the euro area, and improving financial market sentiment, we think the MPC's views have not significantly changed. The reasons behind their growth worries are still in place:

– Risk of tightening credit conditions. Financial market sentiment has improved, and this appears to have somewhat reduced bank funding costs (proxied by the average CDS of the UK's five main lenders). However, bank funding costs remain high and – while the BoE Credit Conditions Survey for 4Q shows that these costs have not been passed on to consumers – their persistency at high levels might lead to tighter credit conditions and thus affect spending.

– The EMU debt crisis remains a key risk. In November, the EMU debt crisis was identified by the MPC as the greatest risk to the UK economy. The deterioration of the crisis that has taken place since the summer, was arguably one of the key reasons why the BoE embarked on a new round of asset purchases in October. Although there have been some signs of improvement, the MPC is still likely to see the EMU debt crisis posing significant downside risks to the UK outlook. Recent speeches by MPC members seem to confirm this.

– Subdued household spending outlook. After having contracted between 4Q10 and 2Q11, consumption was flat in 3Q11. However, consumer confidence remains close to historical lows and is set for a gradual recovery in light of the recent squeeze in real disposable income, tight credit conditions, fiscal consolidation, and the need for balance sheet repair.

- Weakness in the labor market points to significant slack in the economy. Recent data show that the labor market is weakening. The unemployment is at a 15-year high and further deterioration is likely. This will constitute an addition factor impacting household spending. The slack continues to be reflected in subdued wage growth.

Less upside risks to inflation

Declining inflation leaves scope for further asset purchases. The MPC assessment has been proven right: inflation, after peaking in October at 5.2%, has started to recede. It is now at 4.2% (December), in line with the BoE forecasts, and will fall further in the coming months as last year's increases in VAT and commodity prices fall out of the annual comparison and some spare capacity in the economy remains. The MPC is thus likely to be more confident about its forecast for inflation. In addition, inflation expectations have declined in January and wage growth remained subdued.

More QE likely

Summing up, despite some recent positive developments, the continued weakness in the domestic economy, the risks stemming from the EMU debt crisis, and the possibility of tighter credit constraints, suggest that the MPC wants to ease monetary conditions through further asset purchases in order to support the economy. In light of the positive developments, however, the MPC might opt for an amount of additional asset purchases at the lower end of the spectrum. Our expectation is for an additional GBP 50bn. We will discuss the impact on Gilts and sterling below.

Impact on Gilt yields

While it is difficult to separate the impact of the latest round of QE on gilts from the effect of the EMU crisis (which also led to a drop in Gilt yields), a useful analysis is to compare the performance of 10Y gilts vs. 10Y USTs, as both asset classes have benefited from the EMU crisis. In the UK and in the US, the central banks embarked on QE, but in the UK the BoE bought a much higher proportion of M/L-term govies stock than the Fed (25% vs. 13% for the Fed).

The spread between 10Y Gilts and 10Y USTs has always been positive historically, with 10Y Gilt yields trading above 10Y USTs (the only exception was between the end of 2005 and the end of 2006). Since the beginning of 2009 (when the BoE started its APF scheme), this spread started to gradually compress, moving from the 50-100bp range to the 0-50bp range. This trend became even more evident over the last three months when the spread between 10Y Gilts and 10Y USTs went flat (it has now come back to 20bp), following the BoE announcement of a step-up of QE in October and hints of further QE in the November IR. Therefore, the BoE's QE has indeed achieved its aim of lowering Gilt yields (which triggers the portfolio rebalancing effect and ultimately supports demand).

With respect to next week's meeting, consensus (and UniCredit) expectations are for a GBP 50bn increase in asset purchases. If this outcome is confirmed, we expect market reaction to be rather limited. We would anticipate a further drop in yields below 2% in case the BoE announced a higher-than-expected amount of purchases. In case the BoE leaves the stock unchanged, Gilt yields should increase, although the movement should be short-lived, as the macroeconomic outlook is still challenging and given ongoing uncertainties with respect to the EMU crisis.

Impact on sterling

GBP-USD has apparently created some solid base-building above 1.57 and finally even broke 1.58: the UK PMI survey came in firm, but sterling's recovery has been mostly driven by the USD retreat amid rallying stocks. However, further GBP strength could easily be halted, as we expect the BoE to resume asset purchases at next week's MPC meeting, at least another round of GBP 50bn up to a total of GBP 325bn. Such a move will hardly come as a surprise, but it should still cool down any GBP-USD rally and eventually spur a pullback towards 1.57, if the BoE acts more aggressive or hints at further purchases. EUR-GBP should reflect EUR-USD and GBP-USD moves, but the GBP retreat we see against the USD should offer a new opportunity to test the 0.84 area.

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Falling prices no harbinger of further SNB policy action

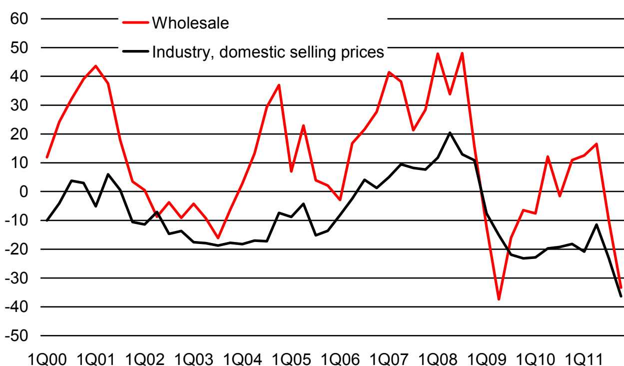
- Swiss January consumer price figures, to be released on 10 February, will show another clearly negative annual headline rate (UniCredit: -0.8%). Moreover, selling price expectations underscore continuing downward pressure in the short term. This implies an undershooting of the SNB's inflation projections, which does, however, not increase the likelihood of further policy action.
- Falling consumer prices remain driven by the strong franc. Despite the minimum exchange rate, the extent of appreciation remains very high. The FX effect has meanwhile fed through largely to consumer prices. But a gap remains, which is likely to be closed in the coming months.
- Despite the deteriorated export situation, the domestic economy is holding up well. In our and the SNB's baseline scenario, the Swiss economy will avoid deeper contraction. Hence, the likely temporary nature of imported deflation is not harmful. On the contrary, it improves the purchasing power of households. Consequently, a stronger fall in consumer prices in early 2012 does not herald increased medium-term deflation risks.

Headline inflation in negative territory

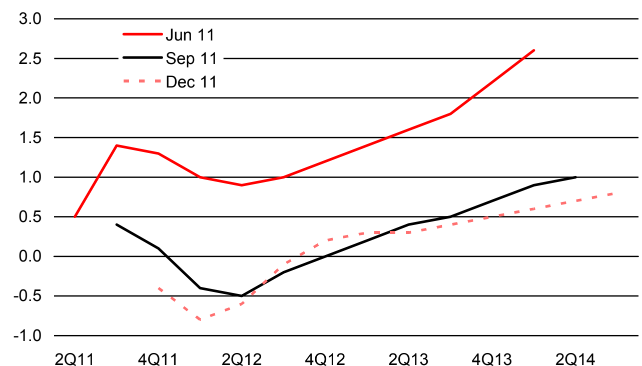
Swiss consumer price inflation turned negative in the fourth quarter. The annual headline rate declined to -0.7% in December. Next week's release of January figures should bring another modest downward movement (UniCredit: -0.8% yoy). And the downward pressure on prices persists in the short term. This is impressively reflected in the selling price expectations of firms in the industrial and wholesale sector for the next three months. Quarterly survey results at the end of the year showed new cyclical lows across the board (see left chart below). Accordingly, we expect headline inflation to drop to around -1½% by March. With the consolidation in the oil price over the last year, the energy price contribution will decline substantially at the same time, driving down the core rate even stronger.

The current inflation projection of the Swiss National Bank (SNB) foresees a more muted drop to "only" -0.8% in the first quarter (see right chart below). So, if the upcoming data releases come out in line with our inflation picture, the SNB will have to revise down their projections by the next quarterly monetary policy meeting in mid-March.

Selling price expectations, diffusion index



SNB conditional inflation projection, yoy (%)



Source: KOF, SNB, UniCredit Research

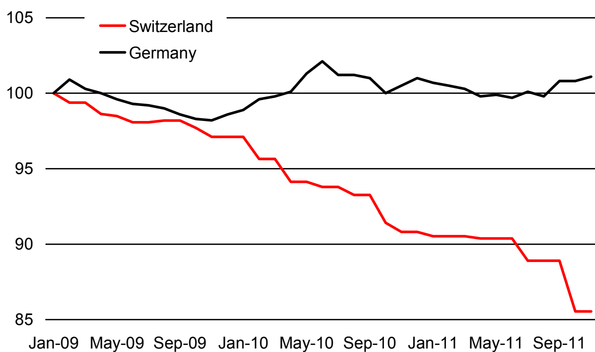
SNB officials reiterated in their latest statement that the central bank is ready to take further measures at any time the economic outlook or the risk of deflation require them. Hence, will the expected acceleration of the downward trend in consumer prices at the beginning of this year eventually pave the way for additional SNB action?

Strong franc feeding through to consumer prices

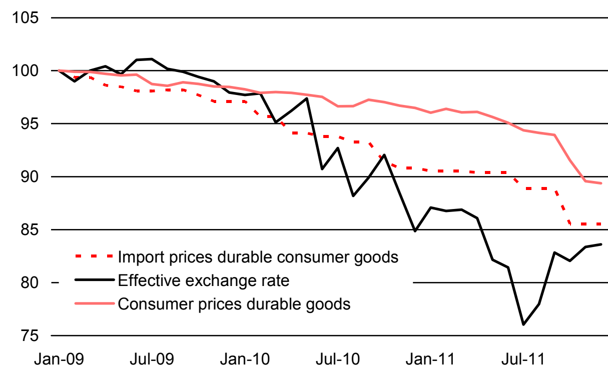
We don't think so. Our main reasoning is that the current downward pressure on prices remains driven by exchange-rate effects. The SNB introduced a minimum exchange rate target versus the euro at the beginning of September last year. Immediately afterwards EUR/CHF jumped from 1.11 to 1.21 and since then remains 17% above its cyclical trough reached in August 2011 at a very low 1.03. This movement was, however, by far not strong enough to compensate for the preceding drastic appreciation since the start of the financial crisis. EUR/CHF remains 20% below the December 2009 (start of EMU debt crisis) and even 26% below the pre-Lehman level. The heavy appreciation continues to feed through to consumer prices via cheaper imports. For some products, above all fuel, currency-related price changes occur very quickly. But the majority of goods prices react with a lag and only if the effect is sustained. Import costs are often hedged or denominated in CHF. Moreover, purchase prices might be fixed for a longer contract period. Consequently, short-term fluctuations in FX rates need not lead to domestic price changes at all. But this time the extended period of franc strength is having a material impact on price levels. Import prices for consumer goods are pointing strongly south. Whereas import prices for durable consumer goods[1] were broadly stable in Germany over the last two years, the corresponding Swiss prices declined roughly 15% (see left chart below).

The divergence in Swiss and German import prices provides a rough gauge as to what extent the strength of the franc is already reflected in actual import prices. Considering unchanged German prices, the decline in Switzerland should have been fully accounted for by the FX effect. With this assumption, the comparison of the effective Swiss exchange rate (trade-weighted versus 21 countries) and import prices for durable consumer prices suggests that most of the adjustment took place by the end of 2011. Furthermore, consumer prices for durable goods meanwhile have largely followed the price changes in primary stages (see right chart below). The latest figures indicate that a gap still remains, which is, however, likely to be closed at the beginning of this year. This is underscored by the above-mentioned selling price expectations.

Import prices for durable consumer goods, index (Jan-09=100)



Swiss indices (Jan-09=100)



Source: BfS, FSO, UniCredit Research

[1] We use prices for durable consumer goods to compare and evaluate the FX effects to exclude the volatility in food and energy prices, which make up a large part of non-durable consumer goods.

Falling consumer prices not necessarily harmful

But although some more price declines lie ahead in the short term, with our expectations of a continuing limited weakening of the Swiss franc (UniCredit EUR/CHF year-end target 2012: 1.28), imported deflation should abate in the course of 2012. The nature of the current downward trend in consumer prices therefore does not need to be of much concern to the SNB. Quite the contrary. Other things being equal, a temporary phase of falling import prices can be rated as "benevolent" deflation. In combination with moderately rising wages of an expected average 1% in 2012, it improves the purchasing power of Swiss households and helps to strengthen domestic demand.

Of course, one cannot deny the concurrent negative effects of the strong currency on the price competitiveness of Swiss manufacturers. The export situation has deteriorated strongly of late, beyond the single effect of the slowdown in global demand. Investment plans have been downsized and unemployment has started to rise again. But considering the successful implementation of the minimum exchange rate and mounting evidence of a gradual improvement in global economic activity, our baseline scenario remains, that the Swiss economy will be able to avoid a deeper contraction. Accordingly, we do not see the emergence of a dangerous downward spiral in household incomes or domestic services and asset price levels, which would constitute the undesired type of permanent broad-based deflation that requires a decisive reaction in monetary policy. This is also reflected in the SNB's monetary policy principles: consumer price deflation has harmful consequences if incomes are affected by the slide in prices. This would cause deterioration in economic performance. Purchases will be deferred, products and services will become increasingly harder to sell and borrowers will no longer be able to meet their obligations.

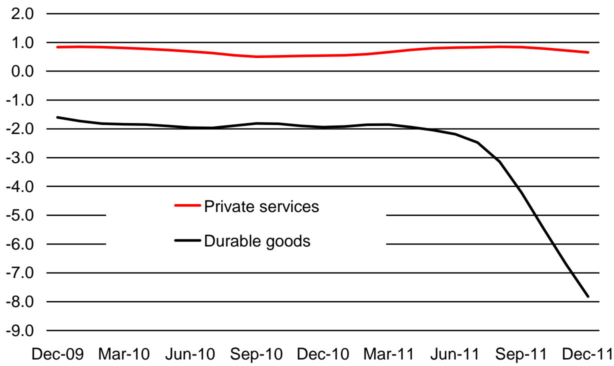
So far, private spending is holding up reasonably well. In contrast to prices for imported goods, prices for domestic services continue to rise (see left chart below). And driven by the low interest rate level and prolonged high immigration, the upward dynamic in house prices even accelerated in the fourth quarter. Prices for owner-occupied apartments climbed 3.3% qoq at the end of 2011.

No imminent change in SNB stance

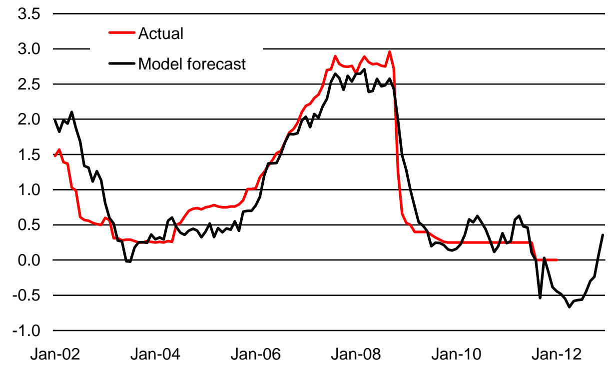
In its latest monetary assessment, the SNB expected moderate GDP growth in the order of 0.5% for 2012 (UniCredit: +¼%) as well as a further weakening of the franc over time. All in all, as long as there are no signs of a stronger-than-expected slowdown in the economy, i.e. a deeper contraction in the first half of 2012, the current pronounced decline in consumer prices is in our view not a harbinger of increased medium-term deflation risks and therefore not likely to change the monetary policy stance of the SNB. Our FX strategists maintain their forecast of an unchanged minimum exchange rate target. Moreover, in this scenario market expectations are more likely to gradually move away from further easing and towards the start of normalization in monetary policy again. In the environment of reduced risk aversion and a pick-up of economic activity later this year, our SNB model[2] suggests a first cautious interest move of the SNB in December 2012 (see right chart below).

[2] Our SNB model estimates the reaction function of the SNB based on developments in core inflation, the unemployment rate, the Swiss PMI and the real effective exchange rate.

Consumer prices, yoy (%)



SNB's 3-month CHF-Libor target rate (%)



Source: BfS, SNB, UniCredit Research

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UniCredit Economic Forecasts

	Real GDP (%, yoy)			Consumer Prices (%, yoy)			Budget Balance (% of GDP)		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
Industrialized countries									
US	**1.7**	**2.3**	**2.5**	**3.1**	**1.8**	**2.3**	**-8.7**	**-7.5**	**-6.0**
Euro area	**1.6**	**0.6**	**1.6**	**2.7**	**2.1**	**1.9**	**-4.1**	**-3.4**	**-3.1**
Germany	3.1	1.2	2.5	2.3	1.8	1.8	-1.0	-0.9	-0.8
France	1.6	0.6	1.7	2.1	1.9	1.7	-5.7	-4.5	-3.4
Italy	0.4	-0.3	0.4	2.8	2.4	1.7	-3.9	-1.5	0.0
Spain	0.7	0.1	1.2	3.1	1.6	1.7	-8.0	-6.5	-4.0
Austria	3.3	0.8	2.0	3.3	2.2	2.0	-3.3	-2.9	-2.5
UK	**0.9**	**0.6**	**1.5**	**4.5**	**2.8**	**2.2**	**-8.4**	**-7.8**	**-7.0**
Switzerland	**1.8**	**0.3**	**1.6**	**0.2**	**-0.5**	**1.1**	**1.0**	**0.5**	**0.2**
Japan	**-0.7**	**2.0**	**1.8**	**-0.3**	**-0.3**	**0.2**	**-10.3**	**-9.1**	**-7.8**
Developing countries									
Central & Eastern Europe									
Russia	4.2	3.9	4.2	8.6	6.2	5.8	2.0	-1.5	-1.5
Poland	4.0	3.1	3.5	4.2	2.9	3.0	-5.8	-3.4	-2.9
Czech Republic	1.7	0.9	2.7	1.9	3.0	2.1	-3.8	-3.4	-2.9
Hungary	1.5	0.0	1.9	3.9	4.9	3.1	1.0	-2.5	-3.2
Turkey	8.3	2.8	4.2	10.5	7.2	6.6	-1.3	-2.0	-2.0
Emerging Asia									
China	9.2	8.5	9.5	5.6	3.5	3.2	-1.6	-0.8	-0.1

Real GDP (%, qoq, sa)	**4Q11**	**1Q12**	**2Q12**	**3Q12**	**4Q12**	**1Q13**	**2Q13**	**3Q13**	**4Q13**
US (annualized)	3.0	2.0	2.2	2.6	2.6	2.4	2.6	2.6	2.6
Euro area	-0.2	0.1	0.3	0.3	0.4	0.5	0.4	0.3	0.3
Germany	0.2	0.2	0.2	0.3	0.4	0.8	0.9	0.7	0.5
France	-0.2	0.1	0.3	0.4	0.4	0.5	0.5	0.4	0.3
Italy	-0.6	-0.1	0.1	0.0	0.1	0.2	0.2	0.1	0.1
Spain	-0.3	-0.1	0.2	0.2	0.3	0.4	0.3	0.2	0.2
Austria	0.0	0.1	0.2	0.4	0.5	0.6	0.5	0.5	0.5
UK	-0.2	0.1	0.2	0.4	0.3	0.4	0.4	0.5	0.5
Switzerland	0.0	-0.1	0.0	0.1	0.3	0.5	0.5	0.6	0.5
Japan	0.5	0.3	0.5	0.5	0.6	0.4	0.3	0.5	0.4
Russia	1.2	0.8	0.7	1.2	1.1	1.0	0.8	0.9	1.2
Poland	1.0	2.1	1.1	0.9	1.0	0.2	1.2	1.1	1.2
Czech Republic	0.1	0.2	0.4	0.4	0.5	0.8	0.8	0.8	0.9
Hungary	0.6	0.2	-0.9	-0.1	-0.2	0.9	1.0	0.8	0.9
Turkey	0.1	-1.0	-1.0	2.5	3.8	0.3	1.3	1.1	1.5
China (%, yoy)	8.5	8.1	8.3	8.5	9.1	9.3	9.5	9.5	9.6

Consumer Prices (%, yoy)	**4Q11**	**1Q12**	**2Q12**	**3Q12**	**4Q12**	**1Q13**	**2Q13**	**3Q13**	**4Q13**
US	3.3	2.6	2.1	1.8	2.0	2.1	2.3	2.4	2.4
Core rate (ex food & energy)	2.2	2.2	1.9	1.7	1.7	1.6	1.7	1.7	1.6
Euro area	2.9	2.4	2.1	2.1	1.9	1.8	1.8	1.9	2.0
Core rate (ex food & energy)	1.6	1.4	1.4	1.4	1.5	1.5	1.6	1.7	1.8
Germany	2.3	1.9	1.8	1.8	1.8	1.8	1.7	1.8	2.0
France	2.4	2.2	1.9	1.8	1.6	1.5	1.6	1.7	1.8
Italy	3.3	3.0	2.6	2.4	1.9	1.7	1.6	1.7	1.7
Spain	2.7	1.8	1.3	1.6	1.8	1.8	1.8	1.7	1.7
Austria	3.5	3.0	2.3	2.0	1.8	1.8	2.0	2.0	2.1
UK	4.6	3.5	3.0	2.5	2.2	2.1	2.2	2.3	2.2
Switzerland	-0.5	-1.1	-1.0	-0.4	0.4	0.9	1.1	1.1	1.2
Japan	-0.1	-0.2	-0.1	0.0	0.1	0.0	0.1	0.1	0.2
Russia	6.1	5.1	4.9	6.3	6.5	5.4	5.5	5.9	6.4
Poland	4.4	3.5	2.8	3.3	3.4	3.1	3.2	3.0	2.9
Czech Republic	2.4	3.1	3.1	3.1	2.5	2.2	2.1	2.1	2.0
Hungary	4.0	4.4	5.0	5.8	4.7	3.3	2.7	2.2	2.2
Turkey	10.5	10.6	9.8	9.3	7.2	7.3	7.1	6.8	6.6
China	5.4	4.1	3.7	3.2	3.0	2.9	3.1	3.2	3.3

Source: UniCredit Research

UniCredit FI/FX & Commodity Forecasts

INTEREST RATE & YIELD FORECAST (%)

		End-1Q		End-2Q		End-3Q		End-4Q	
2012	current	UniCredit	Forward*	UniCredit	Forward*	UniCredit	Forward*	UniCredit	Forward*
Euro area									
Refi Rate	1.00	1.00	0.75	1.00	0.75	1.00	0.75	1.00	0.75
3M Euribor	1.12	1.05	0.83	1.05	0.73	1.05	0.69	1.05	0.70
10Y Bunds	1.82	2.10	1.87	2.40	1.94	2.55	1.99	2.80	2.07
US									
Fed Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3M USD Libor	0.54	0.40	0.42	0.35	0.42	0.35	0.45	0.35	0.47
10Y Treasuries	1.82	2.20	1.90	2.50	1.98	2.70	2.03	3.00	2.11
UK									
Repo Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3M GBP Libor	1.08	1.05	0.98	0.95	0.92	0.95	0.89	0.95	0.90
10Y Gilts	2.04	2.20	2.17	2.50	2.30	2.80	2.34	3.10	2.43
Switzerland									
3M CHF Libor Target Rate	0.00	0.00	0.00	0.00	0.00	0.00	0.25	0.25	0.50
3M CHF Libor	0.07	0.05	0.03	0.05	-0.04	0.20	-0.08	0.35	-0.09
10Y Swissies	0.70	0.70	0.70	0.70	0.72	0.90	0.73	1.10	0.74
Japan									
Target Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3M JPY Libor	0.20	0.25	0.33	0.25	0.33	0.25	0.34	0.25	0.34
Russia									
Reference Rate	5.25	5.25		5.25		5.50		5.50	
3M Money Market Rate	6.92	6.80		6.70		6.50		6.00	
10Y IRS Rate	7.74	7.60		7.60		7.50		7.40	
Poland									
Reference Rate	4.50	4.50	4.50	4.25	4.38	4.00	4.13	4.00	4.13
3M Money Market Rate	4.89	4.88		4.62		4.40		4.42	
10Y IRS Rate	4.84	5.00		4.90		4.70		4.60	
Czech Republic									
Reference Rate	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	0.75
3M Money Market Rate	0.78	1.20		1.20		1.20		1.40	
10Y IRS Rate	2.12	2.40		2.60		2.80		3.00	
Hungary									
Reference Rate	7.00	8.50	7.50	8.00	7.50	7.50	7.38	7.00	7.13
3M Money Market Rate	7.49	8.25		7.90		7.25		7.00	
10Y IRS Rate	7.58	7.90		7.60		7.10		6.75	
Turkey									
Reference Rate	5.75	5.75	5.75	5.75	5.63	5.75	5.63	5.75	5.63
3M Money Market Rate	10.98	11.50		11.00		10.00		9.00	
10Y IRS Rate	8.77	9.30		9.30		9.00		8.00	

EXCHANGE RATE FORECASTS

		End-1Q		End-2Q		End-3Q		End-4Q	
2012	current	UniCredit	Forward	UniCredit	Forward	UniCredit	Forward	UniCredit	Forward
EUR-USD	1.3128	1.22	1.31	1.18	1.31	1.15	1.31	1.15	1.32
EUR-GBP	0.8299	0.80	0.83	0.79	0.83	0.78	0.83	0.78	0.83
EUR-CHF	1.2051	1.22	1.20	1.24	1.20	1.26	1.20	1.28	1.20
EUR-JPY	99.92	94	99.86	92	99.79	91	99.70	91	99.59
EUR-RUB	39.74	39.0	40.05	36.6	40.59	35.1	41.13	35.3	41.73
EUR-PLN	4.19	4.30	4.22	4.20	4.26	4.10	4.30	4.10	4.33
EUR-CZK	25.21	25.70	25.21	25.30	25.21	24.90	25.21	24.50	25.21
EUR-HUF	291.62	300	293.45	300	296.46	290	299.18	277	301.77
EUR-TRY	2.31	2.26	2.34	2.18	2.39	2.15	2.43	2.19	2.47
USD-JPY	76.12	77	76.06	78	75.97	79	75.86	79	75.72
USD-CHF	0.92	1.00	0.92	1.05	0.92	1.10	0.91	1.11	0.91
GBP-USD	1.58	1.52	1.58	1.50	1.58	1.48	1.58	1.47	1.58

COMMODITY PRICE FORECASTS

		End-1Q		End-2Q		End-3Q		End-4Q	
2012	current	UniCredit	Forward	UniCredit	Forward	UniCredit	Forward	UniCredit	Forward
DJ-UBS Commodity Index	290	290		300		310		300	
Oil Price (Brent, USD/b)	112.13	115	106.8	120	105.8	125	104.8	120	103.7

*Bloomberg Consensus for central bank rates

Source: UniCredit Research

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