

## The Fed and ECB Both Face Fresh Challenges

The outlook for Federal Reserve policy became more clouded by stronger than expected core CPI while the ECB may struggle to implement its purchase program. ECB politics will intensify from a starting point of internal opposition that may build given the need to raise the aggregate purchase limits on government bonds and especially for some individual countries as soon as next year.

The net outcome was a second take by markets on the degree to which the ECB can be as dovish as they guided at first, and whether the Fed will cut its policy rate by anywhere close to the amount that is cumulative priced over 2019–20. Markets were whipsawed by the effects as initial bull flatteners across bond curves have been replaced by upward pressure upon yields across maturities in the US, Germany and France. Some of this may be positioning reversals (buy the rumour, sell the fact...) but substantive arguments easily support a more cautious market stance toward both central banks. Spillover effects mixed with volatile trade headlines are putting upward pressure upon Canadian rates. Particularly disconcerting is the possibility that President Draghi misrepresented the degree of consensus at the table.

### ECB Exceeds Expectations—But May Struggle to Implement

First, where the ECB roughly met our expectations was in terms of a 10bps cut to the deposit rate as expected (some forecast -20bps), a tiering system to mitigate the potentially harmful effects of negative rates, and a QE program. When markets saw that, they rejoiced at first.

Where the ECB exceeded expectations was on two important fronts. The monthly purchases of assets under a fresh QE program were lower than expected at €20 billion per month, but open-ended alongside open-ended forward rate guidance. The statement essentially says that purchases will continue until the inflation target has been “robustly” achieved and before the ECB starts to raise rates.

Since the ECB does not forecast inflation to hit its target during its projection horizon and revised down its inflation forecasts particularly for next year (1.2% in 2019, 1.0% in 2020 and 1.5% in 2021), the obvious inference is that a rate hike is unlikely to occur until 2022 at the earliest and that the asset purchase program will continue until at least the end of 2021. A hike in 2022 and the end of purchases then becomes conditioned upon a) upside and downside risks to their inflation forecast before then, and b) whether the inflation target is hit or not by 2022.

One way of estimating the cumulative size of the purchase program may therefore be to multiply the €20 billion per month flow by at least twenty-six months (November 2019 to the end of 2021). That amounts to a purchase program equal to €520 billion or larger.

**Can the ECB actually buy that much? What would this do to the share of eligible securities the ECB would own over time?** This is shown in chart 1. The share rises from just under 30% now to the self-imposed 33% limit by about September 2021. This assumes moderate trend growth in the pool of eligible securities over this time period. In order to hit this ceiling later than September 2021 if at all, either the purchases would have to be scaled back, or the growth in the pool of eligible securities would have to rise more quickly. That, in turn,

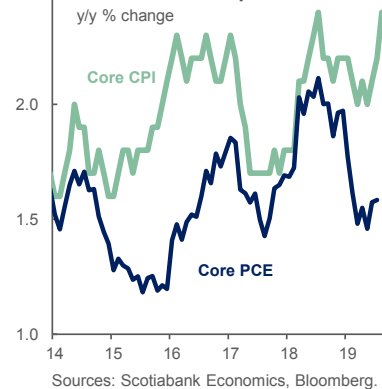
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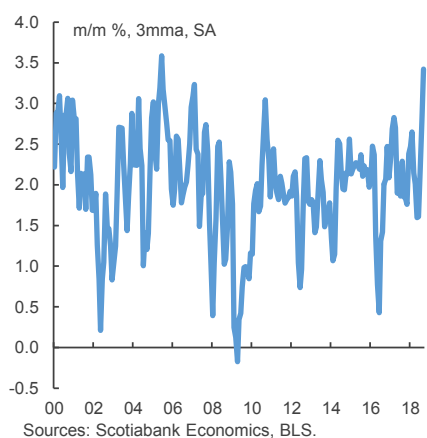
**ECB's Holdings of European Union Sovereign Bonds**



**Will Core PCE Inflation Catch Up?**



**US Core CPI Inflation**



would require either deficit-funded fiscal stimulus (but Draghi sounded exasperated toward such prospects, and perhaps rightly so) and/or a recession that impairs public finances. My personal view remains that the bigger the security blanket offered by the ECB, the *less* likely it is that material fiscal stimulus will be delivered since it removes market discipline that might otherwise incite government to act more decisively.

Mounting deficits perhaps in a recession wouldn't be a great way of staying within the 33% limit. **Therefore the alternative is that incoming President Lagarde will face the need to raise the 33% purchase limit ahead of September 2021 if plans remain on track. In fact, some countries are much closer to hitting their debt limits and would perhaps do so as soon as next year.** If that were to be the case, then Lagarde would either have to raise the aggregate debt limit next year and/or shift the composition of purchases toward countries with more room. The latter approach courts entirely different politics by risking preference toward some issuers over others and the ECB has tended to be loath to do so. That's potentially especially so given that it appears Draghi at least exaggerated the degree of consensus in the meeting.

As an indication of the tensions that will build if limits have to be raised or their composition altered, I thought Draghi's answers to questions in the press conference about the degree of unanimity were a tad confusing. No vote was held and we're asked to believe that this was because there was such a broad consensus that they didn't feel the need to do so. So why not hold a vote and prove it? Given the tone of comments from Germany, France, Holland, Austria and Estonia, I find it hard to believe they were fully on board. Indeed, **subsequent to the communications, it was revealed that each of the French, German and Dutch Governors dissented against the resumption of quantitative easing.** If Germany objects now, then just wait until the ECB needs to raise its share of bunds being purchased, or needs to show increased favour toward more profligate issuers.

Here are the links to the statement ([here](#)), purchase program details ([here](#)), TLTRO III details ([here](#)) and two-tier system details ([here](#)).

## U.S. CORE CPI HITS AN ELEVEN YEAR HIGH

### US headline/core CPI inflation, y/y % change, August:

Actual: 1.7 / 2.4

Scotia: 1.8 / 2.3

Consensus: 1.8 / 2.3

Prior: 1.8 / 2.2

### US headline/core CPI inflation, m/m % change, August:

Actual: 0.1 / 0.3

Scotia: 0.1 / 0.1

Consensus: 0.1 / 0.2

Prior: 0.3 / 0.3

**US core CPI inflation hit an eleven year high in year-ago terms and surpassed expectations.** While it's not the Fed's preferred gauge, it's a warning to bond markets that core PCE inflation could well follow and make greater than expected traction toward the 2% policy target. If so, then markets may be over-pricing cumulative Fed policy easing. That is one reason why the market reaction to the ECB's first announcements was subsequently reversed.

At 2.4% y/y, CPI excluding food and energy during August climbed to its highest since September 2008. We get core PCE inflation only on September 27<sup>th</sup> and hence well after the Fed, but the issue is the extent to which core PCE inflation follows core CPI higher.

The current spread between the two core gauges is approaching its highest on record. August core CPI at 2.4% versus July core PCE at 1.6% is a 0.8% spread when the maximum spread was 0.9% in December 2015. On average, the two measures have deviated from each other by only about 0.2 percentage points over the post-GFC era.

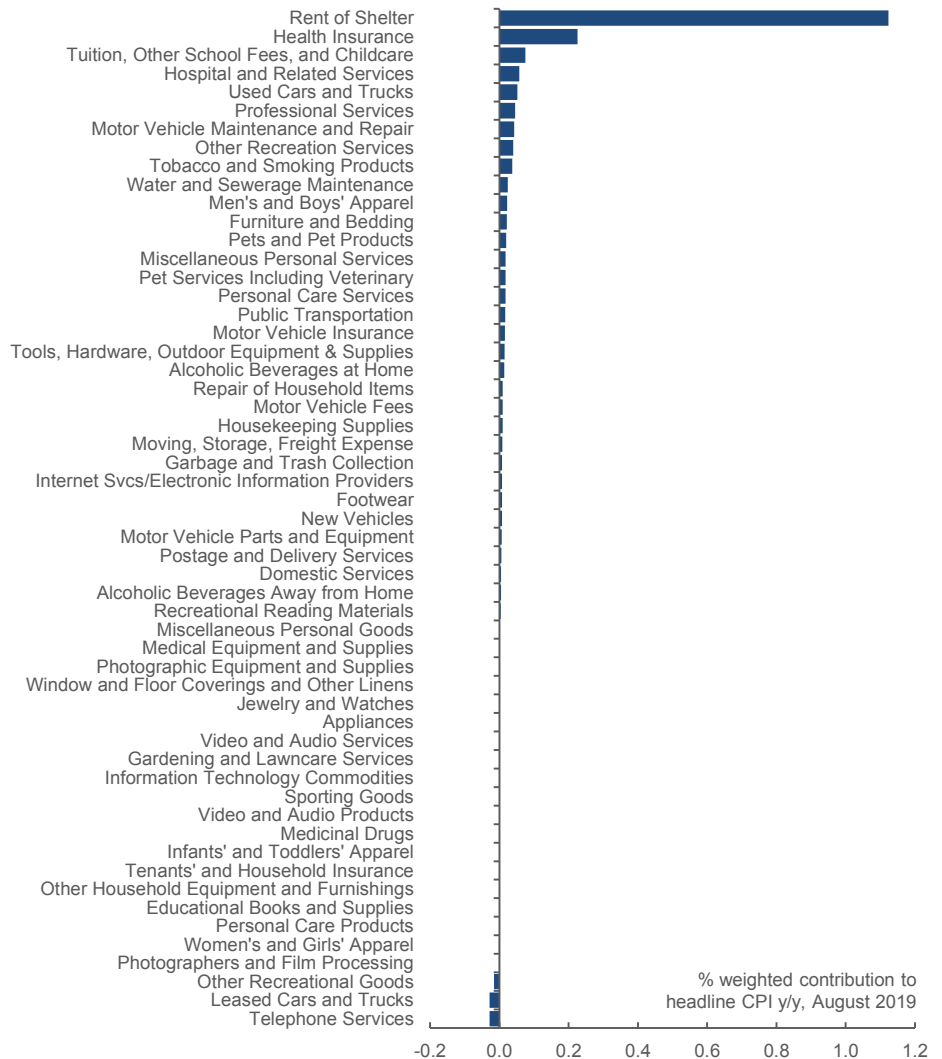
Chart 2 depicts the two measures. First, note the speed with which core CPI has been climbing recently. Second, note the widening gap between the two readings. I think core PCE is likely to catch up to core CPI going forward especially given the sources of the rise in core CPI (see below).

More disconcerting (to doves at least) is that core CPI inflation has been running at 0.3% m/m for three consecutive months. At a seasonally adjusted and annualized rate, that means **core CPI inflation is running at 3.7% on a three month moving average basis.**

At issue is therefore whether Chair Powell repeats what he said in the press conference at the end of July when he noted that this was just a relatively minor mid-cycle adjustment to rates as opposed to the start of a full easing cycle. Or will he repeat what he said last week regarding how the Fed will act as appropriate and avoid prior references. I think he'll repeat 'as appropriate' but the dot plots may be where the FOMC consensus could be more reserved toward prospects for future easing relative to market pricing. Today's inflation print and whether it flows through to PCE would support such an approach.

There was substantial breadth to the year-ago and month-ago inflation readings. Services are up 2.7% y/y. Housing is up 2.8%, with owners' equivalent rent up 3.3%. Medical care (weighted more heavily in PCE!) was up 3.5%. Taken together, housing and medical care comprise 51% of the CPI basket and they both ripped. On a weighted basis, they did the lion's share of the lifting to inflation as shown in chart 4.

**Weighted Contributions To Year-Ago U.S. CPI Change**



Sources: Scotiabank Economics, BLS.

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