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Market Commentary on ECB Quantitative Easing

by Peter Hensman and Paul Brain from Newton Capital Management, part of the BNY Mellon Group

Peter Hensman

In what was probably the most keenly awaited central bank meeting ever, Mario Draghi did not disappoint in launching a eurozone QE programme that includes purchases of sovereign bonds. In contrast to the disbelief in the ECB's transformative powers when it stated in 2012 that it would do "whatever it takes" to save the euro (and the subsequent announcement of the relatively undefined Outright Monetary Transactions initiative), demand to listen to the ECB press conference was so great that websites couldn't handle the volume of interest.

Most of the immediate response to the €60 billion per month purchase programme is positive: US broker Evercore ISI says "Draghi delivers"; the BBC heralds a "Massive QE programme for the eurozone"; Barclays says "ECB fires bazooka to fight deflation"; and the FT's beyondbrics column hails "Draghi's extra-large bazooka – buy on the rumour, buy on the fact". The assumption behind much analysis is that QE works as described, and that increasing willingness to lend and lower borrowing costs will create a sustainable lift to demand. Indeed, Mr Draghi stated in the post-meeting press conference that the policy action was undertaken because the ECB's analysis indicates that "the prevailing degree of monetary accommodation was insufficient".

Our view is more in line with the first public statement made this week by former Bank of England governor, Mervyn King, who suggested that "the idea that monetary stimulus after six years is the answer doesn't seem (right) to me…Simply lowering rates even further or adding monetary stimulus is unlike to solve that (structural) problem". Even if returning inflation to the 2% year-on-year target that the ECB describes was a panacea, the fact that neither the US nor the UK are achieving that – even on their core measures that exclude the decline in energy costs – after so-called 'successful' QE programmes, suggests that market expectations can be disappointed. If ECB QE fails to boost consumer prices in a relatively short space of time, could markets begin to question whether central banks do, in fact, have the tools to continue to underpin inflated asset prices?

In further evidence of central banks' competitive devaluation measures, Denmark's National Bank has also just cut its interest rates and said it too could engage in QE, and the Bank of Canada cut rates unexpectedly yesterday (leading to weakness in the Canadian dollar).

Paul Brain

The European Central Bank (ECB) has launched its own sovereign quantitative easing (QE) programme. However, owing to the nature of its structure, the ECB cannot carry out QE in the same way as other central banks.

The bond markets have been waiting for this event and the suggestion is that they sell off once the actual process starts. It seems strange to suggest that bond prices will go down when the ECB is buying an extra €45 billion a month, but this is certainly what happened in the previous examples of US QE. Apparently the market is prepared to believe that the ECB will achieve its aim of stimulating growth along with inflation, and as a result is happy to sell bonds to the ECB and invest in risk assets.

Unfortunately, the ECB has joined this party a bit late, and the economy's ability to respond to this printing of money is likely to be less now than it was when the US first began buying government debt following the 2008 global financial crisis.

Getting the new money out into the real economy also remains a problem. The banks are reluctant (owing to regulatory constraints) to expand their balance sheets, and there is a lack of demand for the money. Perhaps a new Marshall Plan is required.

The overall global growth backdrop is also still a concern, prompting other central banks (Canada, China, etc) to loosen monetary policy. The decline in the oil price since September 2014 has given central banks an excuse or even a new reason to lower rates. This time round, the beneficial effects of QE will have to be seen rather than anticipated.

Comments from Holger Fahrinkrug,

Chief Economist at Meritten Investment Management, part of the BNY Mellon Group.

ECB QE: Something for everyone

After long hesitation and much diplomatic wrangling, Mario Draghi has gotten his way and has written a new chapter in European central bank history: Effective from March 2015, the ECB will additionally start buying government bonds issued by EMU member states as well as those of EU institutions (agencies) in a bid to expand its balance sheet to about EUR 3 trillion.

In doing so, he performed a delicate balance act, by seeking to accommodate worries over potential losses, prevailing especially among the German population, and trying not to disappoint already elevated market expectations regarding the potential size and structure of the quantitative easing (QE) programme. At first sight, it appears that he has been successful in achieving this goal.

Analysis:

1. As regards size, structure and risk allocation, the QE programme takes account of concerns over potential losses in case of a national default, especially prevailing among Germans. On the other hand, the mix presented has been sufficient to satisfy already elevated market expectations. Mario Draghi has thus successfully pulled off a "monetary balancing act".

2. We expect the euro-zone economy to be supported by the programme, especially so as there are other stimuli already available. “Low for long” interest rates and abundant liquidity combined with a weaker euro, a recovering banking system and lower oil prices stand to boost growth in 2015.
3. Thanks to this economic acceleration, we also expect inflation to first dip into negative territory for few months, but then to stabilise and tick up slightly throughout the remainder of the year. As things stand today, we thus do not believe that the QE programme will have to be extended in September 2016, though this cannot be ruled out.
4. It is up to national governments and the EU commission to take care that the relief provided by the ECB does not lead to slackening reform and consolidation efforts among highly indebted and slowly growing EMU countries. This is not the remit of the ECB.
5. As expectations for today’s ECB decision had already gotten well ahead, we do not expect this move to have any dramatic impact on financial markets. While the ECB QE programme is in place and as long as the Fed is expected to hike rates, the euro should continue to soften moderately. Some market participants anticipate the euro to reach parity with the US dollar within the next 18 months which we consider a rather bold forecast, but not outside the realm of reality. We hardly see any downside potential for German government bond yields, though spreads of bonds of other euro countries should continue to tighten, as here ECB purchases may play a more important role. And finally, risk assets such as equities should also tend to benefit from the ECB’s demonstrating its commitment to returning both economic growth and inflation to a more normal path.

Background

From March onwards, the ECB will purchase private and public-sector assets worth up to EUR 60 billion per month. This includes the existing buying programme for ABS and covered bonds. The programme will continue to remain in place until the ECB sees “a sustained adjustment in the path of inflation”. Initially, the programme will thus have a volume totalling EUR 1.14 trillion. Factoring in balance-sheet-reducing factors such as bonds within the SMP programme reaching maturity and expected repayments of refinancing operations with commercial banks, as the ECB engages in open-market transactions, this should be sufficient to expand the ECB balance sheet by about EUR 800 billion, hence probably taking it to EUR 3 trillion in total.

Purchases will be allocated in accordance with the ECB’s capital key, will be initiated and coordinated by the EZB, but will be conducted on a decentralised basis by the national central banks. Potential losses from bonds of state-affiliated companies will be spread across the euro system, but this will not be the case with risks resulting associated with other purchases. This means that merely 20% of the additional purchases will be subject to risk sharing. This is a concession especially to German QE sceptics and Draghi explained very patiently and in detail why this would not limit the effectiveness of QE. We concur with this assessment; this feature solely rules out (fiscal) reallocation of risks.

In addition to expanding its open-market purchases, the ECB Council has decided to suspend the premium of 10 basis points for future TLTROs in a bid to make such operations more attractive for banks. Hence, the interest rate applicable to upcoming allocations will be equal to the main refinancing rate.

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