Market Bulletin

11 March 2016

The ECB fights back

In brief

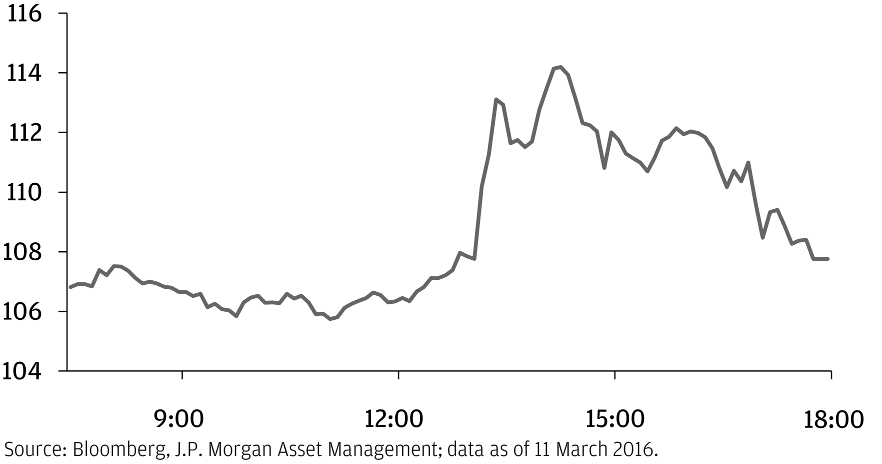
- Quantitative easing took on new meaning this week as the European Central Bank (ECB) unveiled not one but six separate measures to support the eurozone economy and raise inflation.

- Attacking on all fronts is supposed to signal the central bank's determination. But it also carried a distinct whiff of desperation, on a day when the ECB also unveiled sharply lower forecasts for eurozone growth and inflation.

- The package showed the ECB had learned from the Bank of Japan's unhappy experience with negative rates and thought hard about the implications for banks. The new measures also tighten the focus on bank lending as a key channel for monetary policy, rather than the exchange rate.

- However, ECB president Mario Draghi's admission that he didn't expect to cut rates further—despite a forecast for inflation of just 1.6% in 2018—also highlighted the limits to central bank action in this environment. European financial stocks initially surged by 3.5%, but fell back on Draghi's comments, which took the heat out of the equity and bond market rally and left the currency 0.3% higher against the dollar at the end of the day.

EXHIBIT 1: EUROZONE FINANCIALS INTRA-DAY MOVES, 10 MARCH 2016
Euro Stoxx Financials sub-index



Source: Bloomberg, J.P. Morgan Asset Management; data as of 11 March 2016.

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Key policy actions

- The deposit rate was cut by 10bps to -0.4%, in line with expectations, but there was also a surprise 5 basis point (bps) cut in the main rate for refinancing operations and the marginal lending facility rate was cut by 5bps to 0%.
- The programme of sovereign bond purchases—quantitative easing (QE)—was boosted by EUR 20 billion to EUR 80 billion per month, though there was no extension of the endpoint, currently March 2017.
- The scope of asset purchases was expanded to include non-bank investment grade corporate bonds.
- There will be a new round of four targeted longer-term refinancing operations (TLTROs), each with a maturity of four years. Banks will borrow at the refinance rate, or 0%, in the first instance, but can access funds at negative rates if they increase the amount of eligible (non-mortgage) lending by more than 2.5%. In effect, the ECB, would be paying the banks to make new loans.

Analysis and background

By taking action on so many fronts, the ECB clearly wanted to silence those who had been talking up the limits to monetary policy in a negative rate world. But its own new economic forecasts gave added reason to act and were worse than most had expected, on both the inflation and growth fronts. The forecast for the core CPI in 2016 was slashed to 0.1%, down from 1.0% in the December forecast. The growth forecast for 2016 has been cut from 1.7% to 1.4%, which would be lower than the region achieved in 2015.

Increasing the ECB's monthly programme of quantitative easing is uncontroversial and sends a useful signal that negative rates are not the only tool left in the locker. Expanding the scope of purchases to include non-financial investment grade debt is also helpful, especially since national authorities are going to be given the freedom to decide how to make the relative allocations themselves. The euro corporate bond index is roughly 20% of the size of the euro government bond index, so this move potentially expands the scope of official bond purchases by nearly EUR 1 trillion but the relative size of the public and private debt markets varies enormously by country.

Complaints from bankers about the impact of negative policy rates had put the ECB in a tricky position going into the meeting: either it would be accused of caring too little about the financial sector, or caring too much. But it appears to have avoided both extremes by introducing the new TLTROs, which cushion the blow of negative rates for banks, but only to the extent that those banks lend to real-life companies and households. We estimate that the new TLTRO programme has the potential to expand the ECB's balance sheet by €1.25 trillion. For banks in periphery countries it should be particularly helpful in offsetting the hit to profitability from negative rates.

The focus on lending as the key channel for policy also helps deflect the criticism that the ECB is only interested in raising inflation by pushing down the euro. If that it still a key goal of policy, it is not one that has been working very well. The euro is stronger now against the dollar than when the ECB began buying sovereign bonds, and headed up again during Draghi's press conference.

Draghi's comments about further rate cuts were consistent with the decision not to introduce a "tiered" rate structure to limit the negative side-effects of negative rates. Draghi said the governing council decided against tiering, partly out of fear that it would send a signal that rates could go a lot lower.

However, these remarks don't sit very comfortably with the claim that the ECB has plenty more ammunition in the locker—or with a revised staff forecast showing eurozone inflation rising to just 1.3% in 2017 and 1.6% by the end of 2018. The official medium-term target is inflation "below, but close to 2%". Either the staff is deliberately lowballing that forecast for 2018 or the Governing Council has lowered its medium-term target to fit the constraints of policy at the lower bound.

The takeaway appears to be that there are some very clever people working at the ECB, who can find clever solutions to the many technical problems posed by a negative rate environment. But they cannot get around the fundamental problem that monetary policy is less effective—and more prone to awkward side-effects—now than it was two or three hundred basis points ago.

Implications for investors

We may be past the days when Mario Draghi could singlehandedly transform the environment for eurozone investors. But the breadth and sophistication of the steps announced have given some answers to the naysayers and should be modestly supportive of eurozone assets. We see few big implications for the euro, given the very small rate changes announced.

Economic data continues to point to a moderate eurozone recovery fuelled by consumer spending and stronger business and household lending. That is a large and welcome improvement on a few years ago, and provides plenty of opportunities for individual companies, particularly in domestically oriented sectors. But the region needs faster growth to make a serious dent in unemployment, and investors will probably remain nervous of eurozone assets until they see more convincing evidence of faster growth in corporate earnings and higher corporate investment.

The ECB showed the world there was plenty more it could do. But possible is not the same as sensible. The limits to what the ECB can sensibly do in this environment also became clearer, and that broader debate may weigh on market sentiment for some time to come.

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