Market Bulletin

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The ECB "stretches" its monetary policy

In brief

- As widely expected, the European Central Bank (ECB) today announced its intention to extend its quantitative easing (QE) programme by nine months at least until September 2018, leaving the door open to a further expansion in size and duration if conditions were to require it.
- At the same time, the ECB announced that its monthly public and private bonds purchases will be reduced from EUR 60 billion to EUR 30 billion per month as of January 2018, but that it will still reinvest the principal payments from maturing securities.
- This "recalibration" of monetary policy marked a dovish tone from the ECB as it reiterated its forward guidance by stating that interest rates should remain at their present levels for an "extended period of time" and beyond "the horizon of the net asset purchases" until the governing council feels that inflation is nearing its target—a level close to, but below, 2%.
- Given that this scenario was the one expected by most economists, the announcement itself should have a limited impact on financial markets. However, it could mark a tangible inflection point for the euro and for eurozone government bonds yields.
- Equity markets reacted positively to the news with the Eurostoxx 600 up 0.4% at 1600 CET, while bond and foreign exchange (FX) markets seemed more concerned by the ECB's dovish tone on interest rates than by the tapering of its balance sheet as the euro dropped 0.5% against the dollar and German 10-year bund yields dropped 4 basis points (bps).

What has happened?

Almost 10 years after the start of the Great Financial Crisis, which led to a double-dip recession and brought the European economy close to deflation, the ECB has taken today the first step to normalising its monetary policy.

The ECB's battle against recession and deflation has been more of a marathon than a sprint, with its first rate cut occurring in October 2008 and its QE programme starting in October 2014. These measures have proven effective as, even without massive fiscal stimulus, the European economy has already recorded 17 consecutive quarters of expansion. In addition, advanced economic indicators like purchasing managers'

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indices and the European Commission confidence index are at multi-years highs, indicating that the European economy should continue to grow at a healthy pace going forward.

On the inflation front, the ECB's results so far are less conclusive, but the recent stability of both core and headline inflation rates can already be considered as a victory. Meanwhile, the continuous decrease of the unemployment rate, along with easier credit conditions and higher loan demand, should help inflation to gradually grind higher.

As with the end of any marathon, it is now time for the ECB to take credit for these results, but also to stretch its policy muscles at the finish line to avoid any injuries. Today, the ECB has done exactly that with the nine-month extension of its QE programme and the reduction of its public and private bonds purchases to EUR 30 billion per month as of January 2018.

This announcement kills two birds with one stone for the ECB: first, it should further reassure financial markets about the strength of the European recovery; second, it should reassure them about the bank's ability to continue to implement its QE programme without having to deviate from its capital key limits—something that could have soon been on the cards for Germany given the current pace of monthly purchases, due to the scarcity of German bonds.

Today's decision has probably been facilitated by the fact that, as acknowledged by the ECB, the European Commission and member states are now taking on the baton of policy support, with labour market reforms and more fiscal expansion.

Market reaction and implications

Equity markets reacted positively to the news with the Eurostoxx 600 up 0.4% at 1600 CET. Meanwhile, bond and FX markets seemed more concerned by the ECB's dovish tone on interest rates than by the tapering of its balance sheet, as the euro dropped 0.8% against the dollar and German 10-year bund yields dropped 4bps.

If today's decision marks a clear inflection point in the ECB's policy, it should do the same for the euro and for eurozone government bonds yields in the coming months.

In this environment, we believe that European equity markets, and especially value and banking stocks—which are closely correlated with interest rates—may outperform euro area government bonds markets, many of which are already showing negative performance for the year to date.