Market Bulletin

12 September 2019

Super Mario goes out with a bang

Mario Draghi reacted to the increased economic risks to the economic outlook with a bold package of monetary easing measures. The extent to which this package in time supports the economy depends in large part on whether it encourages government spending.

A FIVE-PRONGED APPROACH

The package of stimulus was comprehensive. It included:

Rates deeper into negative territory - The ECB's decision to cut interest rates further into negative territory to -0.5% and indicate that they could go even lower still can be best understood as an attempt to keep the Euro weak to support the struggling manufacturing sector. The business surveys indicate broad based weakness in the export sector and highlight the risk that this could lead to job cuts if the weakness persists. Given the disinflationary effect that prolonged manufacturing weakness could have on the Eurozone economy, the ECB's desire to act before the arrival of Christine Lagarde is understandable.

Tiering - The decision to reduce the effect of negative interest rates on banks will provide some relief for the banking sector but most importantly leaves open the opportunity for Christine Lagarde to take rates even further into negative territory should she feel it necessary or desirable.

TLTROs (Targeted longer-term refinancing operations) - Banks which meet certain lending targets can borrow for up to three years at the average deposit rate. The ECB is effectively paying the banks to borrow as long as they lend it out. Again this could reduce the pressure on banks' net interest margins although the question mark around the demand for private sector loans, given the economic uncertainty, remains.

Forward guidance - The decision to move from date dependent forward guidance to a state dependent forward guidance, saying that interest rates won't rise until the inflation outlook robustly converges to the ECB's inflation target, and that convergence is consistently reflected in the underlying inflation dynamics gives markets the certainty that accommodative monetary policy will remain in place until it works.

QE - However, far more significant is the decision to restart QE at 20bn euros a month and commit not to stop the purchases until 'shortly before' the ECB start to raise interest rates again. This forward guidance on QE is a significant bazooka committing the ECB to continue with QE until they achieve their objectives. This implies that the previous issuer limits that prevented the ECB from owning more than 33% of a country's government debt will be replaced if necessary, this was the big news that markets had been waiting and hoping for.

AUTHOR

Michael Bell
Global Market Strategist

WILL IT WORK?

While negative interest rates and ongoing QE on their own will act predominantly by weakening the currency, if combined with fiscal stimulus from governments encouraged to borrow and invest for the future in growth enhancing projects, they could have a much more significant effect on demand.

The ECB has played their hand and Draghi has gone out with a bang, the ball now rests firmly in the court of those European governments with the fiscal capacity to join in the easing game.

INVESTMENT IMPLICATIONS

Central banks could find themselves in a race to the bottom on interest rates to prevent currency appreciation. With this package the ECB have got ahead of the pack in an ambitious effort to keep the currency low in the face of potential further stimulus from foreign central banks. President Trump was quick to tweet his frustration that the Fed "sits, and sits and sits."

Whether monetary stimulus can provide enduring support for risk assets depends on whether the growth outlook stabilises, which will be partly linked to how the trade war progresses. What seems clear is that lower interest rates and core government bond yields are here to stay for the foreseeable future.

LV–JPM52332 | 09/19 | 0903c02a826c05c6

J.P.Morgan
Asset Management