MARKET INSIGHTS

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Changing of Lagarde, but toolkit challenges remain

The European Central Bank (ECB) made no changes to its key interest rates, asset purchases and forward guidance and is unlikely to make any changes in the coming months. But the new staff forecasts from the ECB show inflation is likely to stay below target. The pressure on ECB President Christine Lagarde to 'do something' will increase as the months roll by and inflation remains stubbornly low. The question is—what can she do?

LOWER GROWTH, LOWER INFLATION

The latest ECB staff macro-projections show that annual GDP growth is expected to slow to 1.1% in 2020, while inflation is also expected to drift lower. In 2022 inflation is projected to stand at just 1.6%. The recent manufacturing business surveys have showed tentative signs of picking up and so the growth slowdown appears less pronounced. But it's too early to be overly confident that this improvement will last. Market-based expectations of medium-term inflation have now fallen close to historic lows.

EXHIBIT 1: EUROPEAN CENTRAL BANK STAFF MACROECONOMIC PROJECTIONS FOR THE EURO AREA

	Real GDP (y/y)				HICP inflation (y/y)			
Meeting	2019	2020	2021	2022	2019	2020	2021	2022
Sep-19	1.1%	1.2%	1.4%	-	1.2%	1.0%	1.5%	-
Dec-19	1.2%	1.1%	1.4%	1.4%	1.2%	1.1%	1.4%	1.6%
Change	+0.1%	-0.1%	0.0%	-	0.0%	+0.1%	-0.1%	-

Source: European Central Bank, J.P. Morgan Asset Management. Data as of 12 December 2019.

THE TOOLKIT CHALLENGE

So what can President Lagarde do to stimulate demand and bring inflation back to target?

We suspect her preference would be that the region's governments share the responsibility. More stimulative fiscal policy is likely to stand a greater chance of boosting growth and inflation. However, there remains considerable reluctance on the part of some governments, most notably Germany.

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Therefore, in the meantime the ECB is conducting a review of monetary policy with the aim of completing it by the end of 2020. This likely includes a consideration of the relative merits of negative rates, among other instruments, in helping the ECB meet its mandate of price stability. In a recent financial stability review by the central bank, negative rates were judged to have supported the overall economy. But they have also coincided with an increase in risk-taking across financial assets, whilst also hurting the prospects for bank profitability.

With a tiered interest rate system only just implemented, and the lower bound on negative rates an unknown, the ECB may prefer to lean on more asset purchases in the near term. The ECB could increase the size of its monthly net asset purchases by tilting more towards corporate purchases or by raising its issuer limits if it gets close to running out of government bonds to buy.

INVESTMENT IMPLICATIONS

Central banks in 2020 will be assessing the merits of current policy and considering new measures, but this may take some time to develop. Market expectations suggest no change to the ECB deposit rate in 2020. But if the economy deteriorates further and inflation remains persistently low it will be hard for the ECB to do nothing. Lower yields in Europe are almost definitely here to stay, which creates significant challenges in generating long-term returns in fixed income.