Market Bulletin

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The European Central Bank aims to ‘thread the needle’

The leader of the European Central Bank (ECB) has become very familiar with the challenge of ‘threading the needle’ in recent years and the test facing Christine Lagarde today was no different. After last month’s major announcements regarding the expansion of its quantitative easing program, the ECB announced few new meaningful measures today. It left its key interest rates unchanged and made no enhancements to its asset purchases. It did however decide to make borrowing conditions more favourable for euro area banks under its Targeted Longer Term Operations III (TLTROs) facility.

With an increasingly restricted toolkit to provide further stimulus, the ECB’s messaging had to be reassuring enough to avoid triggering market volatility and at the same time diplomatic enough to appease divergent views from across the euro area on the appropriate policy path. This task was only made harder by the downgrade of Italy’s sovereign bond rating by Fitch to one level above junk status and the large contraction in eurozone GDP for the first quarter of this year (-3.8% quarter on quarter).

Few new policy changes

With its deposit rate already at -50 basis points, the ECB’s decision to not reduce interest rates so far this year suggests a strong reluctance to go even lower. However, the ECB is not alone in seeing limited value in pushing rates further into negative territory. The Federal Reserve in its own meeting yesterday dismissed the idea that it would consider negative interest rates. The ECB is instead focusing on other tools as its main policy levers.

Borrowing costs for the TLTRO III programme were lowered to -1%, a further 25 basis points lower from last month’s meeting. The recent ECB bank lending survey showed a material increase in demand for loans across the euro area as corporates search for funds to get them though this period. In the near term, another series of short-term refinancing operations were also made available, likely as a safety net over the coming months. These are helpful measures but the magnitude of bond purchases is likely to be more important in supporting government spending to help mitigate the impact on the economy.

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What are the other options?

With markets focused on debt sustainability, particularly in countries such as Italy, the ECB will need to focus on expanding its asset purchase programmes. It could do so by ramping up purchase amounts under the Pandemic Emergency Purchase Programme (PEPP). In the press conference Lagarde suggested that PEPP is the preferred tool as opposed to Outright Monetary Transactions (OMT), previously used in the sovereign debt crisis, given this is a euro area wide issue. An extension of PEPP beyond the end of this year, dependent on the duration of the virus was also highlighted as an option.

Having already announced that it would accept recently downgraded high yield bonds – so called 'fallen angels' – as collateral for banks' loans and made Greek bonds eligible for the PEPP, the ECB could also widen the scope of the asset purchases to include high yield bonds. Lagarde stopped short of explicitly confirming the forthcoming implementation of these measures, but stated that the flexibility of the ECB's mandate can be increased if required.

Ultimately, it is clear that the ECB will need to increase stimulus measures this year to ensure that the wave of bond supply required to fund government stimulus packages is smoothly digested by the market. At this meeting, Lagarde preferred to take a "wait and see approach" in the hope that coordinated government action will shoulder some of the burden and lift some of the pressure on the central bank to save the day.

Investment implications

Trying to find the perfect balance of policy announcement and forward guidance was always a tough challenge and markets appear to have reacted negatively to the measures announced today. The euro has fallen around 0.3% versus the dollar and European equities are also down on the day. The spread of Italian 10-year yields over Germany has been volatile and has broadly risen. With expectations from the ECB that eurozone GDP could fall by 5% - 12% in 2020, calls for further central bank action look set to get louder over the coming months.

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