European Central Bank: Turning words into actions

16 March 2021

IN BRIEF

- The European Central Bank (ECB) Governing council (GC) decided to "significantly increase" monthly Pandemic Emergency Purchase Program (PEPP) purchases over the second quarter of 2021, based on the recent evolution of financing conditions and inflation outlook.
- The European Central Bank's (ECB's) affirmation of its dovish policy stance, combined with its decision to increase the pace of PEPP purchases, confirms the likelihood that short tenor rates will remain negative for even longer than previously expected.
- Despite negative rates, for Euro cash investors, liquidity funds remain a viable strategy for operational cash where liquidity and security are critical.

The perception that the recent spike in bond yields was unjustified given the Eurozone's weak growth and inflation outlook, boosted hopes of ECB action at their March meeting. However, with economic risks related to Covid-19 and financial conditions still relatively accommodative, investors continued to fear inaction. Therefore the significant increase in the pace of PEPP purchases announced by the ECB was widely welcomed by the market. For cash investors, the ECB's dovish tone suggests short term interest rates will remain anchored for the foreseeable future.

DISRUPTING THE RECOVERY

Over the past two months, positive vaccine news, substantial US fiscal stimulus and expectations of a rebound in economic growth triggered a reflation inspired sell-off in US and global bonds.

Unfortunately, Eurozone economic data remains weak due to continued containment measures, the slower pace of vaccine rollouts and more limited fiscal support. The latest OECD forecasts predict the Eurozone will only grow by 3.9% in 2021 compared with 6.5% in the US and 5.1% in the UK. Therefore the rapid migration of the reflation sell-off to Europe, with sovereign and corporate bond yields jumping higher, was unwelcome.

Reacting to these rapid bond market movements, ECB President, Christine Lagarde and several other council members questioned whether such moves were warranted, while Philip Lane, the ECB's Chief Economist spoke of the need to "preserve favourable financing conditions over the pandemic period".[1]

However, the ECB's intervention had been limited to words as financial conditions tightened (**EXHIBIT 1**), with no discernable pick up in the rate of asset purchases via its PEPP program (**EXHIBIT 2**) in February.

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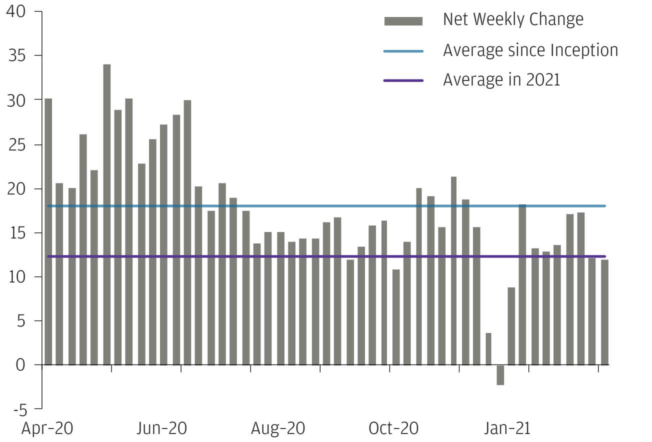
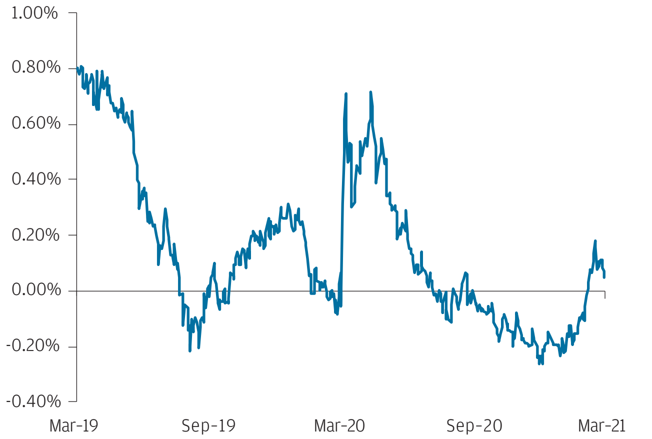
[1] The Compass of Monetary Policy, Speech by Philip Lane on 25 February 2021.

EXHIBIT 1: ECB NET WEEKLY PEPP CHANGE (€ BILLIONS)



Source: Bloomberg, as at 11 March 2021.

EXHIBIT 2: ECB EURO AREA 10-YEAR ALL BONDS SPOT RATE



Source: Bloomberg, as at 11 March 2021.

JUSTIFIABLE ACTIONS

Thankfully, at their monthly policy meeting on the 11 March, the ECB finally turned words into actions. The ECB GC announced that "purchases under the PEPP over the next quarter to be conducted at a significantly higher pace than during the first months of this year".[2]

The ECB justified its decision by noting that while risks were becoming more balanced, downside risks remain. This view was also reflected in the central bank's latest staff projections which were largely unchanged since the December policy meeting. The ECB expects Eurozone GDP to grow by a modest 4% in 2021, implying the economy will not recover to pre-pandemic levels until 2022. Meanwhile, annual inflation is forecast to increase by just 1.4% for 2023, materially below the ECB's target.

Placing this statement in the official communique rather than subsequent press conference, suggest a strong degree of consensus regarding the PEPP pivot. It also confirmed the ECB's dovish policy bias and unwillingness to allow imported bond market volatility to impact liquidity conditions.

While the ECB did not clarify the meaning of "significant", economists estimate that the central bank is likely to increase bond purchases to between EUR 15-25bn per week, compared to an average of EUR 12bn since the start of 2021. While the size of the PEPP program was unchanged, the central bank confirmed it could "recalibrate it if necessary" to ensure sufficient flexibility.

[2] As expected the Main Refi Rate and the Deposit Facility Rate were unchanged at 0.00% and -0.50% respectively.

REPELLING THE MARKET

The initial market feedback to the ECB's reinvigorated, dovish policy stance was positive, with expectations that it should help mute the recent rise in bond yields. German bund yields subsequently declined while the curve flattened and the spread versus equivalent maturity US treasuries hit a 1-year high. Meanwhile, the yield on Italian government bonds declined even further, reducing the German-Italian spread to a 5-year low.

Unfortunately the dovish comments and additional market liquidity are likely to anchor short end rates for the foreseeable future. EURIBOR (**EXHIBIT 3**) rates remain near record lows while the curve (**EXHIBIT 4**) remains close to 14-year tights. While volatility has increased further out the money market curve, EURIBOR levels are unlikely to rise materially with the ECB's targeted long term refinancing operation (TLTRO) funding for banks already high at close to EUR 1.8 trillion, and likely to increase further.

CASH INVESTOR IMPLICATIONS

Euro cash investors have become desensitized to negative interest rates since the ECB cut its Deposit Facility rate to negative levels in mid-2014. The subsequent failure of Eurozone growth and inflation to hit the central banks modest targets triggered additional rate cuts with 3-month EURIBOR hitting a record low of -0.556% at the beginning of 2021.

The ECB's affirmation of its dovish policy stance, combined with their decision to increase the pace of PEPP purchases, confirms the likelihood that short tenor rates will remain negative for even longer than previously expected.

For Euro cash investors, despite negative rates, liquidity funds remain a viable strategy for operational cash where liquidity and security are critical. However, for other cash segments – with more accurate forecasts of cash flows and longer investment horizons, step out strategies offer a worthwhile alternative. Adding longer maturity instruments, reducing liquidity and broadening the range of credit quality should allow investors to add additional yield, while not significantly increasing overall risk or volatility.

EXHIBIT 3: EURIBOR YIELDS

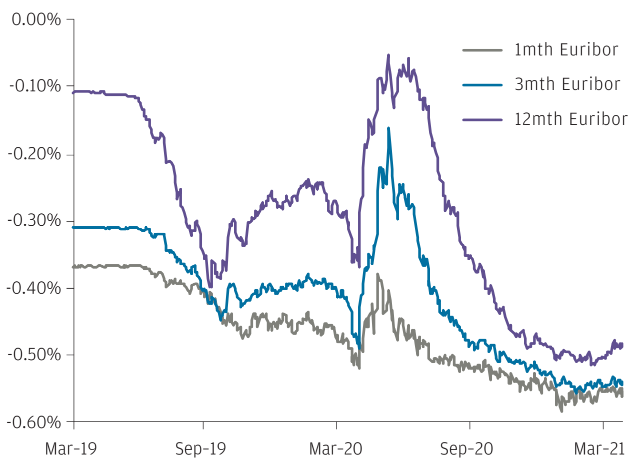
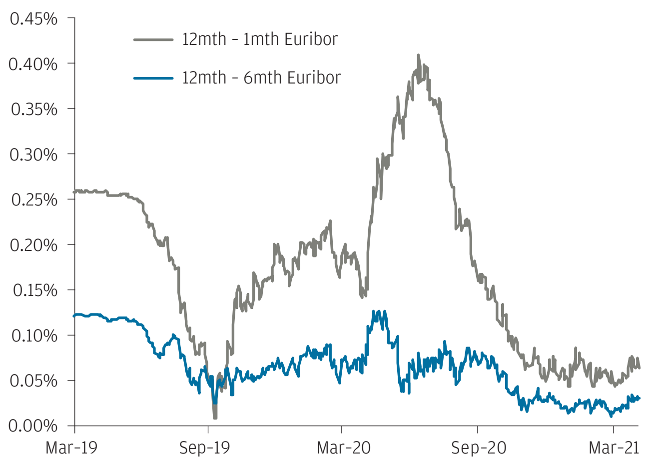


EXHIBIT 4: EURIBOR CURVES



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