MARKET INSIGHTS

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The ECB unveils targeted measures and passes the baton

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Today the European Central Bank (ECB) refrained from cutting its deposit rate by 10 bps, as was being priced by the markets prior to the meeting. Instead it deployed a set of targeted measures, including a temporary addition to its net asset purchases and more favourable lending conditions for euro area banks, aimed at improving credit conditions for small and medium-sized enterprises.

The ECB were clearly forced into action given the potential for a downturn in the eurozone as a result of COVID-19. However, these decisions are unlikely to entirely convince investors that this is enough. Subsequently, global equity markets fell further, while the spread between 10-year Italian and German sovereign bonds initially widened by around 10 basis points.

We continue to believe that targeted fiscal measures need to do the heavy lifting to support the economy in the face of this shock. The best the ECB can do is provide governments with the assurance that it will keep their borrowing costs low, via additional quantitative easing (QE), as deficits expand. European governments now need to demonstrate they are willing to pick up the baton.

Interest rates unchanged

Ahead of the meeting forecasters were torn over whether the ECB would take its deposit rate into deeper negative territory. Negative interest rates are helpful in fighting currency appreciation and reducing the funding costs for governments. However, if negative interest rates can't be passed on to end borrowers they can act as a drag on bank profits.

Despite recent euro strength adding to expectations of a rate cut, the ECB decided to keep rates on hold and instead use other tools. While Christine Lagarde dismissed the notion of being close to the point at which they can no longer helpfully reduce interest rates further, investors may view the lack of a cut as an acknowledgement that further reductions in rates could prove counterproductive.

Quantitative easing gets a temporary boost

The ECB decided to add a temporary package of EUR 120 billion in asset purchases, to be used by the end of the year, in addition to its existing monthly asset purchases of EUR 20 billion. The ECB dismissed the risk of reaching the issuer limits on bond purchases and reminded investors that its ability to continue using this tool effectively is contingent on new debt-funded government spending.

Enhancements to existing TLTROs

Perhaps the most important policy measure introduced at this meeting was the enhancement to the ECB's TLRO III programme (Targeted Longer Term Refinancing Operations). The terms were made even more favourable in order to encourage banks to extend loans to businesses. The ECB reduced the interest rate on loans to euro area banks to -75 basis points if the current levels of credit extended to businesses were maintained. This should provide vital credit to small and medium-sized enterprises who may suffer from cash flow shortfalls as a result of COVID-19.

Investment implications

Today's announcement did little to convince markets that this would be a game changer in the fight against the economic consequences of the COVID-19 outbreak. The main disappointment lies in the fact that the ECB decided not to cut its key interest rate in a similar fashion to its counterparts in the US and the UK.

The ECB acknowledged that while easy monetary policy is a necessary condition in the current climate, it is not necessarily a sufficient one. Lagarde encouraged European governments to pick up the baton and take decisive steps toward providing a coordinated response.

As a consequence, the future developments for the economy and financial markets may be more reliant on the swiftness and size of government action rather than further ECB stimulus.

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