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A BNP Paribas Investment Partner

Weekly Commentary

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Decoding Draghi

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Key takeaways

- The market has underestimated the significance of the ECB's latest policy announcements, and in particular, the four year fixed rate loans to the banks at potentially negative rates.
- The message in the press conference was a little harder to decipher. On the one hand, President Draghi seemed open to the idea of price level path targeting. On the other, he pushed back on the idea that the ECB had given an implicit signal that rates will stay on hold until 2021.

Full commentary

Last Thursday, there was an outbreak of déjà vu in financial markets. The European Central Bank (ECB) announced a fresh stimulus package, as it had in December, and once again, investors were distinctly underwhelmed. However, this time the markets have got it wrong. The latest package is worth a second look.

The ECB cut the deposit rate by 10 basis points and raised the monthly pace of asset purchases from €60 to €80 billion – both broadly in line with expectations. The rabbit that Draghi pulled out of the hat was the announcement of a new set of long-term fixed rate loans to the banks, known as Targeted Longer-Term Refinancing Operations (TLTROs). The ECB stands ready to lend cash, in size, for four years at the negative deposit rate (-0.40%) if the banks meet their lending targets. This ingenious innovation in the ECB's toolkit offers a timely reminder to those who question whether central banks are out of ammunition (for more discussion of this issue, see here), and has snuffed out concerns that easing monetary policy is counterproductive because it hurts the banking sector (at least for the time being).

The principal disappointment – for Foreing Exchange (FX) investors at least – lies in the news on short-term rates. The ECB sent a clear signal that further cuts in the deposit rate are unlikely and chose not to relax the restriction on buying bonds below the deposit rate. The name of the policy game will now be about driving longer-term yields down towards a de facto floor at the current deposit rate (give or take a premium for securities that are in short supply), rather than driving short rates even lower. Currencies are arguably more sensitive to yield differentials at the front end of the curve than at the back, so the March meeting has been characterized in some quarters as an Armistice in the currency wars and even the demise of one leg of the policy divergence trade.

More broadly, many investors believe that the FX channel is the most important aspect of the transmission mechanism in the current environment so these announcements may have disappointed markets by creating the impression that the ECB is choosing to relinquish the few effective bullets it has left. We do not buy into this thesis. Further easing of the monetary stance via asset purchases still has the capacity to cheapen the currency (as well as loosening domestic financial conditions) even if it does not involve a change in official interest rates, as the Quantitative Easing (QE) programs conducted by numerous central banks at unchanged policy rates demonstrate.

Perversely, rates investors may have been disappointed by the March package for precisely the opposite reason: that the ECB will no longer need to use additional bond-buying bullets. The Credit Easing (CE) component of the package – the combination of the TLTROs and purchases of corporate bonds under the ECB's QE program – impressed the market, at least until the press conference began. If you think that ECB CE is a game-changing bazooka that can radically improve the outlook, then you should revise down your expectations of how much QE the ECB will do in the future and revise up your expectations of the future path of policy rates, and that sounds like bad news for rates investors. Once again, we think this is an over-reaction: it is a bit of a stretch to think that ECB CE has shifted the Eurozone's inflation problem from Mission Impossible to Mission Accomplished overnight.

With the ECB only matching expectations on the increase in the stock of asset purchases and some of those purchases being diverted into the corporate bond market, some rates investors might also have been disappointed by the wall of money coming their way. That too looks like a miscalculation. For one thing, the TLTROs will likely unlock a torrent of arm's length QE, with banks able to fund purchases of securities at potentially negative rates. For another, future stimulus from the ECB is now likely to come exclusively in the form of more bond purchases, which means future increases in the stock of purchases in larger increments than the € 1/4 to 1/2 trillion we have become accustomed to.

This week's market developments

Monday, March 7

- Germany factory orders growth stabilized at -0.1% m.o.m. (s.a.) for January

Tuesday, March 8

- Germany Industrial Production growth increased to 3.3% m.o.m. (s.a.) for January
- Eurozone GDP growth (preliminary estimate) increased to 1.6% y.o.y. (s.a.) for the Fourth Quarter

Wednesday, March 9

- UK Industrial Production growth increased to 0.3% m.o.m. (s.a.) for January
- UK Manufacturing Production growth increased to 0.7% m.o.m. (s.a.) for January
- US Wholesale Inventories growth increased to 0.3% m.o.m. (s.a.) for January

Thursday, March 10

- France Industrial Production growth increased to 1.3% m.o.m. (s.a.) for January
- France Manufacturing Production growth increased to 0.8% m.o.m. (s.a.) for January
- US Initial Jobless Claims decreased to 259,000 (s.a.) for the week

Friday, March 11

- US Import Price Index growth improved to -0.3% m.o.m. for February

Source: Bloomberg, as of end March 11, 2016

The process of re-evaluating the March package and in particular the innovation of the new set of TLTROs has already begun. However, some aspects of the March meeting remain difficult to decipher. In particular, President Draghi's enigmatic responses to two questions in the press conference are worthy of further comment: one which hinted that the Council was contemplating a fundamental change in monetary strategy in the future, the other which discouraged investors from believing that the ECB had just taken that step.

When asked about his views on price level path targeting – the radical idea that the ECB should aim to over-shoot the inflation target in the future to compensate for under-shooting in the past and present (see here) – Draghi sounded pretty open-minded about re-interpreting the mandate of price stability in the medium term: *'we'll have to define the medium term in a way that, if the inflation rate was for a long time below 2%, it will be above 2% for some time.'*

If a central bank wants to engineer an inflation over-shoot, it needs to commit to keep policy loose for too long. If the ECB wanted to do that, then signaling that it planned to keep rates on hold until into 2021 would be a great place to start. Indeed, that would be a reasonable interpretation of the signal in the latest set of TLTROs. However, when asked if there was a link between the time horizon over which the ECB is willing to provide fixed-rate funding and the time horizon over which the ECB expects to keep interest rates fixed, President Draghi gave a surprising answer: *'No, there is no relationship.'*

Going forward, the battle between these two narratives – the inclination to over-shoot versus the reluctance to commit to keep rates low for too long – must be monitored closely as it will determine the direction of the ECB strategy.

Central Bank watch

	Last move	Date of move	Current policy rate	Implied 3m rate on March 2016 Interest Rates Futures Contract	Next meeting
Fed	+25 basis points	December 16, 2015	0.25 % - 0.50 %	0.48 %	March 16, 2016
ECB	-5 basis points	March 10, 2016	0.00 %	-0.19 %	April 21, 2016
BoJ	-20 basis points	February 16, 2016	-0.10 % - 0.00%	0.06 %	March 15, 2016
BoE	-50 basis points	March 5, 2009	0.50 %	0.61 %	March 17, 2016

Source: Bloomberg

Next week's market developments

Monday, March 14

- Japan Machine Orders growth is expected to decrease to 1.9% m.o.m. (s.a.) for January
- Eurozone Industrial Production growth is expected to increase to 1.7% m.o.m. (s.a.) for January

Tuesday, March 15

- Japan Tertiary Industry Index growth is expected to increase to 0.3% m.o.m. (s.a.) for January
- US Advance Retail Sales growth is expected to decrease to -0.2% m.o.m. (s.a.) for February
- US Empire State Manufacturing Survey is expected to improve to -10.5 for March

Wednesday, March 16

- UK ILO Unemployment Rate is expected to remain at 5.1% for January
- US Housing Starts are expected to increase to 1,150,000 units (s.a.a.r.) for February
- US CPI growth is expected to decrease to 0.9% y.o.y. for February
- US Industrial Production growth is expected to decrease to -0..3% m.o.m. (s.a.) for February

Thursday, March 17

- US Conference Board Leading Index is expected to increase to 0.2% m.o.m. (s.a.) for February

Friday, March 18

- US University of Michigan Consumer Sentiment Index (preliminary estimate) is expected to increase to 92.2 for March

Source: Bloomberg, as of end March 11, 2016