ECB: trying the big bang

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SUMMARY

- **After disappointing markets in December, the ECB tried a big-bang approach, but actually presents investors with a déjà-vu.**
- **The ECB sees itself not running out of ammunition, but its focus is shifting from interest-rate policy to non-conventional tools.**
- **Market scepticism of the effectiveness of monetary policy in general could diminish the impact of further ECB action.**
- **We believe the latest measures are hardly the game changer some market participants had looked for. We prefer a cautious positioning in European assets for now.**

At the news conference after January's meeting of its policy-setting council, the ECB had indicated that more action was to come. But it had been (deliberately) vague about the instruments it could use and ECB council members had tried not to trigger overly big expectations over the last few weeks. At the same time, a debate raged among market participants about the (in)effectiveness of monetary policy in general and the possible harm that negative deposit rates could do to banks' ability to lend.

The closer the March meeting of the ECB's governing council came, the more published broker research lifted market expectations for bigger ECB steps. Anticipating the market response correctly became harder for the ECB. In this environment, it opted for a raft of measures:

- Cutting its main refinancing (refi) rate by 5bp to 0%, accompanied by a 10bp cut in the deposit rate to minus 0.4%
- Expanding the volume of monthly asset purchases by EUR 20 billion to EUR 80 billion until at least March 2017
- Adding investment-grade euro corporate bonds to the list of eligible assets for purchase
- Starting from June with a new TLTRO refinancing programme of loans with a maturity of four years

We believe the expanded asset buying volume and the inclusion of corporate credit were an attempt by the ECB to surprise markets positively to avoid another disappointment. After an initial euphoric reaction, with the euro losing roughly 1.5 cents against the USD, 10-year Bund yields down by 6bp to 0.16% and the EuroSTOXX equity index rising by roughly 3%, 10-year yields and the euro even surpassed the levels seen before the ECB news and equities gave up their gains.

In our view, the ECB's possible contribution to real growth through these additional measures appears to be limited. The main impact will be in safeguarding growth in times of elevated uncertainty in the short term, improving financial conditions via its purchases of corporate bonds. In addition, for the medium term, the four-year TLTROs and the expanded QE programme should keep yields low for longer and help the central bank in its fight against the build-up of long-term deflation expectations.

At this spring meeting, the ECB delivered substantially more than in December, but it can be hardly satisfied by the 'bang for the buck' in terms of the market response either now or in December. This could be a painful lesson for the ECB.

WHAT'S NEXT?

We believe the discussion in the ECB council about the need for a further easing of monetary conditions will not stop. A key message from the council after its latest meeting is that the ECB believes it is not running out of ammunition, but its focus appears to be shifting from traditional interest-rate measures to non-conventional policy instruments. This might explain some of the disappointment in bond markets.

The ECB looks boxed into a corner by its own rhetoric, as do other central banks, giving the impression that monetary policy measures would be able to generate growth and inflation in the short term. As more and more questions about the effectiveness of this stance arise, we believe there is a risk that further measures could be seen as action for action's sake and will become counterproductive.

The ECB has shown that deviations from the targeted path of inflation put it under pressure to take far-reaching action, even if another plunge in oil prices is the main driver. Missing the inflation target and a potential spill-over into inflation expectations of that miss are clearly key concerns for the ECB. In this respect, its first projection for inflation in 2018 is important: it puts this at just 1.6%. We see the ECB having difficulties meeting the inflation target after 2018 due to the huge output gap and with unit labour costs growth hovering at around 1%. The latter is an important factor in determining core inflation, now far away from the target.

Further action remains on the agenda, in our view. After these latest steps, we do not expect new measures until at least the second half of the year. Any impression that the ECB is now done might well be premature. We believe further policy steps will depend on the incoming economic data. In the course of this year, pressure for additional action could ease if the oil price rises to above USD 50 per barrel, growth picks up in the eurozone and the euro weakens.

A CAUTIOUS VIEW ON EUROPEAN ASSETS

As said, the positive reaction in bond markets was short-lived as participants took the view there was now less to expect in the foreseeable future from the ECB. If developed countries show more signs of reasonable growth and expectations of further interest-rate increases by the US Federal Reserve this year are revived, market vulnerability could rise further. Prolonged asset buying by the ECB could result in a negative supply in eurozone government bonds. Together with more negative money market rates, anchored for longer, this should prevent a sharp and prolonged rise in yields. Nevertheless, as in 2015, a low yield environment does not mean low market volatility and ECB buying is no guarantee for positive returns in bond markets.

As for European equities, we currently prefer a more defensive stance after the ECB meeting. Sentiment should get a further boost from the ECB's QE expansion and could unwind somewhat further the market's extremely pessimistic view of the global economy. However, we see few other drivers to lift the market's spirits. Overall, global corporate earnings trends look less supportive now than they did a couple of months ago. In Europe, there are geopolitical issues that look set to weigh on equities in the next few months including June's EU referendum in the UK, forming a stable government in Spain and the refugee crisis.

Such issues could in the medium term add to the weakness of the euro, but we believe Fed policy will be the main driver. Opportunities for additional US dollar strength could present themselves as the Fed resumes its slow-motion policy tightening later this year.

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