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UPDATE ECB - Slower but longer

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- **ECB will slow monthly asset purchases from EUR 80 billion to EUR 60 billion**
- **Extension to December 2017 is longer than expected**
- **Balance between 'hawks' and 'doves' lead to calm market reactions**

The outcome of the 8 December ECB policy-setting meeting was always going to be a close call. Ahead of the meeting, the Governing Council had been split on any changes to the central bank's pro-growth, pro-inflation asset purchase programme. The 'hawks' – those in favour of scaling back the programme on the basis that an overly stimulative monetary policy could lead to misallocation of capital – include the presidents of the German and Dutch central banks and even some policymakers within the ECB. The 'doves' – who see the still-too-low rate of inflation as justification for prolonging asset purchases – are mainly from the southern eurozone countries, but include ECB president Mario Draghi himself. The stakes were high. Talk of the ECB moving towards a tapering of its asset purchases had led to bouts of market volatility in the months prior to this meeting. The prospect of a more stimulative fiscal policy in the US has sent bond yields higher, both in the US and in Europe.

In our view, markets had firmly priced in an extension of the asset purchase programme, a decision with which we too had reckoned. We had also expected a slowdown in the pace of the bond purchases. With a nod to the hawks, the ECB moved to lower the monthly purchases to EUR 60 billion (from EUR 80 billion). To prevent a negative market reaction and keep the doves on board, the programme's extension to December 2017 - or beyond if necessary to get inflation towards the ECB's 2% target - was longer than expected. The issue of the scarcity in terms of the bonds available for purchase in the market, especially German Bunds, was addressed by modifications to the ECB's self-imposed limits on those purchases. Bonds with maturities of between one and two years will now also be eligible as well as bonds with yields below the ECB's deposit rate of -0.4%. President Draghi did however stipulate that only if it were necessary for a smooth functioning of the programme would the ECB buy bonds with yields below the deposit floor.

With the rate of eurozone inflation remaining far below the ECB's target of close to but below 2% and no signs of inflationary pressure from wages, markets had been concerned about the prospect of any early tapering by the ECB. The eurozone economy has nonetheless been quite stable in recent quarters and leading indicators have suggested growth at or above the eurozone's longer-term trend. The ECB increased the volume of its asset purchases from EUR 60 billion to EUR 80 billion in March 2016 when, according to Draghi, deflation risks were not immaterial. Inflation expectations as measured by 5-year, 5-year forward inflation swaps have risen from 1.41% in March to 1.68% today. Thus, the ECB was able to present this decision as a return to the pace of quantitative easing prior to the increase earlier this year and avoid it being seen as the first step in a tapering process. President Draghi went so far as to say once again that tapering was not discussed during the Governing Council's meeting.

To quash any further market concerns, Draghi kept open the option of increasing the pace again should the economic outlook deteriorate or financial conditions worsen. In reaction to this balanced decision from the ECB, markets traded calmly, with a tilt to the positive side. The euro depreciated slightly, while German bond yields rose only briefly. Equities moved slightly higher.

The ECB's decision does not have any immediate consequences for our asset allocation since it is very much in line with what we expected. We think current monetary policy is positive for global equities. We are however primarily underweight because we do see other risks. We are neutral duration. Seen strictly from a growth and inflation standpoint, yields could move higher, but in our view, quantitative easing in the Eurozone and in Japan, should limit the upside.

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