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WHAT ARE THE IMPLICATIONS OF THE ECB'S QE ANNOUNCEMENT?

EXECUTIVE SUMMARY

The European Central Bank's (ECB) long-awaited announcement on the extension of its quantitative easing (QE) program in early December was met with widespread disappointment. Immediately after the announcement, markets sold off aggressively as popular trades in the euro, equities, and bonds unwound.

In this Price Point, Kenneth Orchard considers why the ECB's announcement fell so short of expectations and assesses the implications of the latest QE package for investors in European bond markets.

WHAT DID THE ECB PACKAGE INCLUDE?

The announcement comprised four main elements:

- A 10-basis-point cut to the ECB's deposit rate to -0.3%.
- An extension of the QE time line from its original end date of September 2016 until at least March 2017.
- An expansion of the range of assets that the ECB can purchase under QE to include local and regional government debt.
- The reinvestment of the principal of bonds bought under QE that have matured and been paid back from March 2017.

WHY DID IT DISAPPOINT?

The announcement was certainly a surprise. ECB President Mario Draghi had previously dropped strong hints that the bank would ease more aggressively, and he has a history of delivering more than is expected, which raised expectations further.

However, it wasn't just the announcement itself that disappointed; the tone Draghi struck in the press conference afterwards was far more hawkish than the one he had adopted just a few weeks before. For example, Draghi had previously said that the ECB was worried about the impact of low oil prices on inflation expectations, but in the

post-QE announcement press conference, he suggested that low oil prices would support household spending and corporate profitability— quite a change in sentiment in less than a month.

The most likely reason for the weaker-than-expected QE package is that Draghi and his chief economist, Peter Praet, faced resistance from more conservative colleagues on the ECB's Governing Council. The economic outlook for Europe has improved, and new inflation forecasts have not been as weak as feared, which may have persuaded the Council to push for a more restrained QE package. The pending U.S. Federal Reserve rate hike has also probably influenced the decision.

MARKET REACTION STIRS MEMORIES OF APRIL'S SELL-OFF

It is important to remember that the ECB announcement did not amount to nothing—the new QE measures were not trivial, even if they came in below expectations. The impact they will have on Europe's real economy, however, is open to debate. Europe suffers from an impaired banking system, a lack of corporate investment, and shallow capital markets—all of which can blunt the effectiveness of monetary stimulus. Lending by eurozone banks also remains low, especially to nonfinancial firms, as banks still hold a large amount of bad loans on their balance sheets. Measures to overcome these issues may be necessary to ensure that QE has the desired impact.

For investors, the market's negative reaction to the ECB's announcement would have brought back unhappy memories of last April's bond market sell-off, one of the causes of which was overconfidence in the prospect of the dollar strengthening against the euro. Earlier in the spring, a combination of very low rates, the ECB's determination to pursue QE (thereby weakening the euro), and expectations of an imminent Fed rate hike prompted many traders to use the euro as the basis for the carry trade. But very weak first-quarter U.S. GDP figures caused investors to delay their expectations, resulting in the dollar falling against the euro – and many investors fleeing from other consensus trades in a bid to limit losses.

Last week, expectations of a weaker euro on the back of robust QE measures were similarly disappointed, causing the euro to gain the most against the U.S. dollar since 2009. This meant another painful day for investors, who had boosted bets on euro weakness to the highest levels since last May. Yet consensus expectations are still for a stronger dollar versus the euro as the Fed resumes hiking and the ECB continues its easing path. Is there a risk of investors being caught again by a surprise euro rally?

COULD THE EURO SURPRISE AGAIN?

Conditions are, in fact, broadly similar to last April. The belief that the U.S. dollar will strengthen against the euro is widespread. Yet if investors were to ignore what the ECB and the Fed are telling us that they are going to do—and focus instead on the economic data coming out from the eurozone and the U.S.—they might be less confident.

The U.S. economy has probably improved enough to justify a Fed rate hike in December, but economic data continue to imply only modest growth for the medium term, meaning that only two to three hikes are likely next year. At the same time, as Draghi noted in his press conference, the eurozone's economy has begun to improve, and consensus growth forecasts for the bloc have increased slightly. The ECB and the Fed remain on divergent paths, but to a lesser extent than previously.

Based on the data alone, the stronger dollar/weaker euro bet looks decidedly less secure, but such is the attention currently paid to central bank policies – and the comments of central bankers – that the underlying data can sometimes be overlooked. On balance, a long position on the U.S. dollar remains a logical call, but it should be treated with caution and reviewed at regular intervals alongside the economic data.

Beyond individual trades, however, it is important not to lose sight of the fact that the ECB remains locked in to easing mode for the whole of 2016 and possibly beyond. The relative attractiveness of the European credit market over the U.S. market should, therefore, persist for the medium term: Higher target rates set by the Fed will

likely send U.S. bond yields higher and prices lower, making it more expensive for U.S. companies to borrow. Meanwhile, European yields are likely to remain low for the foreseeable future, maintaining highly favorable conditions for European issuers.

Budget deficits will likely be slightly higher in peripheral Europe, which will increase issuance levels, but the ECB's extension of QE will absorb most of the additional supply, maintaining overall supply at a stable level. This will be supportive for spreads on peripheral European economies, which look attractive versus core eurozone duration. Eventually, further rate rises in the U.S. will attract investors seeking higher yields, and the European credit cycle will mature, but this a longer-term scenario.

The ECB will return to the QE debate in mid-2016, when it will need to decide whether to end or extend it; the most likely outcome will be a form of tapering. A further cut to the deposit rate cannot be ruled out if the situation in emerging markets deteriorates once again.

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