A Good Start by the ECB

By David Leduc, CFA
Chief Investment Officer

Thomas Higgins, PhD
Chief Economist and Global Macro Strategist

Standish Mellon Asset Management Company LLC

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"The adoption of further balance sheet measures has become warranted to achieve our price stability objective."

— ECB President Mario Draghi

EXECUTIVE SUMMARY

- The ECB has declared its intention to purchase €1.2 trillion in assets across government bond markets, agencies and European institutions in the secondary market.
- We believe this opening salvo into QE will benefit euro area growth and will be helpful in combating the threat of deflation.
- The Fed's experience suggests that QE can lift financial assets prices, bolster confidence and lift economic activity through the "portfolio balance effect."
- We expect the European experience to be similar, though there is less room for asset prices to rise in the current environment.

A GOOD START, BUT WILL THE ECB EVENTUALLY NEED TO DO MORE?

The European Central Bank (ECB) announcement of quantitative easing (QE) at its January policy meeting received a warm welcome from global markets. The ECB will purchase €60 billion a month from March 2015 until at least September 2016 for a total of about €1.2 trillion in asset purchases spread across government, asset-backed and covered bonds. Government bond purchases will be restricted to secondary markets, whilst private sector assets can and have been purchased in the primary market. The hope is that QE in the euro area will be as successful at bolstering asset prices, weakening the euro, lowering borrowing costs and turning the tide against disinflation as it was in the United States. Thus far, the results are promising with yields declining in most core and peripheral Europe bond markets with the notable exception of Greece.

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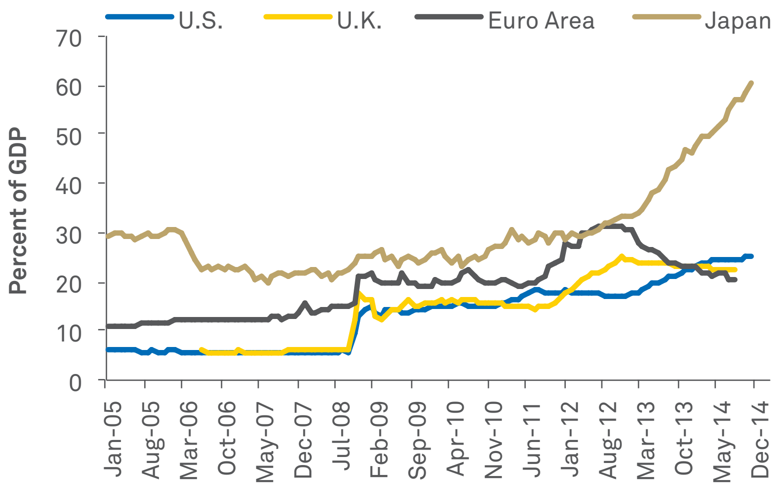
However, the European situation is more challenging than the US in several key ways. First, core inflation and long-term interest rates are already much lower in Europe than they were in the United States at the beginning of QE. Indeed, the US core CPI excluding food and energy stood at 1.8% in December 2008 compared to the euro area core CPI, which hovered at just 0.6% in January 2015. This leaves the ECB with little cushion against deflation. To further complicate matters, short-term interest rates are already negative in many parts of the euro area and 10-year government yields are less than 40 basis points (bps) in the core economies, which compares to 2.27% in the United States before QE. Hence, asset purchases are unlikely to have the same stimulative effect that they did in the United States.

Finally, making policy decisions is more complex in Europe where the ECB must contend with the interests of the 19 separate countries with representation on Governing Council. As a consequence, the ECB may have been slower to act with QE coming 32 months after the European Debt Crisis peaked. Even worse, some ECB officials are already arguing the need to end QE depending on the trajectory of inflation and the program is only just beginning. By contrast, the Federal Reserve implemented its first round of QE in December 2008 just a few months after the Subprime Crisis peaked with the collapse of Lehman Brothers. Subsequently, the Fed added to its purchases with two more rounds of QE before finally winding down the program in October 2014. During that five-year period, the Fed increased its balance sheet five-fold to $4.5 trillion.

G4 Central Bank Balance Sheets



Source: Thomson Reuters Datastream, as of February 20, 2015.

Given the challenges the ECB faces in terms of disinflation and already low interest rates, we believe they need to be at least as aggressive as the Fed in their deflation battle. While the ECB's initial effort appears to be a good one on par with the Fed's first round of QE at around 11% of GDP, more will likely be necessary. This will need to be supplemented with efforts aimed at reducing Europe's bad debt problems in countries such as Greece since high debt levels weigh on the ability of European consumers and businesses to borrow, which may negate the effectiveness of QE.

QE SUCCESSES AND FAILURES

The effect of QE on the US economy and financial markets has generally been positive. Not only did the Fed's asset purchases bring down long-term Treasury yields, they also helped lower yields on corporate bonds and mortgage-backed securities by encouraging investors to move down the risk ladder.[1] This chain reaction amongst risk markets is known as the "portfolio balance effect" and it was highlighted by former Fed Chairman Ben Bernanke back in 2012. There was also a real economic benefit to QE as lower retail mortgage rates helped steady the housing market and reverse home price declines. In addition, a lower discount rate and improving economic outlook lifted stock prices and created a positive wealth effect.

One of the most immediate effects of QE in the US was a weakening of the dollar, similar to what we have seen more recently in Europe and Japan. Interestingly, the impact on the dollar was primarily felt in the first round of QE and gradually reversed in the second and third rounds as the prospects for the US economy improved. The Fed typically downplayed the dollar weakness as a benefit of QE arguing that exports were only 13% of GDP. The same cannot be said of countries such as Germany where exports make of roughly twice as large a share of output.

Much to the chagrin of the Fed, QE has failed to ignite inflation and inflation expectations in a sustained way. Early on, this mostly had to do with the deleveraging process in the United States, but today low energy prices and the weak global environment have almost certainly played a role.

Even so, it is important to point out that core inflation probably would have been much lower had it not been for Fed actions. In addition, recent concerns about the decline in inflation expectations appears to have been overstated given the divergence between market- and survey-based measures of inflation expectations. We believe this will change as the year progresses with the European recovery gathering momentum and a tighter US labor market, supporting wage growth. In fact, the 10-year TIPS (Treasury Inflation Protected Security) breakeven has already increased more than 20 basis points to 1.75bps from its January low.

HOW TO TAKE ADVANTAGE OF QE?

If past is prologue, some of the opportunities of European QE have probably already passed. For example, there may be less downside to the euro against the dollar, though much will depend on relative economic performance in the future. Indeed, as of February 2015 the euro has already weakened by 18% since last summer and regional growth indicators are starting to improve so there is not an obvious need for further euro weakness.

In the United States, one of the best ways to take advantage of QE was through buying up some of the most dislocated areas of the investment grade and high yield bond markets, which generally performed very well through the first and third rounds of QE. The only problem is that euro area corporate spreads are much more compressed today so one has to be more selective. The same is true for some peripheral sovereign bond markets, with the exception of Greece. Greater patience may be necessary for some pay off on the inflation front in Europe.

Greater patience may be necessary for some pay off on the inflation front in Europe.

1 Ben S. Bernanke. "Monetary Policy Since the Onset of the Crisis." Jackson Hole, Wyoming. August 2012.

Comparison of US and European QE Programs

		United States						Euro Area
		QE1 Dec. '08 - Mar. '10 (16 months)		QE2 Nov. '10 - Jun. '11 (8 months)		QE3 Sep. '12 - Oct. '14 (26 months)		Mar. '15 - Sep. '16 (19 months) *End-Date is Tentative
	Size of Program (billions of $ for U.S.; billions of € for Euro Area)	1,725		1,267		1,675		1,200
		At Start of Program	12 Months Later	At Start of Program	12 Months Later	At Start of Program	12 Months Later	Data as of February 2015
Macro	Unemployment Rate (U-3)	7.3	9.9	9.8	8.6	7.8	7.2	11.3
	Core Inflation (YoY %)	1.8	1.8	0.7	2.2	2	1.7	0.6
	U.S. 10-Year Inflation Breakevens	0.1	2.3	2.2	2.1	2.5	2.1	1.7
	German 10-Year Inflation Breakevens	N/A	N/A	1.7	1.7	1.9	1.7	1.0
Currency	USD/EUR	1.40	1.45	1.41	1.38	1.29	1.30	1.13
Bond Rates	U.S. 10-Year Treasury	2.27	3.42	2.57	2.07	1.72	2.88	2.08
	German 10-Year Bund	3.14	3.2	2.42	1.91	1.55	1.98	0.38
	IG Credit Spread (bps) Barclays Index	608	181	168	207	162	142	123
	HY Credit Spread (bps) Barclays Index	1971	656	576	684	529	438	444
Equity Indices	S&P 500	913.2	1109.2	1198	1261.2	1460	1688	2109.8
	DAX 30 (Germany)	4729.9	5903.4	6617.8	6133.2	7310.3	8509.4	11130.9
	CAC 40 (France)	3251.7	3875.8	3842.9	3195.5	3502.1	4114.5	4861.2

Note: Unemployment Rates and Core Inflation statistics refer to their respective regions.
Source: Bloomberg and Thomson Reuters Datastream, as of February 2015.

Either way, we anticipate that further balance sheet expansion by the ECB may be necessary in the coming years if it is really going to turn the tide against disinflation. The Fed increased its balance sheet from 6% to 25% of GDP between 2008-2013 before achieving a sustained recovery. By contrast, Europe's balance sheet has actually contracted over the past two years. The Japanese experience suggests that a more aggressive response early can help mitigate the downside risks.

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