News & Views

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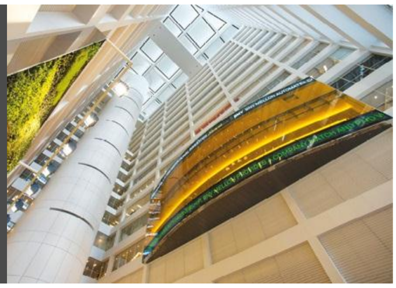

ECB HANGOVER KICKS IN

The initial euphoria which followed the European Central Bank's (ECB) announcement of a raft of new measures on 10 March appeared to wane within 24 hours. Here managers across BNY Mellon Investment Management discuss the ECB's actions and question whether the central bank is now out of ammunition.

ECB announcements included*:

- A deposit rate cut by 0.10% to -0.40%
- An increase in monthly set purchases from €60bn to €80bn.
- Non-bank investment grade corporate bonds now included in the expanded asset purchase programme.
- A cut in the refinancing rate from 0.05% to zero.
- The introduction of four additional Targeted Long Term Refinancing Operations (TLTROs) introduced, each with a four year maturity, starting in June 2016.

Corporate bond inclusion in the European Central Bank's asset purchasing programme was the surprise bullet in the central banks' arsenal delivered on 10 March. The measures announced at the latest ECB meeting have since sparked another round of speculation as to its longevity and impact.

Mellon Capital's[1] head of investment strategy **Sinead Colton** says that while the euro fell versus the US dollar, it swiftly recovered following comments during the ECB President Mario Draghi's press conference. Generally these measures should be positive for European stocks and negative for European sovereign bonds, she says.

The ECB has over delivered, says **Paul Brain**, investment leader of fixed income at Newton. "In a reversal of its damp squib in December, it has done more than the market expected. The initial market reaction (euro down, bonds and equities up) is to be expected, but it didn't last on the day. The longer-term effects of negative rates and quantitative easing are becoming less stimulatory as investors are fatigued and economic growth seems a distant reality."

Peter Hensman, global strategist, Newton agrees, noting: "Like the dogs in Pavlov's experiments, investors and commentators were salivating at the prospect of the ECB delivering another monetary 'bazooka' that would underpin sentiment and risk appetite. Headlines of 'Draghi delivers', 'ECB pulls all the levers' and 'Draghi lends a big hand to the global risk on trade' were typical of the assessment of the plethora of measures delivered by the central bank. And yet for all this, and the complexity of detail, by the end of the official press conference markets had reversed their initially enthusiastic response." Hensman says reams of analysis are now being dispatched to explain exactly why this initial reversal occurred.

According to Alcentra's chief investment officer **Paul Hatfield**: "The initial euphoria at Draghi's bazooka soon wore off and ended up as "is that all you got?" For the credit markets, adding corporate debt to the ECB shopping list and increasing the monthly spend is positive but markets seem to have discounted any future moves and look to doubt the ECB has any more ammunition left."

One component announced by the central bank that could see further positive impact is the new four-year targeted longer-term refinancing operations (TLTROs) package. This reportedly will allow banks

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* *FT*: 'ECB cuts rates and boosts QE', 11 March 2016 and FT: 'Draghi offers bank sweetener to encourage lending', 10 March 2016

to borrow from the central bank at the same rate as the deposit facility - currently -0.4%, depending on how much they lend to businesses and consumers.

Hatfield says the TLTRO introduction as well as the other actions announced will add to recent positive investor sentiment for loans. “CLO liabilities have rallied and I expect new issue CLOs to get closer to printing now. This will help underpin loan demand further,” he adds.

Colton says: “We believe these measures should be positive for eurozone stocks and corporate bonds over the short to medium term and neutral for the euro. Draghi’s comments regarding future rate cuts will likely limit any euro weakness in the near term.

“The ‘whatever it takes’ mantra of ‘super’ Mario has given way to the practicality of balancing the QE impact on European banks and savers with lower credit costs and higher asset prices. Nevertheless the threat of devaluation still has the potential to ruin Europe’s QE party.”

European growth

Taken as a whole some managers believe the ECB’s commitment should bolster sentiment in the long run. **Mark Bogar**, European small cap manager at The Boston Company Asset Management (TBCAM), notes: “The ECB remains supportive of the European economy by trying to fight the risk of deflation with all tools available. This should be positive for the European economy as rates stay low.”

Standish notes the ECB’s new set of growth and inflation forecasts were also released, with what the group called “decent downgrades to both growth and inflation (although largely in line with expectations). The 2018 HICP forecast of 1.6% is particularly notable given its distance from the 2% inflation target.”

	2016 forecast* (December 2015 forecast)	2017 forecast (December 2015 forecast)	2018 forecast
Headline Inflation HICP	0.1 (1)	1.3 (1.6)	1.6
GDP	1.4 (1.7)	1.7 (1.9)	1.8

*Source: ECB 10 March 2016.

Hensman adds: “The short-term consequences of this barrage of policy measures are as challenging as ever to fathom. Longer-term we continue to believe policymakers are incorrect in their opinion that policies aimed at ever cheaper finance and raising current asset prices will provide a sustainable boost to economies. Rather than a linear path of cyclical economic improvement offered by the official narrative, the unintended consequences of distorted market price signals become increasingly evident in volatile and illiquid markets. With these latest policy initiatives unlikely to alter the challenging environment for corporate profitability when faced by an abundance of competition and increasing labour pricing power, there is little reason to change our view.”

Hensman says one shift that is evident is that the ability of the ECB (and Bank of Japan) to continue to use policy to batter their respective currencies is reaching some sort of limit. “An underweight position in the euro, or yen, on the expectation of even greater policy firepower no longer appears justified.”

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