KBC Market Research Desk - Havenlaan 12, 1080 Brussel

Flash

Friday, 11 March 2016

Markets doubt effectiveness ECB measures

Euro exchange rate and term rates sharply higher after volatile session

..Traders sense that the ECB is unable or unwilling to ease further

· Market Response underlines problems investors and policymakers now have

· Market Back-up occurs in spite of wide range of easing measures

·.Strong policy action today warranted by very downbeat economic projections

Negative reaction on suggestion scope for easing is exhausted

After a very volatile session, markets have reacted very negatively for the second time in a row to an ECB policy easing. The initial reaction to a larger than expected package of measures was modestly favourable with term rates and the exchange rate of the Euro both moving lower. However, traders then chose to focus on **a comment** at the subsequent press conference **by ECB president, Mario Draghi, which was interpreted as suggesting the scope for further ECB easing moves was effectively exhausted.**

As **markets prefer to travel hopefully than arrive**, the prospect that the bottom of the easing cycle has now been reached prompted a sharp turnaround in interest rate and currency markets in the wake of Mr Draghi's remarks. The response owed something to the weight of pre-ECB positioning (steeper depo-rate cut expected) and shortcomings in market liquidity at present. However, it also reflects the extent to which financial markets have become heavily dependent on the support of Central Banks **while at the same time becoming increasingly sceptical as to the effectiveness of such support in a macro context**. In turn, this emphasises the extent to which the traditional functioning of markets has been weakened of late.

Communication shortcomings

Our sense is that **there may be some backtracking from today's adverse reaction** to the ECB **but the fact that measures intended to calm markets had the opposite effect owes something to ECB communication shortcomings as well as to the markets themselves.** Having over-promised and under-delivered with the easing measures announced in December, it seems that after under-promising in the run-up to today's announcement the ECB intended to over-deliver through the range and scale of the policy changes adopted today. However, the usually sure-footed Mr Draghi caused a violent reversal of the initial market response through a combination of two remarks he made during the press conference.

The first comment that unsettled markets today was when Mr Draghi noted '*we don't anticipate it will be necessary to reduce rates further*'. While he qualified this by adding that '*facts can change the outlook*' and the press statement continues to say that '*the Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time',* a second comment suggests the possibility Mr Draghi might have been signalling a subtle shift in thinking in Frankfurt. **In an unprompted remark, he said the decision not to opt for a tiered deposit rate**, which had been speculated as a strong possibility, **reflected a**

desire '*not to signal that rates could go as low as the ECB wanted'.* In effect, Mr Draghi was signalling the existence of an effective lower bound. While he also said that '*more emphasis will shift to other non-conventional instruments'* if further action was required, **markets decided that the ECB was effectively signalling it was no longer willing and/or able to do more.**

Diminishing role ECB led to re-pricing

We don't doubt that, in extremis, the ECB would be able to find the means to undertake further significant easing. Nor would we entirely rule out the possibility of some further small tweaking of the deposit rate and/or the size of the asset purchase programme if inflation continues to surprise to the downside. We also have sympathy for an ECB that wants to avoid expectations of further easing every quarter, particularly as a significant measure of patience will be required before the impact of today's measures fully impact the Euro area economy. **However, today's ECB comments are likely to produce a significant and lasting re-pricing in markets on foot of a diminishing role for future ECB actions.**

Measures greater than expected

It should be emphasised that today's measures were notably greater than expected**. A 10 basis point cut in the deposit rate was widely expected. At the margin, this element was possibly smaller than some predicted, perhaps pointing to uncertainty in Frankfurt about the merits of a more aggressive action particularly on the Banking sector**. Although Mr Draghi assisted by ECB vice president Constancio emphasised the ECB's experience with negative deposit rates had been' very positive' and that, *in aggregate*, such measures had benefitted the Euro area banking system, his reservations about a tiered deposit rate suggest a concern that we might be close to a pivot point in this respect. On top of it, the arguments of especially Mr Constancio were based on past developments, while the fears of bank profitability concerns the future.

One element of today's measures that surprised markets was a cut in the key refinancing rate from 5 basis points to zero. Presumably this was intended to give additional impetus to a reduction in borrowing costs in financial markets and beyond even if the marginal adjustment limits its impact. **As this is the rate banks receive on their required reserves at the ECB, it will hurt the sector but it is likely that the generous terms on which new Targeted Long Term Refinancing Operations (TLTRO's) are being offered will more than compensate in this regard**.

New TLTROs: take up disappointing?

The **new TLTRO's will be available in four four-year tranches being offered at quarterly intervals between June 2016 and March 2017**. Banks can borrow up to 30% of eligible assets through these programmes. (As eligible loans are defined as those to euro area non-financial corporations and households excluding loans to households for house purchase).

While the base rate applicable to these TLTRO funds is the prevailing refinancing rate at the starting date, banks that step up their lending to the real economy can benefit from a rate that can be as low as the interest rate on the deposit rate at the start date. So, **in theory** (if policy rates don't change and banks increase lending by 2.5% by January 2018) **banks could access four year funding attracting rates as low as minus 40 basis points.**

Clearly**, this programme will incentivise banks to lend. The great unknown is whether**, even if lower funding costs are fully passed on, **there is a corresponding appetite on the part of borrowers** to stimulate loan demand materially given an on-going focus on deleveraging by many households and businesses across the Euro area at a time of significant global uncertainty and overcapacity.

APP expanded to €80B/month

The ECB further augmented today's easing by increasing its Asset Purchase programme by an additional €20 billion per month to €80 billion. Again, this was a somewhat stronger change than widely envisaged. In order to accomplish this, the ECB also had to increase the issuer and share limits on the relevant securities from 33% to 50% for securities eligible for international organisations and multilateral development banks. **This €20B additional buying is quite a step-up and is likely to have caused significant discomfort for some on the Governing council in terms of whether sovereign bond purchases on this scale effectively constitute monetary financing** in spirit if not according to the letter of the law. As **Mr Draghi emphasised that today's decisions were passed by** '*an overwhelming majority'***,** it is clear concerns in this regard were not widely felt **but perhaps such considerations were important in the markets interpretation of Mr Draghi's remarks** (discussed above) **as hinting that we are at or very close to the limits of ECB policy.**

Corporate bonds illegible: Size minor?

Finally, the ECB announced today that it would expand the range of assets eligible for its asset purchase scheme to include investment grade bonds issued by Euro area non-bank corporations. Our sense from the rather vague response that Mr Draghi gave to a question on the likely size of such purchases under this programme **is that it will not be significant in macro terms, but could be important to improving the functioning of some niche markets.**

Dark staff forecasts; downside risks growth

As this outline of today's measures suggest, the ECB has significantly stepped up its action. **The ECB press statement justifies** '*substantial monetary stimulus to counteract heightened downside risks to the ECB's price stability objective*'**.** Indeed, **very downbeat new economic projections prepared by the ECB staff suggest such risks have materialised to a significant extent**. GDP growth in 2016 is now put at 1.4%, materially softer than the 1.7% pace envisaged three months ago and, disappointingly, also weaker than last year's outturn of 1.6%. While some improvement to a 1.7% pace in 2017 and 1.8% in 2018 is anticipated, the ECB continues to see **risks remaining to the downside.**

A sluggish and vulnerable recovery is not conducive to a speedy rebound in inflation even if the impact of low energy prices is excluded. Excluding energy and food, consumer prices pick up only slowly from an expected 0.9% increase in 2016 to 1.3% in 2017 (both 0.2% lower than the previous projections envisaged) and to 1.6% in 2018. With headline inflation seen substantially lower in 2016 (0.1% v 01.0% previously) and also clearly lower in 2017 (1.3% v 1.6%), **the ECB acknowledges the risk of second round effects** that may threaten the projection of an inflation rate of 1.6% in 2018 that probably still lies somewhat below the target of '*below, but close to, 2%*'

Conclusion

On the path for inflation envisaged in these projections, it is clear that the ECB felt it had to act forcefully today. What is altogether less clear is whether today's measures or today's market reaction make it more likely that the inflation target will be reached anytime soon. £Higher euro, lower equities and higher yields doesn't augur well, as they deteriorate instead of ameliorate the financial conditions. Main feature, lower deposit rate and lower currency, exhausted. That needed to be offset by a raft of other measures that eye nice, but may not get the necessary size to turn the fortunes for the economy and inflation in the desired medium term. Other policymakers need to come to the rescue but they are entangled in existential political crisis (on migration, Brexit) which makes it unlikely that they take the heavy lifting over from a more and more compromised monetary policy that has little ammunition left.

Austin Hughes, KBC Dublin
Piet Lammens, KBC Brussels

Contacts

Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41	**Brussels**	
Peter Wuyts	+32 2 417 32 35	Corporate Desk	+32 2 417 45 82
Joke Mertens	+32 2 417 30 59	Institutional Desk	+32 2 417 46 25
Mathias van der Jeugt	+32 2 417 51 94	France	+32 2 417 32 65
Dublin Research		London	+44 207 256 4848
Austin Hughes	+353 1 664 6889	Singapore	+65 533 34 10
Shawn Britton	+353 1 664 6892		
Prague Research (CSOB)			
Jan Cermak	+420 2 6135 3578	**Prague**	+420 2 6135 3535
Jan Bures	+420 2 6135 3574		
Petr Baca	+420 2 6135 3570		
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8809	**Bratislava**	+421 2 5966 8820
Budapest Research			
David Nemeth	+36 1 328 9989	**Budapest**	+36 1 328 99 85

ALL OUR REPORTS ARE AVAILABLE ON WWW.KBCCORPORATES.COM/RESEARCH