

A pragmatic move by the ECB

Dovish taper supports growth and risk assets in the region

The ECB has announced that it will extend QE well into 2018, though at a reduced pace. Ongoing stimulus should support growth, corporate earnings, and risk assets in the Eurozone, especially equities. It should also help to prevent the euro from strengthening further in the near term and allow inflation to gradually pick-up. Crucially, the ECB has avoided making a policy mistake by removing stimulus too quickly.



Source: iStock by Getty Images

The ECB has explained what it plans to do with its QE asset purchase programme in 2018. From January, it will reduce the size of monthly purchases from the current pace of 60 billion euros a month to 30 billion a month, continuing buying at this reduced pace until September 2018 “or beyond, if necessary”.

The ECB announcement was on the dovish side relative to expectations. For example, there had been speculation before the

announcement that the ECB would only extend QE by six months in 2018, rather than the nine months it actually announced.

There had also been speculation that if the ECB did extend QE by nine months, it would do so at a pace of only 20 billion euros a month, rather than 30 billion a month.

So the announced size and length of the extension in QE were both on the high end. What’s more, in the press conference following the announcement ECB President

Mario Draghi said that QE would be unlikely to stop suddenly, implying that even after September 2018, there would continue to be some asset purchases, even if they were of a relatively small amount.

Details also dovish

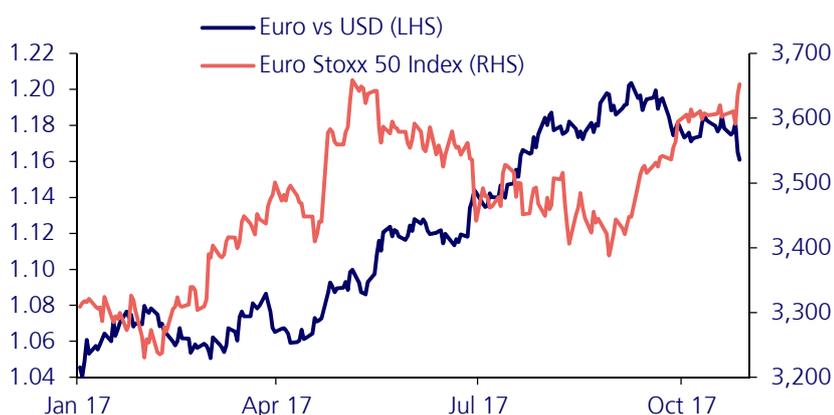
Other elements of the ECB announcement were also on the dovish side. For example, the ECB governing council kept the phrase used in previous statements stating that it could increase the QE programme in size (i.e. more than 30 billion euros) or duration (i.e. beyond September 2018) if needed (i.e. if the outlook for inflation to move gradually higher changed).

The ECB also said that it would continue reinvesting the principal from its current stock of securities as they mature “for an extended period of time after the end of its net asset purchases” and “in any case for as long as necessary”.

In the Q&A session following the announcement, ECB Vice-President Vitor Constancio indicated that reinvestments could be around 10 billion euros a month, which is substantial. The ECB will provide more detail on the size and breakdown of reinvestments in 2018 on November 6.

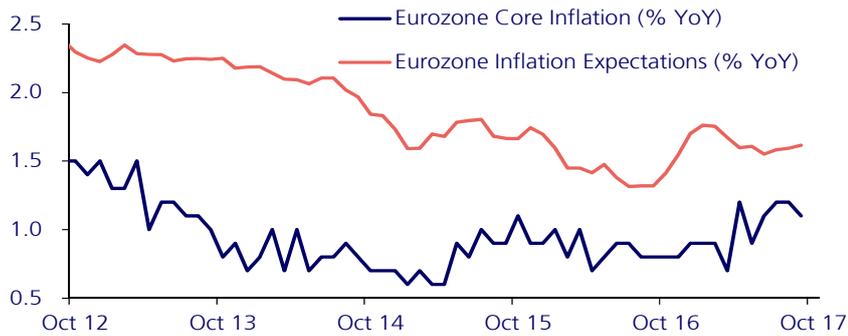
In terms of the composition of the 30 billion in asset purchases, Draghi said that they didn’t discuss the detail, but that the ECB

Chart 1: Euro Stoxx 50 close to YTD highs while Euro weakens



Source: Bloomberg

Chart 2: Inflation & inflation expectations still too low



Source: Bloomberg

would continue buying “sizeable quantities of corporate bonds”. Sovereign bonds are still likely to make up the majority of purchases, however.

The immediate market reaction also suggests that overall the ECB’s plans were at the dovish end of expectations. The euro fell by around a cent and a half versus the USD after the ECB announcement.

Many core and periphery Eurozone government bond yields were lower by around 6-9 bps on Thursday 26 October, with Spanish bond yields down by around 11 bps. The Euro Stoxx 50 closed up 1.3%, reaching close to its year-to-date high in May, just after the French elections.

Economic implications

The ECB announcement is supportive for growth and financial market and business confidence. The ECB has avoided the potential policy mistake of removing accommodation too quickly. This should help the Eurozone economic recovery to continue, with strong growth likely for the next few quarters.

Continued growth implies further falls in unemployment that will support consumer spending, while strong business confidence will support business investment. In this environment, corporate earnings should continue to grow as well, which will help support risk assets in the region, especially equities.

The ECB announcement will also support inflation expectations. Inflation remains below the ECB’s close to 2% target, at 1.5% on the headline measure and 1.1% on the core measure.

Headline inflation will likely fall in the coming months as base effects from high oil prices unwind. As Draghi himself noted, “... measures of underlying inflation have ticked up moderately since early 2017, but have yet to show more convincing signs of an upward trend”.

It was therefore crucial for the inflation outlook that the ECB did not remove monetary stimulus too quickly. Inflation expectations, and to some extent core inflation, have been on a gradual upward trend recently (see Chart 2), but too aggressive a reduction in QE could have put an end to this trend.

Market implications

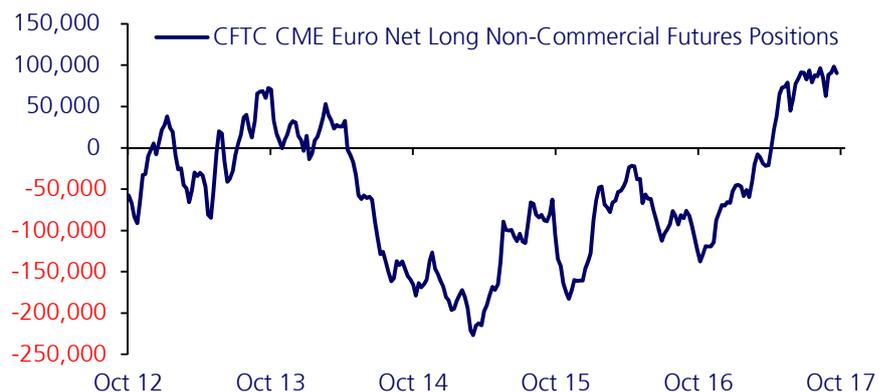
We expect Eurozone equities to be supported by the continued robust macro and earnings outlook, and the reduction in risk of a potential policy mistake by the ECB.

Core and periphery bond yields may fall back a little further in the near term, but the long-term trend is still likely to be higher because of the strong growth outlook and the fact that QE will eventually end. Political risks could also resurface, as they have recently in Spain, to drive yields in periphery markets higher.

In particular, one key political event risk for periphery bonds in 2018 will be the Italian elections, which must take place by May 2018 at the latest. At the moment, support for anti-establishment parties such as the 5 Star Movement remains high. Recent electoral law reforms have reduced the chances that they will actually gain power, but as the election draws nearer investors could still become concerned, depending upon the opinion polls closer to the time of the election

In terms of FX market implications, the relatively dovish ECB seems to have taken the wind out of the sails of euro bulls. Combined with extreme long euro (see Chart 3) and short dollar positioning, a reversal of this positioning now looks likely, implying further euro weakness versus the USD.

Chart 3: Euro positioning still very long



Source: Bloomberg, data as of 17 October

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