Market Flash

5 September 2014

ECB moves to boost inflation and liquidity

Policy measures will help to anchor low bond yields and keep the currency weak.

The ECB yesterday lowered the corridor for its benchmark interest rates by 10bps and also confirmed that it will begin outright purchases of Asset Backed Securities (ABS) from October, in response to persistently low inflation and weakening activity indicators in the region.

The rate cut is aimed at easing monetary conditions further and removing uncertainty whether rates are at their lower bound. This assurance should encourage banks to take up funds at the forthcoming Targeted Long Term Refinancing Operations (TLTROs), beginning in two weeks. The announcement of outright ABS purchases is also aimed at strengthening the TLTRO uptake by freeing up space on banks' balance sheets. Outright purchases of ABS are a form of Quantitative Easing (QE) and, along with the TLTROs, will help to expand the ECB's balance sheet, thereby providing credit to the real economy.

Policy measures will keep the euro weak

Forward guidance remains in place and with interest rates at their lower bound, the market will be increasingly focused on full blown QE as the next policy measure, especially if inflation stays persistently low. Encouragingly for the ECB, the initial response to the policy announcements was a stabilisation in inflation expectations in the market. While the raft of measures announced by the ECB will likely see the central bank on hold for the foreseeable future, the policy measures will also help to anchor low bond yields and keep the euro weak.

In previous press conferences, ECB President Draghi has pointed to the divergence in the monetary policies between major advanced economies as a key contributor to euro weakness versus the USD. This implies that the ECB may be expecting the common currency to weaken further. If the US Federal Reserve upgrades its assessment of inflation and activity at this month's meeting, we can expect the EUR/USD to fall further in the near term.

Weak euro to boost earnings

Investors shifted out of European equities in August as economic momentum weakened in the eurozone and geopolitical worries heightened. Earnings revision in Europe has also disappointed thus far. However, we are not overly bearish on the region at this stage. The selloff in Europe has made valuations cheaper and in our view, over the medium term, there is room for some price earnings expansion and stronger earnings growth, in part due to the weaker euro. The expectation of further policy easing may also help keep sentiment raised.

Meanwhile, potential short term euro weakness aside, investors looking for longer term euro exposure can also consider European financials bonds. A programme to buy ABS would potentially remove risky assets off banks' books, hence enhancing their solvency. This would in turn raise their ability to extend loans to the economy. We find the risk reward trade off offered by bonds with maturities between five to seven years to be relatively more attractive.

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