Flash

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Mixed signals, but dovish Draghi prevails

ECB extends timeframe, but scales back amount of bond purchases

Draghi says cutback isn't tapering and signals 'sustained market presence'

Euro weaken, equities gains and long term yields firm as market listens to Draghi

Measures announced should keep downward pressure on short term interest rates and steepen yield curves

But bond purchase measures impact may impact countries differently

Substantial differences between what the European Central Bank said it was doing and what the markets immediately judged it to have done resulted in very choppy trading conditions in FX and term interest rate markets in the immediate aftermath of the ECB'S announcement of alterations to the size and duration of its Asset Purchase Programme (APP).**While very dovish comments by ECB president, Mario Draghi, soon eased market concerns, we remain to be convinced that this is more than a temporary reprieve.**

What the ECB has done today is quite clever in a number of respects and may buy some time. It also suggests that official interest rates may remain lower for a little longer than the market had begun to fear of late but our sense is that confusion may soon return and contradictions re-emerge in relation to the broader thrust of ECB policy. A re-assessment may consider the possibility that the ECB has now taken a first and uneven step on a potentially problematic path towards reducing its 'unconventional' support to markets. That possibility could have an important influence on market conditions in early 2017.

The announcement today that the ECB would extend the APP beyond the prospective March 2017 deadline was almost universally anticipated and, consequently, had little impact on financial markets. **However, the decision to reduce the monthly volume of purchases from €80billion to €60billion from March was not widely expected and was seen initially as quite hawkish.** As a result, there was a strong if very short-lived 'taper tantrum' in the immediate aftermath of the 12.45 pm ECB announcement that drove the Euro and term interest rates materially higher.

Draghi to the rescue

ECB president Mario Draghi's determined efforts to soothe market concerns prompted a relatively speedy reaction that more than fully reversed the jump in the Euro and also unwound much of the initial rise in term rates. Mr Draghi suggested that alterations announced today to the APP were intended to preserve the 'extraordinary degree of monetary accommodation' already in place. Mr Draghi indicated that the ECB wanted to send a message signalling its 'sustained presence' in markets that would lead to 'a more lasting transmission of our stimulus measures' rather than any hint of a beginning of the end of easy ECB policy.

Crucially, Mr Draghi emphasised that 'tapering was not discussed today'. Instead, he explained a proposed scaling back of the ECB's monthly bond purchases as simply returning the size of monthly bond purchases to levels that prevailed prior to last March when there was a step-up in the volume of buying. He said this adjustment reflected the fact that the concerns that prompted the increase in

purchases nine months ago have progressively diminished in the interim.

Modest eco upturn & below target inflation

This instinctively appealing justification that the proposed reduction in monthly bond purchases reflects improved economic circumstances and reduced risks is somewhat at odds with the rather downbeat new projections released by the ECB today. Although the press statement refers to a 'moderate but firming recovery', Mr Draghi indicated that the outlook for growth and inflation is 'broadly unchanged' from September with **risks remaining to the downside**.

The details of the ECB's new projections also paint a picture of a lacklustre upturn and a fairly prolonged period of below target inflation. They show consumption growth slowing from +1.7% in 2017 to just 1.4% in 2019 as a lower unemployment forecast is offset by slower wage growth. In the same vein, underlying inflation has been slightly downgraded for both 2017 and 2018 (to 1.1% and 1.4% respectively). Mr Draghi also noted that the ECB's first public inflation projection for 2019 of 1.7% **is 'not really' in line with the ECB's goal of an inflation rate 'below, but close to, 2%'.** In that respect, the projections extrapolate into the future the observation from the press statement that 'there are no signs yet of a convincing upward trend in underlying inflation'.

In light of the new ECB projections, the persistence of downside risks to a relatively subdued outlook and the dovish chord struck by Mr Draghi today, it might have been envisaged that the ECB would retain policy at current settings. On the basis of the mantra repeated in every ECB press statement since March this would have entailed continuing with an APP of €80billion per month. As the October press statement noted; 'we confirm that the monthly asset purchases of €80 billion are intended to run until the end of March 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim' (our emphasis in bold). As today's projections don't show a sustained adjustment in inflation, they can't properly explain the proposed reduction in monthly purchases to €60billion from next April.

Did the ECB ease or tighten or both?

The turnaround in the Euro and interest rates as Mr Draghi spoke **suggests that investors largely believed the ECB president's assertion** that today's adjustments to the parameters of the Asset Purchase Programme did not constitute the start of a tapering process. **In part, this judgement speaks of the credibility of Mr Draghi but it may also owe something to some potentially questionable arithmetic.** Extending the APP means an additional €540billion of purchases between April and December of next year. It has been suggested that this represents a somewhat larger stimulus than would have been entailed by the consensus expectation of a six month extension to the APP at an unchanged €80billion monthly rate which would amount to a cumulative €480billion. However, that calculation assumes that the APP would stop completely in September 2017. If instead we make a still relatively hawkish assumption that 'tapering' would reduce monthly APP purchases to €40-50 billion from October, **the decision represents notably less support for the Euro area bond market through 2017 than might have been previously. Only if the market believes that support in 2018 and beyond is greater than it previously envisaged does it make sense not to think of today's tapering as tightening.**

Some measures may have important implications

To ensure that the APP would not run into purchase ceilings, **it was widely expected that the ECB would increase its issuer and issuance limits from the current threshold of 33% towards 50%.** However, this did not occur. Instead, the ECB decided to increase the eligible pool of bonds by 'decreasing the minimum remaining maturity for eligible securities from two years to one year'. In addition, it was decided that 'purchases of securities under the APP with a yield to maturity below the interest rate on the ECB's deposit facility will be permitted to the extent necessary'.

The approach adopted by the ECB is interesting in several respects. By allowing APP purchases of bonds with a minimum of one rather than two years remaining maturity, **the approach chosen** by the ECB today **should put a measure of downward pressure on market interest rates at the shorter end of the curve.** This effect will be notably further enhanced by the decision to permit purchases of bonds yielding less than the ECB's deposit rate.

So, **the form of adjustment to the APP chosen by the ECB might be expected to lead to steeper yield curves.** The expectation in the press statement that key ECB interest rates will remain 'at present or lower levels….well past the horizon of our net asset purchases' which has now been extended to December 2017 will also assist in differentiating the impact between the shorter and longer ends of the yield curve.

In this regard, **the announcements likely owe something to the ECB's assessment of the relative strengths and weaknesses of various aspects of the initiatives introduced by the Bank of Japan earlier this year. In turn, an environment in which short term rates are anchored and longer term rates less so is likely to benefit the Euro area financial sector.**

By opting not to increase current issuer/issue thresholds- a course of action widely expected by markets- **the ECB has**

avoided a further intensification of a potentially destabilising role as a bond buyer of first resort. This also avoids possible legal complications in the event of a debt restructuring. A further consideration is that the approach chosen makes for an easier exit strategy because of the shorter permitted maturity profile of additional bond purchases.

The impact of these measures may not be felt evenly across all Euro area countries, implying the possibility of widening yield spreads. The shorter maturity profile and the allowance of the purchase of bonds yielding less than the ECB's deposit rate means that **they should be relatively helpful for Germany** whereas on fairly crude calculations, we reckon that at the recent rate of Irish APP purchase, the ECB may reach its limit for Irish bond purchases in March or April 2017. A broadly similar problem apply to Portugal.

All is calm…for now

To summarise, we think the adjustment of the APP from €80billion per month to €60billion from April represents a modest tightening of ECB policy relative to market expectations. However, **very dovish comments** by Mr Draghi and the novel combination of **initiatives that should produce a steeper yield curve** while sustaining downward pressure on shorter end market interest rates **have prevented a pronounced negative market reaction at least for now.**

We think the announcements likely represent a possibly difficult compromise between those within the ECB who see a need to extend easing because of a still subdued economic outlook and those with deep misgivings about Quantitative Easing who want some clear signal that such measures will be wound down. In coming weeks and months both sides may point to particular aspects of the announcement to argue policy is tilted more in their preferred direction. **In circumstances where broader economic and political developments may be more conducive to notably increased volatility, future market 'tantrums' about tapering may become notably more problematic than today's storm in a teacup.**

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