IE
Global Investment Event

22 January 2015

The European Central Bank (ECB) announces sovereign bond Quantitative Easing (QE)

- The ECB belatedly joined the US, UK and Japanese central banks in announcing that it will buy government bonds in an attempt to prevent deflation from becoming entrenched and boost economic momentum.
- The ECB will buy EUR60bn of assets per month between this March and September 2016. Consequently, unless inflation looks on track to return to the 2% inflation target soon, the ECB will buy EUR1.1trn of assets. The ECB left the door open to extending the programme if inflation disappoints.
- Although the package was larger than the EUR500bn initially floated, it was in line with yesterday's rumours.
- Disappointingly, the risk associated with government bonds bought under the programme will sit with the central banks of the issuing countries rather than being shared across the Eurozone. Although that was probably the price ECB president Draghi had to pay to get a larger package through, it does reduce the credibility of the package as a back-stop.
- QE programmes in other countries have tended to coincide with periods of equity outperformance relative to government bonds. If this were to happen again it would benefit the equity holdings of our multi-asset portfolios.

The facts

After months of build-up, the European Central Bank (ECB) finally bowed to the inevitable today by announcing the extension of its asset-purchase programme to include government bonds and the debt of European institutions as well as the asset-backed securities and covered bonds already included in the scope of the programme. The ECB's intention is to purchase EUR60bn of assets per month between March 2015 and September 2016, which equates to a total of EUR1.14trn. The size of the programme is in line with yesterday's leaks, and so was consistent with latest market expectations, but well ahead of the EUR500bn initially rumoured. As expected, the purchases of securities issued by Eurozone governments and agencies will be based on each country's contribution to the ECB's capital base, which is itself based on the size of the economy. In other words, the largest purchases will be of German, French and Italian assets.

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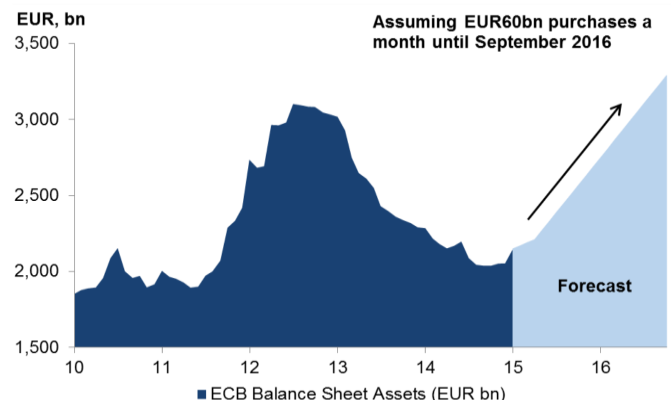
The ECB's programme equates to around 10% of Eurozone Gross Domestic Product (GDP) as compared to the eventual sizes of the equivalent US, UK and Japanese programmes of 11%, 21% and 26% of GDP respectively. The ECB left the door open to ending the programme early or extending it by saying that purchases will be conducted until it sees a sustained adjustment in the path of inflation which is consistent with hitting the 2% inflation target in the medium term.

The ECB's operational aim is to swell its balance sheet

The ECB's operational aim is to increase the size of its balance sheet by over EUR600bn from its current EUR2,168bn to around the EUR2,800bn it averaged in Q1 2012. That task is a little bigger than it seems, given that banks are due to pay back around EUR200bn of loans to the ECB and may not choose to renew all of those loans. Nevertheless, the programme is more than big enough to achieve this.

Figure 1: The ECB's aim is to expand its balance sheet by over EUR1 trillion by September 2016



Source: Bloomberg, HSCB Global Asset Management, data as at January 2015. For illustrative purposes only. Any forecast, projection or target contained in this presentation is for information purposes only and is not guaranteed in any way. HSBC accepts no liability for any failure to meet such forecasts, projections or targets.

The ECB seems to have compromised on risk sharing in order to achieve consensus on a larger package

Disappointingly, although purchases of securities of European institutions will be subject to loss sharing, purchases of government bonds will not. So rather than the ECB buying government bonds and holding them on its own balance sheet, the ECB will instruct the national central banks to buy the bonds of their respective governments and hold them on their balance sheets. This will keep the credit risk of each country's debt isolated on the balance sheets of its own central bank .

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Any mark-to-market losses, or profits, on the bonds of individual countries would therefore fall on that country's central bank, eating into its capital base, and not be shared across each member country proportionally. This will reduce the market credibility of the programme as a back-stop and is likely to have been a necessary compromise to get ECB council members to agree to the programme, particularly such a large programme.

The ECB's economic aim is to avoid deflation becoming entrenched

The ECB's economic aim is to boost growth and try to prevent the Eurozone from experiencing a prolonged period of deflation i.e. falling prices. The Eurozone has grown by just 0.8% over the last year and surveys suggest that it may not have expanded at all in Q4 2014. Eurozone Consumer Price Index (CPI) inflation has steadily fallen from 3.0% in November 2011 to -0.2% in December 2014.

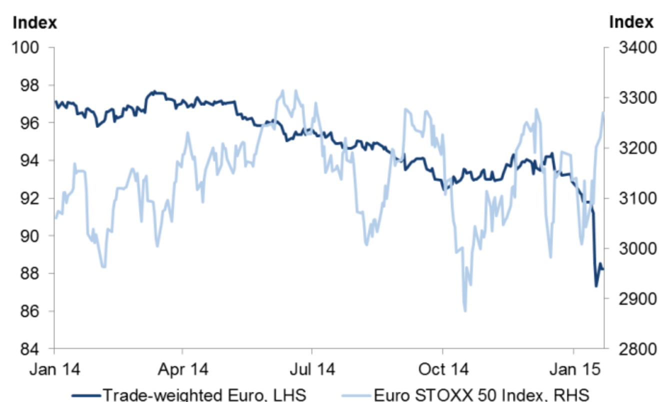
Inflation is likely to fall further in the months ahead as the 56% fall in the euro price of a barrel of oil since the end of June continues to feed through. In addition, spare capacity, as illustrated by an output gap estimated to have been -2.8% of GDP in 2014, is also weighing down on prices. This spare capacity is illustrated in a non-energy industrial goods annual inflation rate of 0%.

Market impact

In anticipation of sovereign bond quantitative easing, the euro dropped over 6% on a trade weighted basis from 16 December to 21 January. In addition, German 10-year bund yields fell 10 basis point (bp) to 0.52%, while Spanish and Italian peripheral spreads narrowed by 16bp and 20bp respectively during the same period.

The depreciation of the euro is a boost for European exporters and consequently corporate earnings. European stocks, as measured by the Euro STOXX 50 index, rallied 9.6% from 16 December to 21 January, with German equities outperforming.

Figure 2: The EUR has depreciated against a basket of currencies in anticipation of QE, while equities have rallied



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The market's initial reaction to the ECB's announcement caused a rally in both equity and fixed income markets. European equities, as measured by the Euro STOXX 50 index, rose by over 1% at the time writing, with the peripheral stock markets of Spain and Italy outperforming.

Moreover, core government bond yields fell within the Eurozone, with German 10-year bund yields dropping 7bp to 0.45% and French 10-year government bond yields falling 9bp to 0.61%. Peripheral spreads also narrowed further, particularly in Greece and Portugal. In addition, the euro dropped sharply on the announcement, depreciating around 1% against the USD to 1.15.

Investment implications

Simulations carried out on macroeconomic models suggest that ECB QE should eventually boost output, consumer price levels and equity prices but suppress bond yields and the exchange rate. Macro model simulations also suggest that the countries with the best capitalised banks may see the largest boosts to bank lending and to output.

In addition, analysis of previous episodes of QE over the past six years in the US, the UK and Japan suggests that global equities usually rally post QE announcements and there is a short-term increase in equity Price-to-Earnings (PE) ratios. QE announcements have also tended to mark a turning point in the performance of equities relative to bonds, as equities have risen and bonds have fallen. Bonds have tended to underperform as yields have often increased in anticipation of a boost to both growth and inflation expectations. This would be beneficial for our multi-asset portfolios which are mainly overweight global equities relative to government bonds.

Figure 3: Global equities have tended to outperform bonds when QE was implemented in the US

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Cyclical equity sectors have on average outperformed around prior QE announcements, especially autos, industrials, chemicals and media. The utilities, banks, real estate and food & beverage sectors have tended to underperform.

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