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The ECB goes further than expected

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For the ECB, the situation was becoming more and more complicated : inflation close to all-time low (both for headline and core figures), long-term inflation expectations at their all-time low, the effective euro threatening to appreciate further, deteriorating global growth outlook. Moreover, the central bank cut dramatically its growth and inflation forecasts for 2016, respectively from 1.7 to 1.4% and from 1 to 0.1%. The 2018 inflation forecast is 1.6% only.

It was necessary to act and to overcome the disappointment generated by the December 2015 governing council (time extension of the PSPP and cut in the deposit rate to -0,30%). This time, the ECB made big announcements:

- **Cut in the key rates:** the refinancing and the marginal lending facily rates have been cut by 5 bps to respectively 0.00 and 0.25%. The deposit facility rate has been cut 10 bps to -0.40%. The ECB let the door open to further cuts.
- **Rise in the pace of QE purchases from 60 to 80 bn per month.** Issuer and issue share limits for supranationals are raised from 33 to 50%.
- **Extension of the purchases to investment grade non-financial corporations.**
- **New series of targeted longer-term refinancing operations (TLTRO-2),** each with a four-year maturity, at a rate of between -0.40% and 0%. As such, banks will be able to borrow a total amount of up to 30% of their outstanding loans to non-financial businesses and households (excluding housing loans) as at January 2016.

What's the takeaway on these measures? Are they in line with expectations?

- **Mario Draghi made it clear that the ECB had no intention of lowering interest rates any further (even though that option is not officially ruled out).** That is why a system of dual deposit rates has not been put in place. Mr Draghi says that such a system might have maintained expectations of future interest rate cuts, which is not in his plans. If need be, the ECB will further mobilise "unconventional" measures. **This is a sign of appeasement for the banks, which fear for their profitability.**
- **The increase in assets that the ECB will purchase by March 2017 is up by €240bn** (2.2% of GDP), which will bring the total amount of assets that the ECB will have bought by that time to nearly €1800 bn (16.5% of GDP).**The increase in the programme** is quite significant, but **below expectations** of an increase of €300 to 500 bn (via a simultaneous increase in the amount of securities purchased and the duration of the programme).**That said, this "disappointment" should be put into perspective,** because:
    - (1) the increase in monthly purchases is quite significant (+33%);
    - (2) the expansion of the QE to include corporate bonds profoundly changes the nature of it (the ECB is thereby making an implicit commitment to finance businesses with exceptional terms for the entire duration of the QE);

    - (3) the scheduled end of the QE (March 2017) is not set in stone. In particular, a new downward revision of the ECB's forecasts would quite naturally end up extending the securities purchasing programme.

- **In addition, several measures go well beyond expectations:**
    - **Expansion of the QE to purchases of non-financial corporate bonds**. The aim of this measure is to reduce the risk of tensions on the credit market. The ECB's financial stress indicator, which is back up to its 2012 levels, has probably alerted the central bank. Regardless of the direct impact on the asset class (see below), this measure's indirect purpose is to encourage portfolio reallocations in favour of risky assets.
    - **The horizon for liquidity operations.** In practice, the ECB has scheduled four TLTROs of four years each (in June, September and December 2016, with the final one in March 2017). This means the banks' horizon in liquidity terms is pushed to... 2021!
    - **Rates may be negative for the ECB's loans to banks, depending on how much credit the banks give to the real economy.** In practice, TLTROs will be done at refinancing rates (0%). To get the banks lend more with borrowed liquidities, banks that exceed a lending benchmark between 1 February 2016 and 31 January 2018 will have a negative interest rate applied (retroactively) to the borrowed liquidities. The more the bank has exceeded its lending benchmark, the more negative the rate will be (with the deposit rate at -0.4% for a minimum).**Ultimately, then, the aim is to retroactively neutralise the impact of negative rates** for the banks that have "played the game" of financing the real economy.

What does the inclusion of NFC debt imply?

- **We expect the corporate bond market to react positively to this measure.** Currently, outstanding securities of this type stand at € 653 bn (37% of the euro Investment Grade universe). At this stage, we do not have a lot of details regarding this programme (maturity, sector, country). This action will definitely encourage the search for yield but could create some valuation distortion within the euro credit universe.
- **No doubt, the extension facilitates the implementation of the QE.** The extension of the QE to these assets allows aims to solve the scarcity issue (according to our assumptions, the Bundesbank would have no more security to purchase after the end of 2017, in the case there is no issue share limit for corporates or the summer 2017 if there is a 33% issue share limit for corporates). **To sum up, the extension of the QE to corporate securities allow to raise the pace of the programme.**
- **However, we should not overestimate the impact of this programme of NFC fundamentals.** Indeed, businesses that issue on the IG euro bond market have enjoyed very good financing terms over the last years despite the recent deterioration. Unlike SMEs, which are harder hit by credit rationing, they have not been penalised by the tighter bank-loan conditions. They have benefited from investors' strong appetite, paired with historically-low rates to prolong the maturity of their debt and significantly reduce their financing cost. In addition, financing needs of Eurozone Corporates are limited in a low growth environment. The size of the market has remained stable since 2008: the market has only increased by 20% since 2008 versus +376% over the 2000-2008 period.

Limited impact on the Bund market (less paper scarcity). But positive impact expected on peripherals.

- **The relatively limited cut in the deposit rate and on the top of that, the sentence of Mario Draghi during the press conference ("From today's perspective, we don't anticipate it will be necessary to reduce rates further") induced a upward parallel shift of the German yield curve.** This allows the long-term yields to rise to some extent. Indeed, before the governing council, the Bundesbank could only buy securities with a maturity above 6.5 years to respect the "yield constraint": it fell to approximatively 3 years now. Besides, **these announcements are positive for peripheral govies.**

Headwinds on the euro. The currency depreciation seems to be less a priority than in the past for the ECB.

- There are two opposite factors: the increase in the QE's pace (euro depreciation) and the slight increase in short-term yields (euro appreciation). That being said, the ECB policy has already considerably weakened the currency since early 2015: net portfolio outflows are already extremely large and more aggressive cuts in the deposit rate would have been necessary to trigger a new depreciation trend. Currency depreciation seems to be less a priority than in the past for the ECB.

How effective will monetary policy be?

- That is the central question. Mario Draghi has rightly stated that without the securities purchases made by the ECB in the past, the eurozone would have fallen into deflation. **Unconventional monetary policy operations are behind the financial defragmentation we have seen (**widespread decline in interest rates, sovereign spreads, bank loans extended to SMEs, reduction in spreads between lending rates offered to large corporations and those offered to SMEs).
- In terms of the impact of negative rates on the banks, he was also intent on repeating that: (1) these latter had benefited from capital gains from the widespread interest rate cuts and (2) the banking system, taken as a whole, was able to offset the losses in revenue with an increase in volumes of loans made. Moreover, the fact that the decline in deposit rates comes with the option of borrowing at negative rates from the ECB clearly limits the negative impact on profitability.
- **That said, the future impact of these measures on growth in GDP should not be overestimated.** Our growth forecast is now marginally higher than the ECB's in 2015 (1.5% vs 1.4%). We are holding on to our 1.4% growth forecast for 2017 (vs 1.7% for the ECB). In fact, it is one thing is to maintain financial conditions that are conducive to domestic growth – which the ECB has just done – and another thing entirely to see growth accelerate in a global environment that we believe will be flat for the foreseeable future.