IE

Global Investment Event

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For Professional Clients and Institutional Investors

The European Central Bank eased monetary policy further to counter stagnant growth and disinflationary pressures within the Eurozone

- At its September meeting, the European Central Bank (ECB) eased monetary policy further by cutting all three main interest rates by 10bp; and announcing the beginning of an asset-backed securities (ABS) and covered bond purchase programme in October.
- ECB President Mario Draghi reiterated the Governing Council's *"unanimous"* commitment to consider using further unconventional measures should they be needed in the future to ensure price stability.
- European equity markets rallied strongly on 4 September following the ECB meeting. Core Eurozone government bond yields remained little changed, while peripheral bond yields fell. The euro dropped sharply, falling to its lowest level in over a year.
- The additional stimulus measures are expected to be supportive for risk assets, such as equities, globally in our view. The reduction in interest rates was largely unanticipated by the market; and the new programme of ABS and covered bond purchases was wider in scope and more timely than most market participants had expected.

The facts

Although the Eurozone economy emerged from recession over a year ago, its recovery has so far failed to gather convincing momentum. Since the start of 2014, both Eurozone activity and inflation data have consistently surprised to the downside.

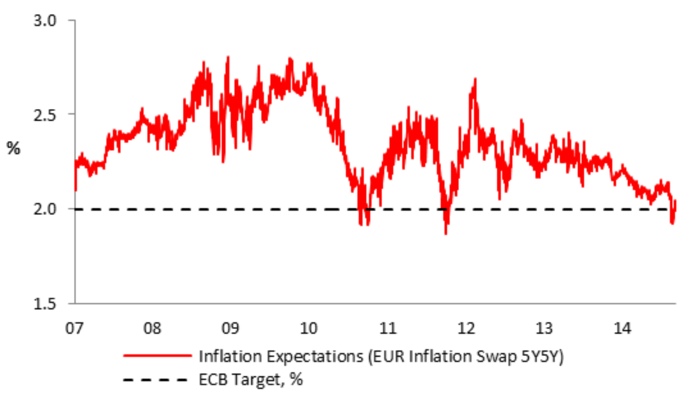
The latest estimate of Q2 GDP showed Eurozone growth to be stagnant (0.0% qoq), with Germany and Italy contracting by 0.2% qoq and France's GDP remaining unchanged from the previous quarter. In addition, due to a combination of the strength of the euro, which has pushed down import prices and spare capacity weighing on domestically generated inflation, headline inflation has fallen sharply from 2.7% yoy in September 2012 to just 0.3% yoy in August 2014. This is substantially below the ECB's target of below, but close to, 2%.

Indeed, the most recent downbeat data has prompted ECB staff members to revise down further their forecasts for 2014 Eurozone growth and inflation. Compared to the forecasts announced after the ECB meeting in June, the 2014 GDP forecast was revised down in September from 1.0% to 0.9% and the inflation forecast revised down from 0.7% to 0.6%.

Back in June, in response to the lacklustre activity data and looming threat of deflation, the European Central Bank (ECB) announced a monetary stimulus package. This included cutting both the refinancing rate and the deposit rate by 10bp, to 0.15% and -0.10% respectively; and reducing the rate charged on the marginal lending facility by 35bp to 0.40%. In addition, the ECB halted the sterilisation of purchases under the Securities Market Programme (SMP) and introduced new measures aimed at improving the functioning of the monetary transmission mechanism by offering "targeted" cheap four-year loans to banks.

However, despite these measures, the risk of a prolonged period of low inflation has continued to increase, threatening price stability in the region. This prompted ECB President Mario Draghi to become significantly more dovish in his speech at the Jackson Hole symposium on 22 August, in which he acknowledged that inflation expectations had experienced *"significant declines at all horizons"* in August and vowed that the ECB will *"use all the available instruments needed to ensure price stability over the medium term"*.

Figure 1: Inflation expectations have been falling



Source: Bloomberg, as at 4 September 2014.

HSBC Global Asset Management

Following Draghi's comments at Jackson Hole, at its September meeting the ECB eased monetary policy further to fight the threat of deflation with the following measures and announcements:

Interest rate decision

The ECB cut all three of its main interest rates by 10bp. The refinancing rate was reduced from 0.15% to 0.05%, the deposit rate fell from -0.10% to -0.20% and the rate on the marginal lending facility fell from 0.40% to 0.30%. ECB President Mario Draghi explicitly confirmed that interest rates are now firmly at their lower bound.

Purchases of asset-backed securities (ABS) and covered bonds

The ECB will begin purchasing a broad portfolio of asset-backed securities (ABS) and covered bonds in October to inject further liquidity into the Eurozone's financial system. The programme was wider in scope, and more timely, than most market participants expected. Draghi stressed that the ECB would only purchase *"simple and transparent"* ABS. Investors are likely to look towards the October ECB meeting for further details on the size and scope of the programme.

Further unconventional monetary policy measures

Should the threat to the Eurozone's price stability remain even after these new stimulus measures have taken effect, ECB President Mario Draghi reiterated the Governing Council's *"unanimous"* commitment to use further unconventional measures. This may be in the form of outright purchases of Eurozone government bonds.

Market impact

Speculation that the ECB would take additional steps to stimulate the economy, following ECB President Mario Draghi's dovish speech at Jackson Hole on 22 August, drove European equity markets higher. Between 22 August and 3 September, the Euro Stoxx 50 index rose by over 3%, albeit with some volatility as the situation in Ukraine developed, outperforming global equities which also rose.

Following the announcement of additional stimulus measures by the ECB at its September meeting, European equity markets rallied strongly. The Euro Stoxx 50 index rose 1.8% on 4 September, with peripheral stock markets outperforming. European equities have now risen just over 5% since the beginning of August and have returned 5.6% year-to-date (as at 4 September).

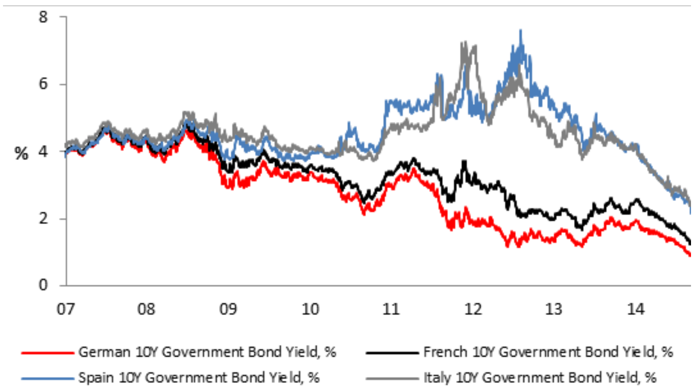
Figure 2: European stocks rallied strongly on news of further monetary easing from the ECB

Source: Bloomberg, as at 4 September 2014

10-year government bond yields across the Eurozone continued to reach fresh record lows in the run up to September's ECB meeting on a weak growth outlook and monetary stimulus hopes. Indeed, German and French 10-year government bond yields fell to record lows of 0.87% and 1.22% respectively on 28 August. The spreads of peripheral bond yields over German yields had also narrowed slightly with the spread of Italian 10-year bond yields over German yields dropping from 160bp to 150bp between 22 August and 3 September.

After the ECB's announcement, despite some volatility, German 10-year bund yields ended 4 September little changed, rising 1bp to 0.96%. French 10-year government bond yields also experienced modest moves, falling 4bp to 1.30%. However, in the periphery government bond yields fell markedly with Spanish and Italian 10-year yields both slipping 11bp to 2.15% and 2.35% respectively. As a result, peripheral bond yield spreads narrowed.

Figure 3: Eurozone bond yields have hit record lows this year on stagnant growth, weak inflation and monetary stimulus



Source: Bloomberg, as at 4 September 2014

Between 22 August and 3 September, the euro weakened by 1.0% against the USD as hopes rose of further monetary stimulus. Following the ECB's decision to cut interest rates and begin a programme of ABS and covered bond purchases, the euro dropped sharply, falling to its lowest level against the USD since July 2013 to 1.30 at the close of European markets. The euro has now depreciated over 6% against the USD since early May, providing a boost for Eurozone exporters, and this is likely to reduce disinflationary pressures through higher import prices.

Figure 4: The euro fell to its lowest in over a year against the USD on the ECB's announcement

Source: Bloomberg, as at 4 September 2014

Investment implications

The injection of liquidity by the ECB should be supportive for risk assets, such as equities, globally. The reduction in interest rates was largely unanticipated by the market; and the new programme of ABS and covered bond purchases was wider in scope and more timely than most market participants had probably expected.

The measures taken by the ECB should improve the growth prospects of the peripheral Eurozone economies in particular by improving their access to credit. It therefore seems likely in our view that peripheral spreads will narrow further. Their equity markets could also continue to benefit from improving growth prospects.

This easing of the ECB's policy stance, particularly at a time when the US Federal Reserve and the Bank of England seem to be on the verge of heading towards tightening policy, could also add to downward pressure on the euro.

Our long-term investment views have not changed, we continue to favour most riskier assets, such as equities, over perceived 'safe-haven' developed market government bonds. The ECB action supports the view that the world's major developed market central banks are ready and willing to provide monetary stimulus if necessary to support their economies.

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