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TRENDMACRO LIVE!

On the April ECB Rate Decision

Wednesday, April 4, 2012
Lorcan Roche Kelly

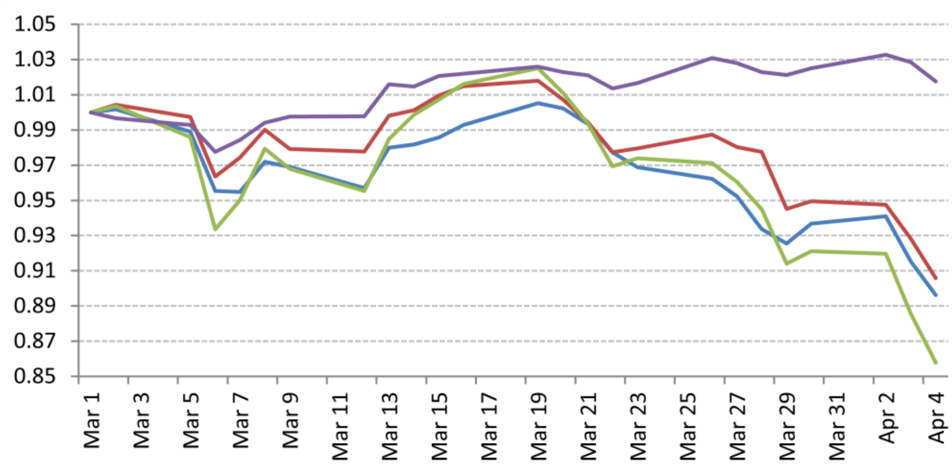
The ECB stands pat -- apparently markets will just have to wait to see if LTRO worked.

Yesterday's FOMC minutes were viewed as a "not now" for QE3 and today's ECB monetary policy decision was the expected "no change." It seems markets are on their own for the moment, and they don't like it much (see chart below).

The ECB made no changes to interest rates, and announced no monetary policy shifts.

- Mario Draghi's statement at the beginning of the press conference said that risks remain to the downside, and that inflation is likely to remain above target -- close to, but below, 2% -- until 2013.
- Monetary growth is still below trend. Euro area M3 growth is probably the single most important factor to watch to see if the 3-year Longer Term Refinancing Operations (LTRO) are having an effect on lending into the euro area economy.
- Latest readings of M3 are improved but at 2.8% are still far below the historical average of above 6% -- and taking inflation into account, have hardly given a positive reading in three years.

STOXX EA Bank Index — IBEX — FTSE MIB — S&P 500
Normalized to zero on March 1, 2012



Source: Bloomberg, TrendMacro calculations

Update to strategic view

ECB, EUROPE MACRO, EUROPE BONDS, EUROPE FINANCIAL STOCKS: The ECB stands pat, waiting to see if its two LTRO operations will do more than rescue Europe's banks -- so far M3 growth has been less than impressive. Markets seem disappointed. Peripheral debt is only pulling back from its "LTROphoria" pricing for perfection, but for Europe's banks, this pullback is getting overdone.

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- Draghi said that the latest figures available to the ECB do not reflect the full effect of the second 3-year LTRO, so next month's data will give a better idea of the effectiveness of the operations (see "How Big was the LTRO, Really?" February 29, 2012). But this is probably the last month he can use this excuse.
- Another low M3 growth figure for March -- due on April 30 -- would put pressure on Draghi to ease further. If it comes in close to or below the growth rate of inflation, we would expect a rate cut by May.
- Draghi also pushed again for further supply side measures in euro area economies, restating his position that the European social model is in need of reform.

Nice words aside, the ECB has done nothing to help markets today. And European markets -- especially those in Italy and Spain have come under severe pressure over the past few weeks.

- The Spanish budget does nothing to improve prospects for the structural reforms underway, and the projected debt/GDP ratio increase to 79.8% by 2012 reduces Spain's greatest economic advantages over its peers -- it's low stock of debt. The higher market yields on Spanish debt -- now well above 5% on the 10-year -- are unlikely to lead to many problems for the Spanish government in the short term, as it has already succeeded in funding 47% of its 2012 needs.
- Financial stocks in the periphery have not had a great March, either. LTROphoria (see "LTROphoria" February 27, 2012) has certainly worn off. But there does not seem to be a single catalyst for the sell-off, although comments from the European Banking Authority (EBA) hardly helped matters when they said Basel III rules, if implemented now, would require another round of capital raising.

As policy-makers choose to sit on their hands, the market is left to find its own way. For the moment, the market seems to have decided that it would like to scale back its exposure to the risks and opportunities in European financial stocks, and in peripheral market debt. We predicted as much with respect to debt -- that situation got about as good as it couple possibly get early last month, from where it could only get worse again (see "Unquestionable Success?" March 9, 2012).

But financial stocks were never priced to perfection like this, and with a decline over the last month erasing almost half the post-LTRO gains, they are getting interesting again. We still maintain that the best recovery play in Europe is the financial sector. While the current reversal is not what we had predicted, it is not going to turn into a repeat of the crises of 2008 or 2011. The ECB has, at least, assured us of that.

Bottom line

The ECB stands pat, waiting to see if its two LTRO operations will do more

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