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MACROCOSM

V(Q)E-Day

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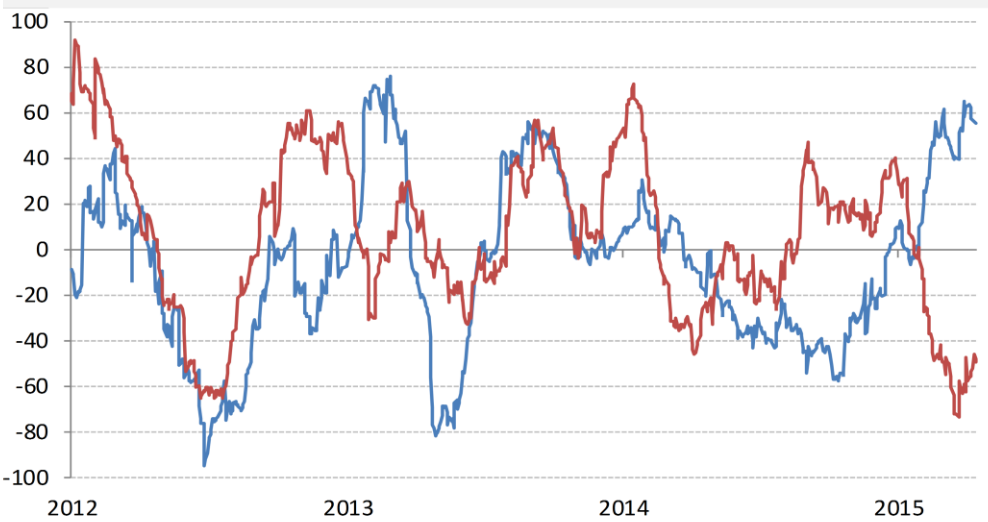
Donald Luskin

The DICK-tators at the ECB declare a QE victory for a recovery already in place for years.

Luckily yesterday's European Central Bank Governing Council meeting was disrupted by a woman who jumped up on the table before President Mario Draghi, wearing a sweatshirt reading "End ECB DICK-tatorship" and hurling confetti. If it weren't for that, the policy meeting would have been utterly uneventful. But isn't that the whole point of having announced, at the January meeting, a large fixed amount of sovereign bond purchases each month through late next year -- precisely to lock in policy expectations in "whatever it takes" mode (see "On the January ECB Policy Meeting" January 22, 2015)? It's the ultimate forward guidance -- taking policy uncertainty off the table, even if there is no good argument for the policy's efficacy for its own sake, other than as a signal.

Whatever the mechanism, it's been working. Economic performance in the euro area has been strong all this calendar year, turning around as expectations for ECB QE started to solidify, and long before actual purchases began last month. For the euro area, economic surprises have been on the upside, while for the US they've been on the downside (please see the chart below). Year-to-date, euro area equities have strongly



Source: Citigroup, TrendMacro calculations

Update to strategic view

ECB, EUROPE MACRO, EUROPE STOCKS, EUROPE BONDS, EUROPE FINANCIAL STOCKS, FX: The ECB is crowing about the success of its new QE program, but the reality is that euro area recovery has been in place long before QE was implemented or even imagined. The euro has actually strengthened since QE began, and with the most dovish expectations for the ECB now realized, we don't see why it should weaken from here. Similarly, we see little room on the downside for euro area sovereign yields. Stocks and the banking sector can continue to benefit from the underlying recovery that has long preceded QE. There is a risk of short-term Grexit crisis, but QE might ease the blow -- and in the end, it would teach a useful lesson to populists in other countries, especially Spain.

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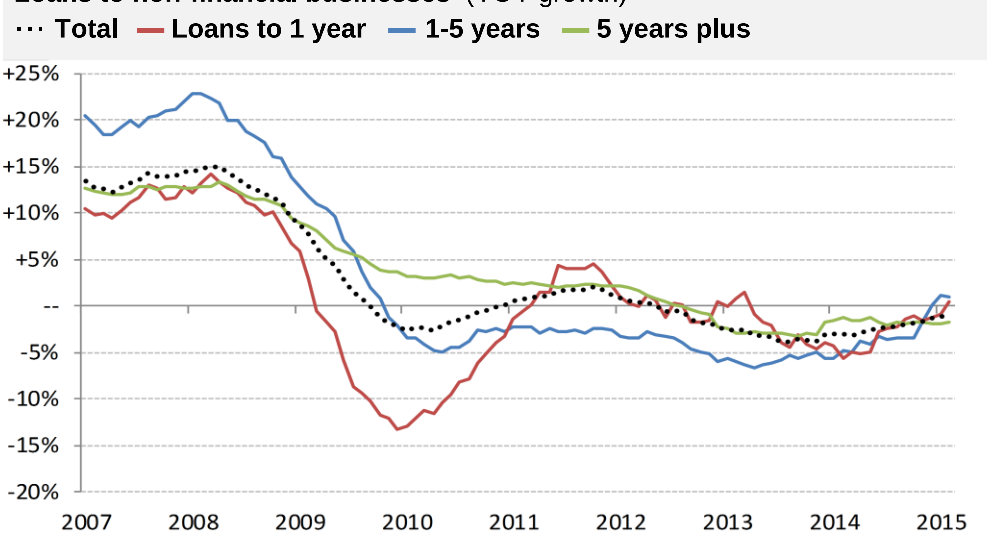
outperformed the S&P 500 -- 20.9% in local currency and 6.0% in USD versus 2.3%. How different the reality has turned out to be from the dominant narrative in markets at year-end, after a year of poor performance in the euro area -- that the US was the only major economy that is growing.

- Draghi, as we might expect from this consummate politician, attributes Europe's surprising performance to QE. At the March Governing Council meeting, when as we noted QE hadn't even begun, he declared the new program to be "quite effective and quite positive."
- We think that was an undeserved victory lap. We've been pointing to euro area recovery since the darkest days of 2012, and we were very positive on the euro area at year-end 2014. But we didn't put a lot of stock in the efficacy of QE. We focused at year-end on (1) the gift of lower energy prices, in countries that generally do not have significant energy production industries to be harmed; (2) the ongoing benefits of structural reforms in labor and product markets; and (3) the regulatory liberation of euro area banks with ECB being installed as the Single Supervisory Mechanism (see "2015: Oil Change for the Global Economy, Non-US Edition" December 31, 2014).
- Evolving positive macro data that has supported our view includes, most significantly, euro are loans to non-financial businesses. Two years of outright contraction reversed about a year ago, and growth is now outright positive in the two shorter-term categories (please see the chart below, and "Data Insights: Euro Area Recovery Monitor" April 15, 2015).

Loans to non-financial businesses (YOY growth)



Source: ECB, TrendMacro calculations

- Similarly, the ECB's quarterly survey of bank lending officers has shown lending standards tightening less since 2012, and getting outright easier since mid-2014; loan demand slowed its contraction since 2012, and began to grow in early-2014; and expected loan

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[About us]

Recommended Reading

Moore's Law: A 50th Anniversary Assessment
Bret Swanson
Entropy Economics
April 14, 2015

Saudi Arabia's Plan to Extend the Age of Oil
Peter Waldman
Bloomberg Business
April 12, 2015

The End of Expensive Oil?
Frank A. Wolak
SIEPR Policy Brief
March 2015

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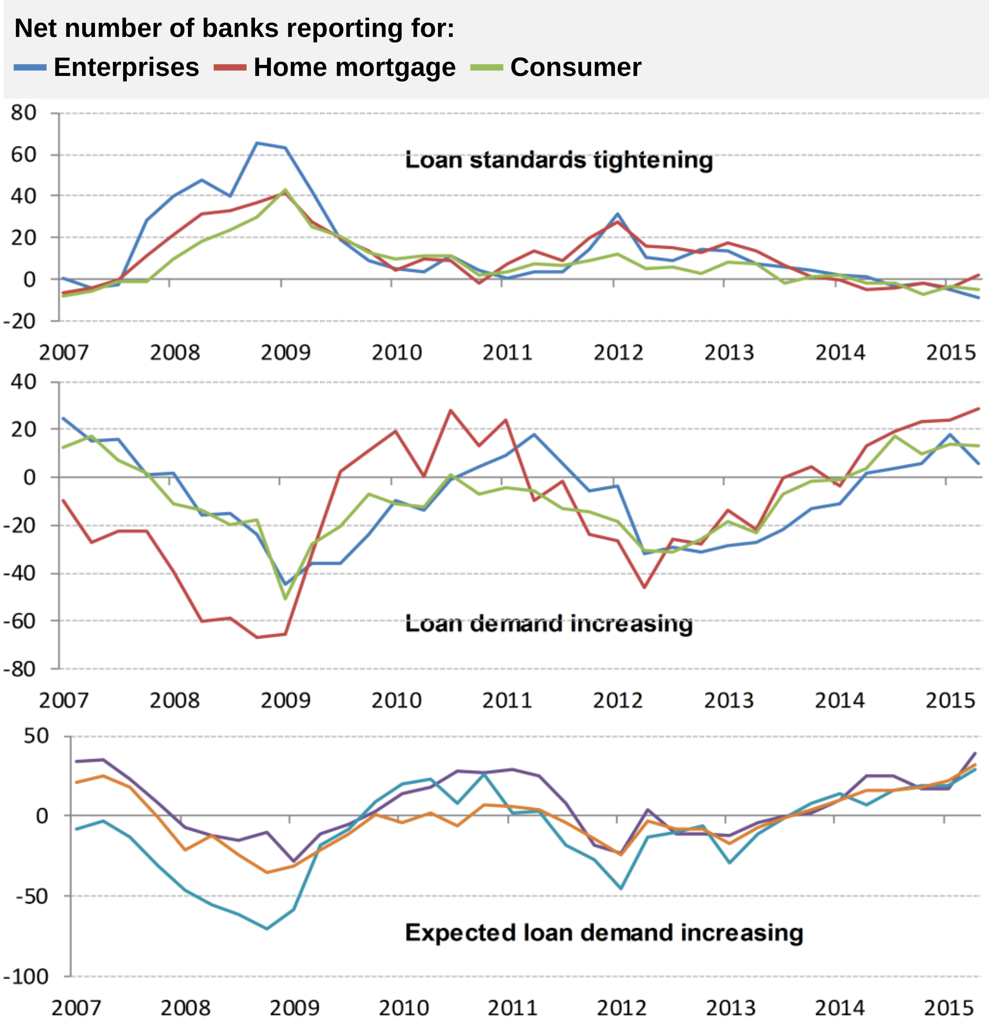
demand began to grow a year before that (please see the charts below).



Source: ECB Bank Lending Survey, TrendMacro calculations

- Long-term inflation expectations have begun to stabilize only since mid-January. But that, and their sharp drop last August -- which Draghi used to brilliant political effect in his improvised speech at Jackson Hole declaring a deflation emergency (see "'Whatever It Takes' Comes to Jackson Hole" August 25, 2014) -- we believe had little do with ECB policy or anything else endogenous to the euro area. It was, simply, an oil shock. The sudden drop in global oil prices that began from last June's peak implies, we believe, a permanent new epoch of ever-lower prices, which quite rationally should drive a step-wise shift in the level of long-term inflation expectations (see "The Deflation Hoax" January 8, 2015).
- On that subject, yesterday Draghi claimed that QE saved Europe from the deflationary impact of lower oil prices -- "our monetary policy stance avoided that risk, and it eased the pass-through of lower oil prices into higher consumption…"

- We're dubious that Draghi should be proud of such a thing. Is he not necessarily admitting that his policies inflated away the windfall bestowed by lower oil prices?
- In fairness to Draghi, at one point in yesterday's press conference he did admit that the "recovery…has been in place a long time before we actually did QE… Certainly the monetary policy stance helped but there must be other factors."
- Beyond fairness to Draghi, but rather to give credit where it is due, his bold action in August 2012, unilaterally promising that the ECB would do "whatever it takes" to save the euro, was the turning point that began the euro area's recovery, and indeed ended the global financial crisis that had begun in 2007 (see "On Draghi in London" July 26, 2012, and "Whatever It Takes Turns Two" July 25, 2014).
- If nothing else, his ability to make QE happen over German objections reinvigorates confidence in Draghi's effectiveness and power. It was touch-and-go for a while, with very public infighting that threatened last year to tear the Governing Council apart (see "On the ECB November Policy Decision" November 6, 2014).

But we continue to be skeptical that QE itself -- the physical act of buying euro area sovereign bonds, aside from its political and policy signaling value -- ought to have any effect. We believe that bond purchases make sense when yields are excessively high. At such times -- such as when the Fed began buying mortgage-backed securities in late 2009, and the two times when the ECB bought distressed peripheral sovereigns under the Securities Markets Programme -- the purchases are prudential interventions that stabilize markets that have been destabilized by self-perpetuating fire-sales. But what is the marginal gain for the world by the ECB buying German bunds with negative nominal yields, or Spanish bonds with a 1-handle?

- All that QE accomplishes now is to de-risk banks or any other institution or individual who formerly held the bonds that the ECB purchased.
- The typical explanation for how QE works is the "portfolio balance channel," in which the de-risked former bond-holder re-risks by buying substitute assets in what amounts to a reach for yield, thus theoretically raising all asset prices (see "Is the Fed Moving the Stock Market?" March 11, 2013).
- But that cuts against another case for QE in the euro area at this moment -- the idea that de-risking the banks will cushion the region from any systemic blows that may occur, such as a Greek default or the exit of Greece from the euro currency. If the banks just re-risk after selling their sovereigns to the ECB, then they'll probably be in more peril under such circumstances than if they'd just stayed with their sovereigns.
- As of this writing, Greek sovereign yields are blowing out to levels not seen since early 2013, when they were on their way down from 45%. There is no obvious political solution to the impasse that pits Greece against "the institutions" formerly known as the troika. While we believe strongly -- and we think the elites of the core euro area agree -- that a Greek default and exit from the euro would be

a survivable and short-lived crisis, it would be a crisis nevertheless with outcomes difficult to predict once it is set in motion (see "Greece: Failure Is an Option" February 10, 2015). In the face of such a crisis, a de-risked banking sector would be a nice thing to have -- a re-risked one, not so much.

- We believe that the deepest risk faced by the euro now is the political risk borne of complacency now that so much recovery has taken place since the darkest days of 2011 and 2012. It was this complacency that allowed SYRIZA to get elected in Greece, and now it threatens to elect an even more leftist party -- Podemos -- in Spain's elections later this year. Greece is too small to really matter. Spain matters.
- So a Greek crisis and Greek exit from the euro would probably be a good thing, as it would be a wake-up call for the Spanish electorate that radical populism is not a sustainable course (see "From Grexit to Griddance" February 23, 2015).
- While these threats still overhang the euro area, we can be sure that however economically ineffectual it make be, Draghi's QE program will continue.
- But that doesn't mean we should expect the euro to continue to weaken. We note that, versus the dollar, the euro has actually been strengthening since QE actually began in March. It had been in a weakening trend for quite a while, well before QE or any of the ECB's easing initiatives of 2014 were conceived or announced.
- If the euro exchange rate is, primarily, a function of expectations, then the move ought to be over. Now that Draghi has exceeded all expectations, and overcome German opposition and implemented a sovereign bond purchase program, what more is there to possibly expect?
- The same logic suggest that euro area sovereign yields just don't have that much more room to fall.
- On the other hand, euro area stocks, and the banking sector, can continue to benefit from ongoing economic recovery that was in place long before QE started, and can continue now that a largely irrelevant QE has arrived.

Bottom line

The ECB is crowing about the success of its new QE program, but the reality is that euro area recovery has been in place long before QE was implemented or even imagined. The euro has actually strengthened since QE began, and with the most dovish expectations for the ECB now realized, we don't see why it should weaken from here. Similarly, we see little room on the downside for euro area sovereign yields. Stocks and the banking sector can continue to benefit from the underlying recovery that has long preceded QE. There is a risk of short-term Grexit crisis, but QE might ease the blow -- and in the end, it would teach a useful lesson to populists in other countries, especially Spain.