Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Europe Research Affiliate

TRENDMACRO LIVE!

On the ECB January Policy Decision

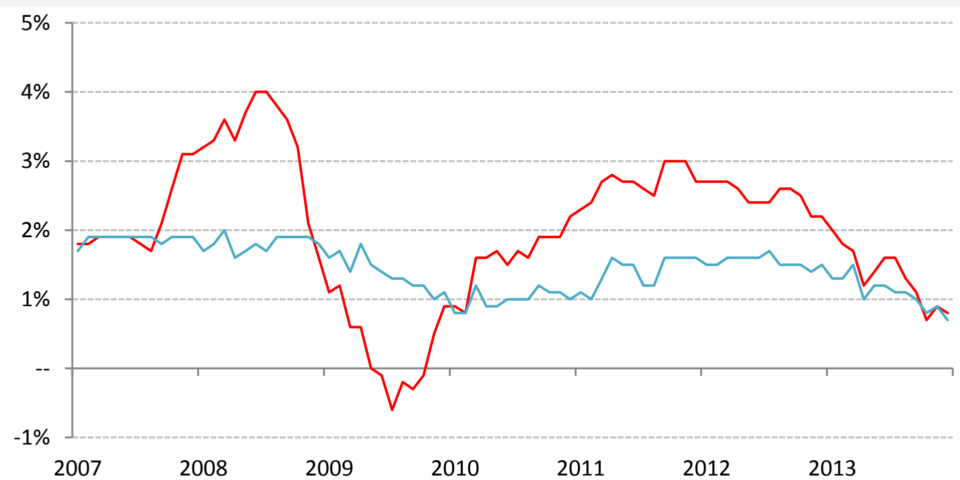
Thursday, January 9, 2014

Donald Luskin, with research input from Lorcan Roche Kelly

Euro area inflation is far below the ECB's target -- but why take any risk to fix it?

Core inflation in the euro area at only 0.7% year-on-year is the lowest in the history of the data. Headline inflation at 0.8% isn't much different (please see the chart below). Though this strongly cuts against the European Central Bank's "primary objective" of price stability -- defined as inflation "below, but close to, 2% over the medium term" -- today the ECB announced no change in interest rates. At today's press conference, the only tilt in policy to take regard of the low inflation environment was to use what Draghi called "firmer language" to express its existing forward guidance -- saying the Governing Council "strongly emphasises" its commitment to keep policy accommodative, and that it "firmly reiterate[s]" the intention to keep rates low for an extended period.

Euro area inflation, year-on-year — All items — Core



Source: Eurostat, TrendMacro calculations

- A cut from this point would have taken rates into negative territory. That's an option ECB President Mario Draghi has kept on the table (see "On the November ECB Policy Decision" November 7, 2013), but it would be a risky venture into unexplored policy territory.
- *Apparently Draghi's judgment is that, all things considered at this time, intervening in the face of below-target inflation isn't worth the risk.*

Update to strategic view

ECB, EUROPE MACRO, EUROPE STOCKS, EUROPE BONDS: No rate cut from the ECB, despite the lowest inflation in the history of the data. For a central bank for whom price stability is the "primary objective," this signals that the ECB is taking seriously the strong positive signals from euro area equity and bond markets -- so it needn't venture further into risky new policies such as negative rates. With the existential risk of currency disunion off the table -- indeed, Latvia just signed up as the 18th state to adopt the euro -- the euro area is poised for recovery from recession. We expect continued strong performance from its equity and bond markets.

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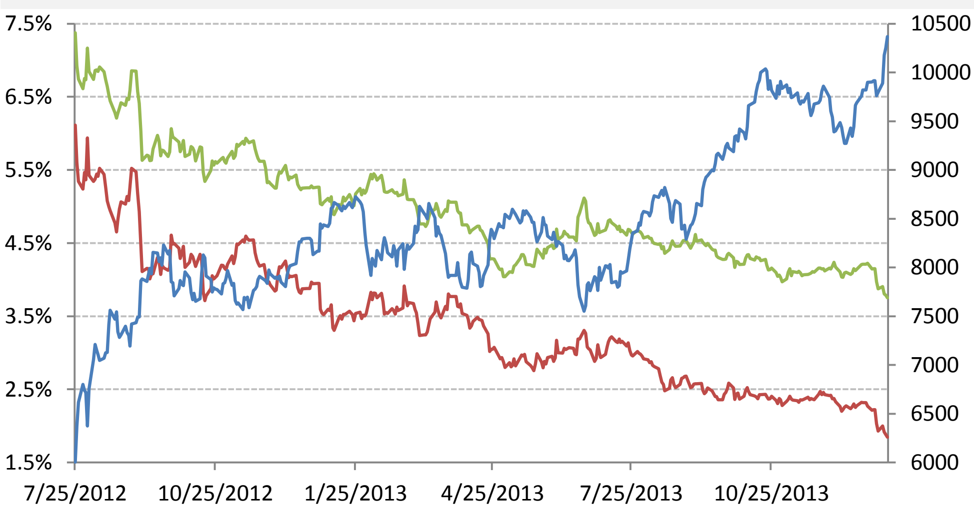
- *Besides, with the fixed-rate full-allocation liquidity facility extended late last year to November 2015* (again, see "On the November ECB Policy Decision"), *policy is effectively determined not by the ECB but by demand for liquidity from the euro area's banks. If looser policy is needed, all they have to do is ask.*
- And it was Draghi who said last year, "the fact that inflation is low is not, by itself, bad; with low inflation, you can buy more stuff."
- The value in this seemingly know-nothing statement (if it were true, we would welcome prices collapsing to zero) is the phrase "by itself." This challenges us to think about the context of today's low inflation. All considered, the context isn't so bad.
- Just a year and a half ago, amidst a crisis that threatened the world financial system, Draghi was committing the ECB to "whatever it takes" to save the euro currency (see "On Draghi in London" July 26, 2012). Thanks to that commitment the crisis has passed -- in fact last week the euro currency union admitted Latvia as its new 18th member state.
- With the euro crisis in the rear-view mirror, the euro area no longer has to labor under the intense existential threat of imminent financial chaos. That makes the euro area -- indeed, the whole world -- a less risky and more growth-friendly place (please see "Data Insights: Euro Area Recovery Monitor" January 9, 2014). Thus in 2013, a year in which equities soared world-wide, Germany's was the best performing major stock market in dollar terms (see "2013: The Year of Living Not Dangerously" December 31, 2013).
- But the acid test is Spain. Spain is a large economy that runs a large fiscal deficit -- and suffers from very high unemployment. It has led the charge in labor market, banking and government spending reform. That makes it the poster-child for everything wrong in the euro area, and the model for how to fix it. As a speculation in euro area recovery, it has always been our favorite

Spain, since Draghi's "whatever it takes" speech July 26, 2012
— 10-year sovereign yield — Spread to bund — IBEX stock market index



Source: Bloomberg, TrendMacro calculations

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Agenda Research
Sixmilebridge Ireland
617 600 6969
lorcan@trendmacro.com

[About us]

Recommended Reading

How the 'Wolf of Wall Street' Really Did It
Ronald L. Rubin
Wall Street Journal
January 3, 2014

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(see, among many, "SpanDax" July 12, 2013).

- Since Draghi's "whatever it takes" speech, Spanish stocks are up 72% in euro terms, and sovereign yields and spreads have massively contracted (please see the chart on the previous page). Unemployment has stabilized, and a glimmer of growth has returned (see "Europe's Ghosts of Stress Tests Past" October 22, 2013).
- The beginning of recovery in Spain -- and all it symbolizes -- ramifies powerfully throughout the whole euro area and the world.
- So should it really matter to the ECB than euro area inflation is below but close to 1% instead of below but close to 2%? Apparently not.
- Isn't this the same kind of logic the Fed is using to have initiated tapering of Large-Scale Asset Purchases in the face of below-target inflation? The central banks of the world can see the global economy poised to accelerate, as we have since mid-year (see "A Major Upgrade to our Strategic Outlook" September 12, 2013). Surely they are relying on this acceleration to bring inflation closer to their targets. Indeed, someday they may find themselves sorry they weren't more careful about what they wished for (see "Inflation in Fashion" October 29, 2013).
- For now, the very positive development is that by turning away from risky policies of dubious effectiveness, the world's central bank are taking themselves off the table as the final sources of global systemic risk (again, see "2013: The Year of Living Not Dangerously").

Bottom line

No rate cut from the ECB, despite the lowest inflation in the history of the data. For a central bank for whom price stability is the "primary objective," this signals that the ECB is taking seriously the strong positive signals from euro area equity and bond markets -- so it needn't venture further into risky new policies such as negative rates. With the existential risk of currency disunion off the table -- indeed, Latvia just signed up as the 18th state to adopt the euro -- the euro area is poised for recovery from recession. We expect continued strong performance from its equity and bond markets.