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MACROCOSM

Draghi Commits to QE

Friday, May 9, 2014

Donald Luskin with research input from Lorcan Roche Kelly

A broad-based asset purchase program is all but inevitable for June. But will it matter?

Update to strategic view

ECB, EUROPE BONDS, EUROPE STOCKS: Draghi has committed the ECB to acting against too-low inflation at the next meeting in June, and we think that means a broad-based asset purchase program that will exclude sovereigns. We don't think it will have much of an effect. Perhaps it could bring credit-flow to life in the peripheral euro area, and boost already booming equity markets. But if it does succeed in moving inflation up from here, that would punish Italian and Spanish bonds. Now at record low yields, their great bull market is over anyway -- but all the more so in the unlikely event that the ECB's purchase program actually works.

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In yesterday's press conference following the European Central Bank's monetary policy decision, ECB President Mario Draghi dropped a bombshell when he said that the ECB governing council would be "comfortable with acting" at the June meeting.

The big question is what action the ECB would be comfortable with -- but we think it is now nearly inevitable that quantitative easing is coming to the euro area.

Draghi outlined the ECB's reaction function in a speech in Amsterdam last month (please see the table below).

Scenario	Response
Unwarranted tightening of the policy stance	Lowering of the interest rate corridor including negative interest rates
Further impairments in the transmission of the ECB's stance	LTRO targeted toward bank lending or an ABS purchase program
Worsening of the medium-term outlook for inflation ✓	Broad-based asset purchase program

We have checked the last of the Draghi's three scenarios, above, because according to his remarks yesterday, that's precisely where *he* believes we are:

> …there is consensus about being dissatisfied with the projected path of inflation, and so there is a consensus in not being resigned to this and accepting this as a fact of nature, which would lead to having consensus about action…

He made it contingent on "the staff projections that will come out in early June." Presuming those show a worsening outlook for medium term inflation -- and it is hard to see how they won't -- *the response from the ECB at the June meeting will be the announcement of a broad-based* *asset purchase program. To be clear, it will not be an interest rate cut or another liquidity operation, as those would be responses to the wrong scenario.*

What forms might such a program take? Article 18 of the [treaty governing the ECB] states:

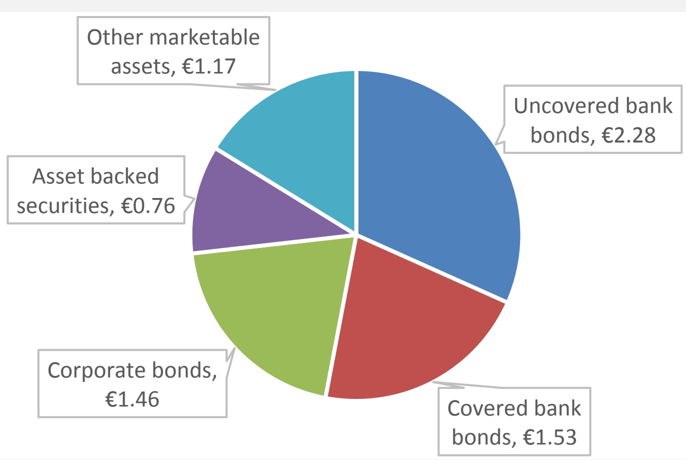
> *18.1 In order to achieve the objectives of the ESCB [Eurosystem of Central Banks] and to carry out its tasks, the ECB and the national central banks may:*
>
> - *operate in the financial markets by buying and selling outright (spot and forward) or under repurchase agreement and by lending or borrowing claims and marketable instruments, whether in euro or other currencies, as well as precious metals…*

That article places no real restrictions on what the ECB could purchase. However, Article 123 of the Treaty on the European Union prohibits the ECB's purchase of sovereign debt. In the dire circumstances of the euro area's debt and currency crises, the ECB did in fact purchase sovereign bonds under its Securities Markets Programme -- but this was highly controversial, and is not likely to be repeated except under extreme need.

Beyond that, the ECB can buy anything. It could even buy assets not denominated in the euro -- an idea that has been getting an airing recently, but which would be politically difficult. Indeed the ECB's own rules require that purchased assets be euro-denominated -- but those rules could be changed. And it certainly would be amusing if the ECB decided to purchase gold.

Acting within the current rules and according to the ECB's own calculations, there is €7.2 trillion of assets it could purchase (please see the chart below).

Assets eligible for purchase by the ECB EUR trillions



Source: ECB, TrendMacro calculations

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Draghi's ideal response would involve a long-time hobbyhorse -- the creation of a new euro area platform for asset-back securities based on small and medium-sized enterprise credits (see "Not a Big Bang, But It Could Work" May 29, 2013). *But for now, his preferred response is a broad-based asset purchase program.*

- It will not exclusively target a single class of instruments -- much the way the US Federal Reserve's QE3 was spread across both Treasury securities and MBS.
- We think Draghi will target a monthly amount for purchases and announce a desired macroeconomic outcome -- rather than give an overall total amount -- which would allow him more flexibility in the implementation of the program. Again, this is exactly what the Fed has done with QE3.

There is one major contingency: the June ECB staff projections. The governing council will have access to them before its decision, but we won't get to see them until after the decision has been made. It is always possible that there will be a surprise improvement in the inflation outlook that would give the hawks on the council a strong reason to push back. With Draghi's statements having seemingly committed him irrevocably, such a turn of events would be an embarrassment that might end up with a worst-of-all-worlds outcome -- a puny asset purchase program with no hope of success, squandering the ECB's hard-won credibility.

But -- really -- we cannot be highly confident that even a large-scale purchase program would have any particular effect. Now five years into a massive and prolonged easing cycle, we fear that both the ECB and the Fed are so far down the diminishing returns curve that nothing they might do along these lines would really make any difference (see "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013).

- If an ECB purchase program does succeed in lifting inflation expectations, one negative side-effect would be to induce a back-up in peripheral euro area sovereign bond yields -- which, in the case of Spain and Italy, have fallen to all-time lows.
- The offsetting positive could be something of a reinvigoration of credit-flow in the peripheral euro area, an offsetting assist to peripheral euro area equity markets.

Bottom line

Draghi has committed the ECB to acting against too-low inflation at the next meeting in June, and we think that means a broad-based asset purchase program that will exclude sovereigns. We don't think it will have much of an effect. Perhaps it could bring credit-flow to life in the peripheral euro area, and boost already booming equity markets. But if it does succeed in moving inflation up from here, that would punish Italian and Spanish bonds. Now at record low yields, their great bull market is over anyway -- but all the more so in the unlikely event that the ECB's purchase program actually works.