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MACROCOSM

Buy More Stuff

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Donald Luskin with research input from **Lorcan Roche Kelly**

Dear Mario: All is forgiven. Love, Bundesbank. PS: Big ABS purchases start today.

Global markets today are celebrating what is being taken as a very dovish speech in Frankfurt by ECB President Mario Draghi. Perfect: the dominant negative narrative in the back half of this year has been about the risk of a triple-dip recession in Europe -- while, according to the narrative, the ECB has collapsed into internal bickering while it perversely refuses to do quantitative easing like all the other central banks in the world have. Oh yes -- a rate cut from the Peoples Bank of China is helping today, too, but it's the ECB we wish to focus on in this report.

- *On the surface, Draghi's speech doesn't actually say anything he hasn't said many times before. But therein lies the power of its message.*
- Draghi reiterated this morning the deflation scare he cooked up in his August improvisation at Jackson Hole (see "'Whatever It Takes' Comes to Jackson Hole" August 25, 2014). It was this bit of political theater -- designed so that his colleagues on the Governing Council couldn't block his intention to inaugurate an Asset Backed Securities Purchase Programme (ABSPP) -- that outraged the Bundesbank, and set in motion months of embarrassing public bickering within an institution that prizes the credibility that comes from unanimity (see "On the ECB November Policy Decision" November 6, 2014).
- *The fact that Draghi can repeat, on German soil no less, exactly the same deflation argument he used in Jackson Hole -- that persistent below-target inflation is unanchoring long-term inflation expectations, and must be repaired by ECB asset purchases -- indicates both that Draghi has emerged from a season of conflict with this policy wishes intact, and that fences have been mended on the Governing Council.*
- *Both elements are important, but the latter is key. No individual policy the ECB could announce is more important than this -- the preservation of the fundamental coherency and credibility of the one institution in the euro area capable of holding the euro currency union together.*

As Draghi doubles down on his deflation rationale for asset purchases this morning, we can't help but chuckle as we contemplate the irony of his statement in a June 2013 press conference: "the fact that inflation is low is

Update to strategic view

ECB, EUROPE STOCKS, EUROPE BONDS, EUROPE FINANCIAL STOCKS, EUROPE MACRO: A dovish speech on German soil signals that Draghi and the Bundesbank have settled their very public disagreement, and that Draghi's policy preferences are still on track. This strongly reduces the greatest risk the euro area has faced -- the loss of institutional coherency at the ECB. We don't think it signals the ECB will buy sovereigns. ABS purchases start today, and we expect them to be front-end loaded, with initial volumes running at about €10 billion per week. Combined with lower oil prices and next year's banking union, all this bolsters our long-standing contrarian positive outlook on the euro area.

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not, by itself, bad; with low inflation, you can buy more stuff." Well, a little more than a year later, low inflation is not only bad, it is an emergency. And that emergency requires that the ECB be the one to "buy more stuff."

That said, this morning's speech does not increase the chance of the ECB buying sovereign bonds -- true textbook quantitative easing (see "No Way ECB QE" October 1, 2014). If the already announced purchased programs need to be extended, there are instruments -- such as corporate bonds -- that could be purchased without risking the political fallout a controversial program like sovereign QE would surely attract.

- Looking at the purchase programs already announced, today sees the start of the ABSPP. The legal act governing this program was published on the ECB's website yesterday, which was the last step ahead of actual implementation.
- The purchases will be undertaken by four private asset managers appointed as agents by the ECB. The ECB will issue explicit instructions to them, and will do its own due diligence on pricing ahead of transaction approval.
- After a current "initial phase" supervision will be decentralized -- national central banks will take over the purchases at some point in the future. This is no doubt a sop to the French, who embarrassed Draghi by publically carping about what they saw as a diminished role for the Banque de France in the ABSPP (again, see "On the ECB November Policy Decision").
- ABS purchases, like the third Covered Bond Purchase Program (CBPP3) that has already begun, will continue for a period of two years.
- We expect the ECB will do its best to front-load ABS purchases, rather than spread them out evenly over two years. This is what it has done with the CBPP3, which has been buying at a pace far exceeding that of either of the previous two covered bond purchase programs.
- We will have to wait until December 1 to get an idea of that pace of ABS purchases -- they will only be reported on a settlement basis. But we expect that weekly purchases in the region of €10 billion are certainly possible in the initial phase.
- This would serve two purposes. There would be a portfolio channel effect, as Draghi described in his speech. But more important, there would be a strong signaling effect from high initial purchases.
- Rapid initial purchases would lend credibility to the ECB's balance sheet expansion target. In the meantime, there is a serious "headline" risk that the balance sheet will fall below €2 trillion in the coming weeks, if asset purchases are not conducted at a sufficient pace to neutralize repayments of the 3-yr LTROs, another €8.5 billion of which was announced today.
- But for those who insist on being disappointed by anything but sovereign bond QE, rapid initial purchases will be bad news -- it will signal that sovereign QE is not necessary.

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We continue to be bullish on euro area equities. That's been a long-standing contrarian position for us, which was well vindicated in the first half of this year -- the PIIGS nations were able to boast the best-performing stock markets in the world. In the second half, under the shadow of geopolitical risk emanating from Ukraine -- and the cloud of discord overhanging the ECB -- it hasn't been as much fun.

- We have never expected the ECB to undertake sovereign QE, and are not bearish on the euro area for the lack of it. We think Draghi's policy direction is sufficient and sensible, aimed as it is at bolstering lending by supporting bank capital adequacy (see "The ECB's Real Agenda" October 22, 2014).
- We continue to be quite excited by the possibilities for widespread reform and restructuring of euro area banking starting in 2015, when the ECB's new role as Single Supervisory Mechanism virtually abolished cross-border regulatory barriers for the banks (see "Stop Stressing, Start Lending" October 24, 2014).
- Finally, the steep drop in global crude oil prices seen over the last several months enhances the bull case for the euro area (see "Don't Let a Good Oil Crisis Go to Waste" October 21, 2014). It gives the euro area the same implicit tax cut that it gives everyone else. But, uniquely for Europe, it strongly reduces the risk that Russia would stop providing natural gas as part of its Ukraine strategy -- needing as it does now to do anything it can to prop up energy revenues.

Bottom line

A dovish speech on German soil signals that Draghi and the Bundesbank have settled their very public disagreement, and that Draghi's policy preferences are still on track. This strongly reduces the greatest risk the euro area has faced -- the loss of institutional coherency at the ECB. We don't think it signals the ECB will buy sovereigns. ABS purchases start today, and we expect them to be front-end loaded, with initial volumes running at about €10 billion per week. Combined with lower oil prices and next year's banking union, all this bolsters our long-standing contrarian positive outlook on the euro area.