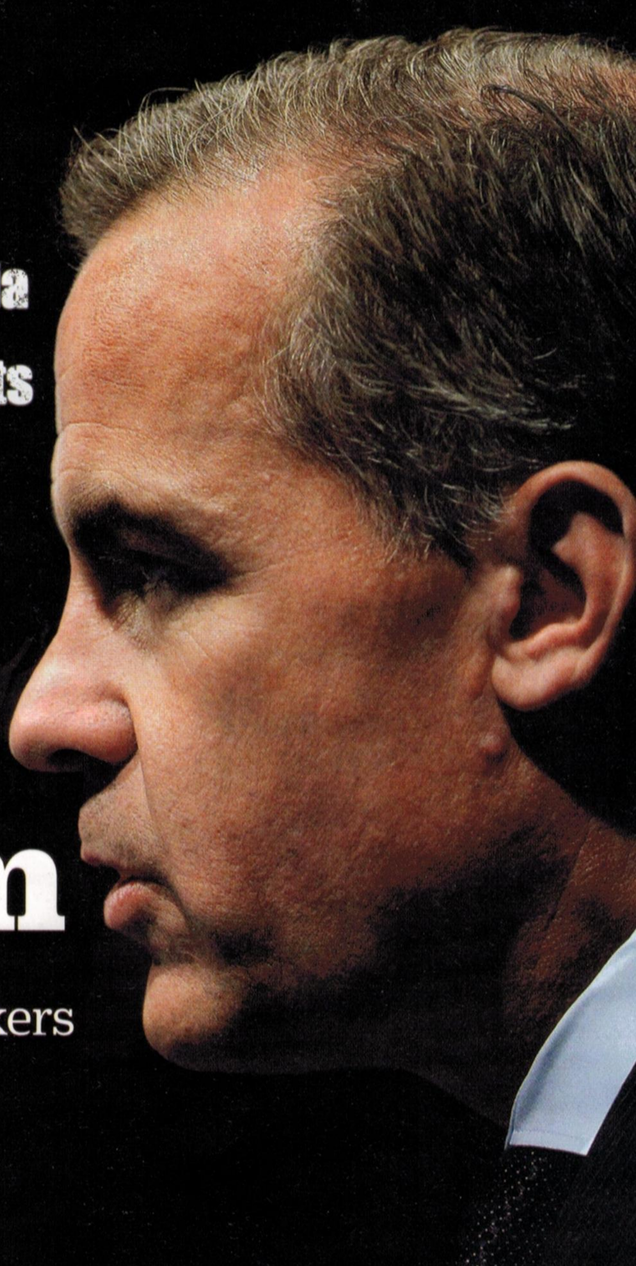
money marketing

Trusted insight for professional advisers

22 May 2014 / No. 1,438/ £3.95

Alex Wright
Finding value in the IPO bonanza
26

- Lowering LTIs Lowering LTVs
- Scaling back Help to Buy
- Tightening underwriting criteria
- Increasing capital requirements
- Increasing interest rates



Carney's conundrum

London decoupling means policymakers have no easy answers

Protection brief pages 40-43

Investment
How should Draghi tackle low Euro inflation?
28

Chris Gilchrist
Be wary of back to the future investments
35

Innovation
The Platforum looks at new advice solutions
44

Investment

ANALYSIS

QE pressure builds on ECB chief Draghi to do 'whatever it takes'

Experts are divided on the best way for the ECB to tackle the eurozone's low level of inflation

PAMELA MORRIS

European Central Bank president Mario Draghi is coming under increasing pressure to apply his infamous "whatever it takes" approach to Europe's deflation problem by introducing quantitative easing.

But some investors say that implementing QE in the region may prove more difficult than markets anticipate.

As inflation in the eurozone hovers around record lows, speculation has been building in recent months as to whether the ECB will embark on further monetary easing in an attempt to stop the region drifting into a Japan-style deflationary cycle.

> 'If the ECB were to implement a similar QE programme [to the US], it would need to buy around €1.3tn of assets'

Inflation levels in the eurozone picked up during April, rising to 0.7 per cent from 0.5 per cent in March, but this figure remains well below the ECB's target of keeping inflation at just under 2 per cent.

Draghi has argued repeatedly that the region will not end up in a deflationary cycle but has also stressed that the bank will retain an "accommodating stance" on monetary policy for as long as necessary.

He has said he will use "all the possible instruments" to tackle falling prices in Europe.

Hints of action

At the previous ECB meeting, Draghi also warned that the current strength of the euro had become a "serious concern" and hinted that the central bank may take action next month to ease monetary policy.

Bundesbank president Jens Weidmann has said the German central bank is "prepared to take action" to support ECB policy but stressed that QE may not be suitable for dealing with Europe's low inflation.

As the likelihood increases of further policy action in Europe, some investors are preparing to take advantage of opportunities thrown up by monetary stimulus in the eurozone. But others warn that the central bank could struggle to introduce QE, leaving markets disappointed.

UBS Global Asset Management

EXPERT VIEW

JESSICA HINDS

We're all still guessing what Draghi will do

President Draghi's declaration that the governing council is "comfortable with acting next time" provided some assurance that the ECB is not blind to deflation and the threat posed by the strength of the euro exchange rate.

But his vagueness left us guessing just what the bank may do in June. The consensus seems to be that the bank will cut the main refinancing rate by 10 or 15 basis points from the current level of 0.25 per cent. This would be the bare minimum. After stating so clearly that the bank will - not may - act once it has seen the new staff forecasts, it would be a massive disappointment if it did nothing.

The ECB may also announce measures to increase liquidity in the banking sector at or before its next meeting. We would expect the policy of providing unlimited one-week and three-month loans to banks at a fixed rate to be extended beyond the last currently scheduled operation in July. Further one- or three-year loans may also be offered.

After stating so clearly that the bank will – not may –act, it would be a massive disappointment if it did nothing

"That leaves QE. While the president did not mention the policy specifically last week, previous comments confirmed our long-held view that unsterilised asset purchases are a possibility. It is even possible that the reason the bank did not act this month is it is busy concocting a radical programme of asset purchases behind the scenes, which will be unveiled in June.

Jessica Hinds is European economist at Capital Economics

senior fixed income economist Joshua McCallum says there is a distinct difference between market expectations of QE as a large-scale programme of debt purchases and how the ECB would choose to bring about monetary stimulus through the purchase of private debt.

Problems either way

In reality, both options would be likely to cause problems for the central bank if put into practice, according to McCallum.

The ECB's preferred option of purchasing private debt from a pool of SMEs through asset-backed securities is unlikely to prove viable, says McCallum, because the private debt market in the eurozone is simply too small.

"If Europe had a functioning ABS market, it is likely the ECB would have already bought a significant amount of ABSs.

"Unfortunately, the market for private debt in the eurozone is not developed enough to allow the ECB to conduct a large-scale purchasing programme," he says.

Europe's outstanding private debt market is too small with around €900bn (£733bn) in ABSs, according to ECB figures. This is below the levels needed if a QE programme were

'The market for private debt in the eurozone is not developed enough to allow the ECB to conduct a large-scale purchasing programme'

£733bn

Europe's outstanding private debt market has around £733bn in asset-backed securities

to reach the size of the US Federal Reserve's programme. McCallum adds: "There are transparency issues which make it difficult to estimate the implicit credit risk of those securities. And last, there is not enough harmonisation at a European level.

"Resolving these and other technical issues will take some time."

McCallum believes the alternative option of buying sovereign bonds may also fail to create the desired effect of boosting the broader European economy.

He says: "The amount of assets the Federal Reserve has bought so far through its QE programme is equivalent to about 13 per cent of US GDP. If the ECB were to implement a similar QE programme, it would need to buy around €1.3tn of assets.

"Buying sovereign bonds on this scale would likely cause a substantial fall in sovereign bond yields, which is part of the objective. However, ongoing financial market fragmentation in the eurozone means it might not have the expected loosening effects on the rest of the economy."

Under pressure

Baillie Gifford's Gerald Smith, manager of the Monks investment trust, agrees that these issues surrounding the central bank's implementation of QE could result in market disappointment.

He says: "There is a lot of pressure on the ECB to go out and act.

"But there are not really enough private sector bonds that the ECB can actually buy to do really large-scale QE. So the market is expecting it to buy government bonds now but the risk is that the bank will not do that because institutionally it is difficult for it to buy government bonds. This would be quite a negative surprise for markets."

But Rathbones fixed income manager Bryn Jones has been buying French banks' bonds in anticipation of eventual asset purchases by the ECB. He says the central bank could buy problem loans from banks rather than government debt because this would enable banks to increase their lending.

"What the ECB will do eventually is some form of asset purchase programme where it takes some of the dodgy loans of the banks. Of course, that is going to be very supportive for the banks," he says.

"We have been playing in the old-style tier-one bonds so we have been buying Crédit Agricole and BPCE, a set of French regional banks.

"We think, since sovereigns have rallied a long way... that the way to go is to find some of the too-big-to-fail banks in the bigger economies and buy those to get extra yield."

The ECB will hold its next policy meeting on 5 June. Options on the table include taking the deposit rate negative for the first time, targeted measures aimed at boosting lending to SMEs or initiating some form of asset purchase programme.

ADVISER VIEWS

Nick McBreen
IFA
Worldwide Financial Planning

"Some economies in Europe, such as France, really are going nowhere at the moment and Draghi must be looking in on the UK and seeing that, on the surface at least, all that money printing is making a difference. In the US, the Fed's programme certainly seems to be working although of course we don't yet know what impact it will have long-term. So I think QE may well be being considered as an option by Draghi."

Jonathan Davis
Managing director
Jonathan Davis Wealth Management

"Essentially, if the European Central Bank wants QE to happen, it will happen because the central bank can ultimately do whatever it wants. There is certainly a strong whiff of disinflation in the air in Europe and evidence is building that the West could be entering an era of deflation that Japan had for 20 years."