

European Strategy Bulletin



Europe Strategy Bulletin | 12th September 2019

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ECB to ease again: stocks gain despite slower growth, bond markets remain strong

- The ECB delivers significant monetary expansion:
 - **Rates cut.** The deposit rate was cut by 10bp to -0.5%; the benchmark rate was unchanged at 0.0%; the marginal lending rate was unchanged at 0.25%. These rates are to stay at these levels until inflation consistently converges towards the ECB's 2% target.
 - **Renewed quantitative easing (QE) of €20bn a month** from 1st November for an open-ended period to reinforce the accommodative impact of the rate cut. The QE will end before the eventual first rise in interest rates.
 - **For third targeted longer-term refinancing operations (TLTROs) lending programme, maturity extended from two years to three years.** Rates slightly more favourable at above the main refinancing rate. The aim is to impact positively upon the transmission mechanism of bank lending.
 - **Two-tier deposit system** to offset impact of negative rates on bank profitability.
 - **Ongoing reinvestment of maturing bonds** for an extended period and beyond the date of the eventual first rate rise, in order to ensure the necessary liquidity.
- The ECB will remain broadly accommodative and adjust their tools for as long as necessary. This "permanent" easing to have limited, positive impact on European economies.
- The ECB's forecasts were reduced slightly for growth and inflation for 2019 and 2020.
- The ECB's Governing Council were united in their view of the need to act. However, there were differing views on the severity of the economic slowdown.
- In response to the announcement, the Euro initially weakened to \$1.0984 before recovering to 1.1046, the Eurostoxx 50 Index rose to 1% led by bank stocks before easing, bonds rallied led by peripheral countries' debt.

The ECB today delivered significant monetary easing. It was ECB President Mario Draghi's last meeting in charge today, before he hands over to Christine Lagarde in November. Two aspects of the announcement disappointed investors. Firstly, the deposit rate was only cut by 10bp, versus growing expectations of a 20bp reduction. Secondly, the monthly size of the quantitative easing programme is smaller than expected, with a slightly later start than had been anticipated. However, this was more than offset by the ECB's open-ended commitment to ongoing quantitative easing, and also by the extension of the duration of TLTROs from two years to three. We still await some details of the TLTRO, most notably how much of banks' reserves will be exempt from the new even lower deposit rate.

By way of background, European economies have been under pressure in their manufacturing sectors. Exports have declined amid the ongoing trade war – **figure 1**. There are signs that this has started to feed through into falling capex. In turn, this has the potential to drag down employment and wages. The ECB has therefore decided to act. As **figure 2** shows, the ECB has already had mild success in supporting broad money supply growth. The latter was running at 5.2% in July, up from 4.5%. The latest additional easing measures will hopefully stimulate that further. The big

unknown is whether the package is sufficient to prompt stronger lending growth, which saw unchanged growth in July at a sluggish 3.9%.

Mr. Draghi specifically expressed three concerns today:

1. The European economic slowdown is now more marked. The ECB September forecast for real growth for 2019 was lowered to 1.1% and to 1.2% for 2020. The forecast for 2021 was maintained at 1.4%. The third quarterly growth outlook is moderately positive, supported by strong employment and wage growth as well as by resilient services and construction, so the concern relates to the fourth quarter onwards into 2020.
2. The ECB's Harmonised Index of Consumer Prices (HICP) inflation forecast for 2019 was lowered to 1.2%, 1.0% for 2020, and 1.5% for 2021. While lower energy costs were offset by higher food costs, the concern is that high levels of capacity utilization have been slow to feed through to price pressures.
3. Persistent geopolitical and trade risks.

There was more emphasis on the need for fiscal support from governments with the fiscal space to act. Fiscal expansion and structural reform are likely to be more actively promoted by incoming ECB President Christine Lagarde.

Conclusions for European assets:

Fixed income:

Expensive sovereign bonds will get more expensive still, but we would not chase them. The Global Investment Committee remains underweight European sovereign bonds on a 12-18 month view. Four-fifths of European Investment Grade (IG) sovereigns are yielding under 1%. In the coming weeks that four-fifths figure could rise further.

Figure 3 shows that the countries who are likely to benefit most from the third TLTRO are in the Eurozone's peripheral countries, which should be supportive for their growth. However, peripheral sovereign bonds were particularly strong today. Spain's 10-year yield was down 4bp to 0.21% and Portugal's 10-year yield down 4bp to 0.22%. That indicates that the upcoming second round of quantitative easing will be more decisive as a driver.

European high yield (HY) corporates offer opportunity as there is likely to be a 'trickle-down' of demand from the ECB's purchases in the sovereign and investment grade corporate areas as investors reach for yield. In addition, HY offers decent coupons and decent positive yields relative to the benign outlook for defaults and leverage.

Equities:

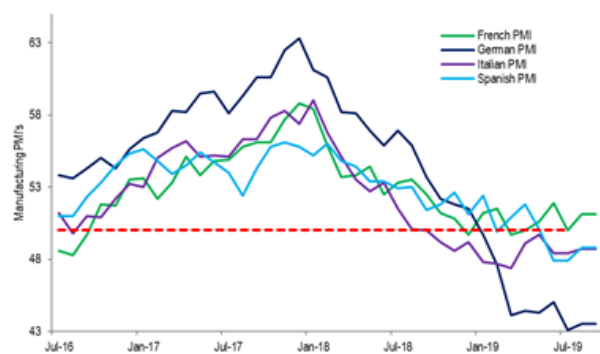
The initial strong 1% move upwards in the EuroStoxx 50 Index during the ECB meeting has now retraced as the market digests the slower growth forecasts, however is still +0.45% on the day. While the ECB's upcoming measures offer some reassurance that growth won't collapse, the underlying growth engines in Europe are not strong. In addition, the trade war is likely to keep downward pressure on corporate earnings.

So we recommend a selective approach. By country, we favour Switzerland. By sector, we favour financials, IT, and healthcare. In addition, deep-value sectors like cars are dependent on trade-related announcements as potential catalysts. Overall, we prefer defensives over cyclical and value over growth. **Figure 4** shows the yield gap as strongly supportive of European equities versus bonds, and leads us to strongly favour stocks with high dividend yields.

Euro:

Today's measures reinforce the Euro weakness with the EUR trading down as low as \$1.0984, before regaining lost ground but staying within its medium-term downtrend – **figure 5**. Mr. Draghi explicitly stated that the ECB was not targeting a lower or indeed any exchange rate. It is also notable that in recent days the currency has not rallied despite the improvement in the Italian political backdrop after a new more pro-EU coalition was formed.

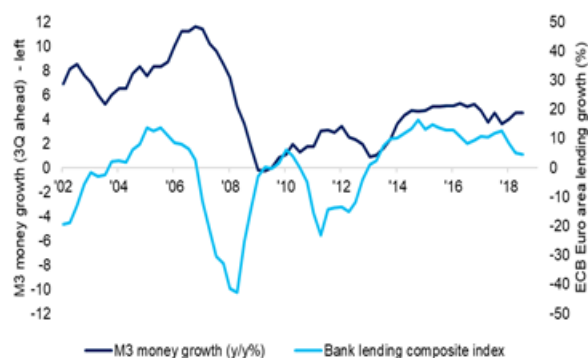
Figure 1: Falling Euro-area manufacturing PMI's



Source: Bloomberg as of September 11th 2019

All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

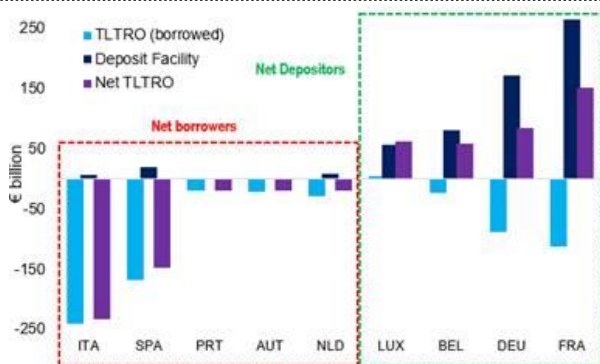
Figure 2: M3 money growth v bank lending



Source: Bloomberg as of September 11th 2019

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Figure 3: Net borrowers/deposits by country



Source: ECB, Citi Research as of September 11th 2019

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Figure 4: European yield gap (%)



Source: Bloomberg as of September 11th 2019

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Figure 5: Euro against the US Dollar



Source: Bloomberg as of September 11th 2019

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