ECB: Lesser monthly purchases, but for longer

- Refinancing rate held at 0.0%
- Marginal lending rate held at 0.25%
- Deposit rate held at -0.40%
- Low rates expected for an extended period beyond end of asset purchase program
- Monthly asset purchases to be cut from €80 billion to €60 billion from April 2017
- Parameters for selecting bonds for purchase to be adjusted
- Inflation target retained, flexibility may be shown over asset purchase programme size and duration
- Remain underweight European equities and cautious on the Euro

The European Central Bank (ECB) President Draghi today cast in the most constructive light possible the bank's surprise decision to reduce the pace of bond purchases within its asset purchase program, saying a complete tapering was not envisioned. He also emphasized new steps to make the program more effective.

European equity and bond markets have been dependent on ECB easing for many months, particularly as the economic upturn has not been strong and the political backdrop has worsened. In European sovereign bond markets particularly, valuations have become very extended. Indeed, while Citi Research forecast this shift from the ECB, the strong consensus across the marketplace was for no tapering, a view that had been strengthened as a result of the recent rise in global bond yields. Today's start to the tapering process is expected to reduce investor complacency. At the same time, the extended period of asset purchases will equate to an extra €540 billion, which should be supportive of markets.

Draghi believes the economic recovery to be "moderate but firming". This seems to be supported by recent data releases. Since the 20 October meeting, the composite Euro Area Composite PMI indicator has moved to an 11-month high of 53.9. Lending has also improved, rising 2.2% year-on-year in September, the fastest rise since mid-2009. The M3 measure of the money supply is being driven by M1 money supply growth of 7.9% in October. Draghi also noted the support from the slightly stronger global recovery as well as the pass-through of monetary policy starting to support corporate deleveraging. The 0.3% real GDP growth achieved in the second and third quarters is expected to continue into 2017. Once again Draghi has stated that Europe needs more structural reforms in order to raise productivity. He emphasized the need for fiscal expansion, with more infrastructure spending.

The inflation outlook remains "subdued". As inflation rose to 0.6% in November, this was largely due to higher energy prices. The outlook is for further rises in the headline rate due to the base effects of the rising energy price. Even so, with forecast rises to 1.3% in 2017, 1.5% in 2018 and 1.7% in 2019, the Governing Council felt the need to extend its programme in a bid to achieve its 2% inflation target.

As well extending its asset purchase programme, the ECB have announced changes to the parameters of the programme, to expand the eligible universe of bonds to buy. As shown in **figure 1**, the net supply of European

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bonds has been shrinking throughout this year. The ECB can now purchase government bonds, which are yielding below the deposit rate, the latter unchanged at -0.4%. This expanded universe could now include instruments such as short-term German government debt, although Draghi also sees this adjustment as an “option” and by no means a necessity. The restriction on purchases of government bonds with maturities under two years has also been relaxed, allowing for allowing for maturities between 1 and 30 years. We estimate that these two measures combined could potentially raise the size of the universe of eligible bonds by one-fifth.

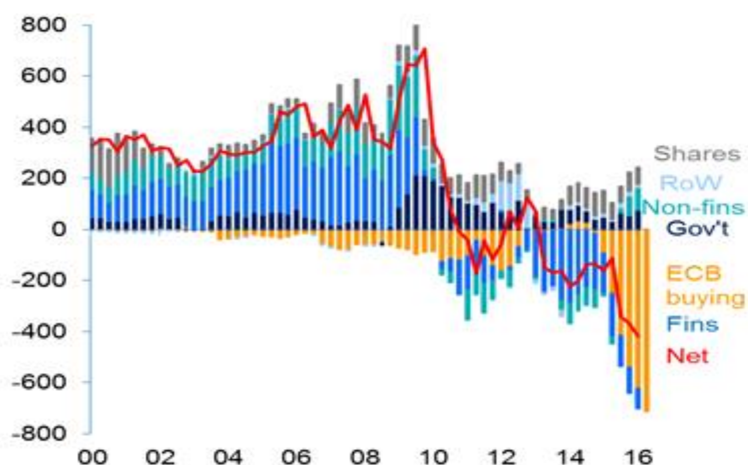
Sovereign bonds have generally weakened, with German 10-year Bund yields up by 6 basis points (bps) at 0.418% and now trading at their highest level since January this year. In Italy, the **10-year** yield has risen by 9 bps to 1.97%, however the 2-year yield has dropped to -0.06%. Bund 2s10s steepened roughly 15bp on the news. These steepenings can be explained by the two parameter adjustments described above.

While the bond market has focused mainly on the reduced monthly asset purchase size, equities have initially moved higher, driven by the extension of the programme, which equates to €540 billion of additional quantitative easing compared with the €480 billion previously expected. The Euro Stoxx 50 is off its high yet still up 1.17% on the day.

An indicator to monitor in the coming days is the spread between the Italian and German 10-year government bonds. As seen in **figure 2** below, the perceived Italian risk has been falling despite the recent referendum result. Any signs of the political challenges impacting on the ability to recapitalize the banks sector are likely to be reflected in a widening spread. This in turn could prompt a consolidation in European equities given the potential scale of the challenge.

The Euro spiked to US$1.0874 before retreating towards where it had begun at US$1.0650 during Mario Draghi’s press statement. The increase in total asset purchases over a longer period is expected to keep downward pressure on the Euro. Citi Research are forecasting the Euro to head towards US$1.05 over the next three months and towards US$0.98 over 6-12 months.

Figure 1: ECB Net Supply



Source: Citi Research as of December 8th, 2016.

Figure 2: Spread differential between Italian and German 10-year Government Bonds

Sources: Bloomberg as of December 8th, 2016.

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