ECB: QE, vLTRO, rate cut – what's next?

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While there is a lot of talk about QE these days, the hurdles to implementing it are still quite high, in our view. But what, if? Growing expectations of a QE programme should push yields further down, contribute to more intra-Euro-zone spread narrowing, and likely also push curves flatter. Note that our ECB base case remains: no move.

With his remarks during the last press conference about the Governing Council being "unanimous in its commitment to using also unconventional instruments" Mario Draghi opened the door for all kinds of speculation of what the ECB might be preparing to do. For the moment, the ECB probably tries to talk rates and the EUR down. Words might be followed by action.

In any case, speculation about possible ECB action will drive markets and so we take a look into which circumstances could cause which kind of ECB action. As a base case …

- … we expect inflation to pick up to 0.8-0.9% in April (flash estimate on 30 April) and to approach one percent later
- … we expect no more rate cuts, and no asset purchases, be it private or public
- … we can easily imagine the full-allotment-fixed-rate procedure to be prolonged beyond July 2015, also to signal decoupling from the Fed's move towards normalization.
- … we would not exclude steps to dampen volatility on money markets like stopping the SMP sterilization or reducing minimum reserve requirements.

Still, over the next quarters, a number of problems are likely to persist and may cause conventional or unconventional ECB actions.

The case for a rate cut: when words are not enough

What we feel the ECB is closest to is a cut in the refi rate by 10 or 15 basis points, and possibly also in the deposit rate. The most likely trigger would be a de-anchoring of inflation expectations that can result from further EUR strength. Thresholds are hard to pin down. However, EURUSD above 1.40 and moving north could be a trigger. A negative deposit rate would be a strong signal to markets.

Contents

Conditional vLTROs: the problem of weak lending

Bank lending is likely to remain subdued, especially towards SMEs in Southern Europe. In the Euro area, bank loans have a share of roughly 80% in corporate funding. The ECB might decide to introduce a three- to four-year refinancing operation at a rate that will be reduced for banks increasing their lending activity. Whether banks will jump on this, in an era of deleveraging, is questionable, however. The Bank of England's experience with the "Funding for Lending" was not overwhelming. In the Euro area, it could be just pushing on a string. Markets could consider it as "more of the same" and not very effective. In the end, for banks, lending is mostly a question of availability of capital.

Quantitative Easing: the bazooka

Inflation rates close to zero ("lowflation") may persist for longer, e.g. because the output gap is bigger than assumed. The ECB's deflation worries may then increase to a degree that makes Quantitative Easing (QE) inevitable. The objective of asset purchases would be to increase liquidity and boost bank lending, but also to create positive wealth effects, to weaken the EUR, to push interest rates further down, especially in Southern Europe, and ultimately to increase aggregate demand and GDP growth.

QE can come in a lot of shades: Buying corporate bonds would have the advantage that it is politically less sensitive as this has nothing to do with funding governments. Although exotic, the ECB could even consider buying equities with a fair chance of selling them with a profit. Both corporate bonds and equities would be mainly bought from private non-banks so that broad money growth would rise. The corporate bond market is certainly not large enough to allow for a huge effect. But the ECB may still start in this segment.

Article 18 of its statute gives the ECB the right to buy government bonds on secondary markets "in order to achieve the objectives of the ESCB" – i.e. price stability. A € 1,000 bn programme would be sizable – representing some 15 % of the Euro-area government bond market and a bit more than 10% of Euro-area GDP. The ECB would have to decide which bonds to buy, taking the shares of Euro-area countries in the ECB's capital would be the most obvious way. The ECB will likely favour shorter maturities following the thinking in the OMT-program and LTRO's. If extra muscles were needed, the ECB could lengthen the targeted maturities at a later stage.

The main argument against QE is moral hazard. Buying govies – even in secondary markets – is very close to funding governments by printing money. The OMT programme would come with conditions attached. QE would be unconditional – probably not the right signal to countries like France that continue to interpret the stability pact generously.

The hurdle for implementing QE may be lower than it was a few months ago but it is probably still quite high – in our view higher than the hurdle for a kind of "Funding for Lending" programme. QE could become more realistic in the autumn, but only if inflation rates are still clearly below 1%.

Less controversy, more ABS

Although not quite QE, because of limited volumes involved, ABS buying could be a more likely option as it does not involve controversial government funding.

In addition, it could ease the lacklustre lending to SME's especially in the periphery where the banks still struggle with deleveraging and the inadequate capital position. Securitisation could be a way to ease the access to credit for real economy borrowers and at the same time broaden funding options for banks.

According to AFME at the end of 2012 the amount of placed securitisations outstanding in Europe amounted to approximately € 800 bn or € 1,700 bn including the retained issuance. However, the securitisation market has been shrinking lately and the placed issuance was down by 10 % in 2013. In 2006 and 2007 public issuance of European securitisations amounted to € 450 bn per year. After the crisis the market has been only a shadow of the past with the volumes amounting to € 80-90 bn in 2010-2013.

As Draghi pointed out, regulation should be eased before ABS market can reasonably be expected to revive. Capital requirements for holding ABS both for banks and insurance companies would have to be eased. Also revisiting banks LCR-requirements, such as the assets that can be included in the liquidity buffers, could provide a boost to the market. Reshaping the regulation landscape is, however, an uncertain and slow process.

According to WSJ at the moment the insurance sector needs to hold 4.8 times capital holding a certain AAA rated RMBS vs holding an AAA rated corporate bond. The charge is slightly higher than for a BB rated corporate bond considered in junk territory which clearly illustrates the punitive regulatory treatment of the instruments at the moment.

The ECB has already started to look at options within the ABS markets, and more information can be expected later this year.

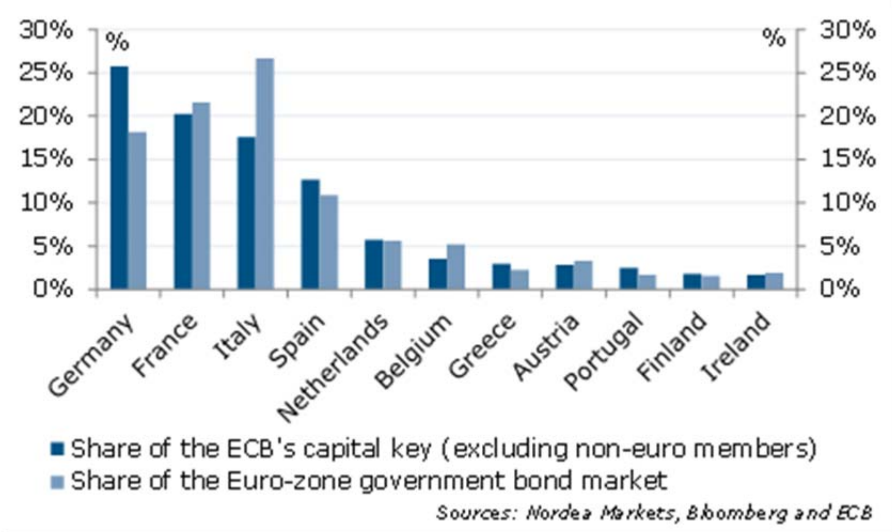
Lower yields, flatter curves and tighter spreads

Growing expectations of a QE programme should push yields further down, contribute to more intra-Euro-zone spread narrowing, and likely also push curves flatter. The effect on the curve is the most uncertain of these, since unlike e.g. the Fed, the ECB might have a stronger preference to target its purchases to shorter maturities.

The effect on spreads of course depends on the structure of the programme. In case of government bonds the most likely way to go would be to divide the bonds using the different countries shares in the ECB's capital key, i.e. relative to the size of their economies and population. In theory then, the larger the purchases relative to the size of the bond market are, the larger the effect on the level of yields.

In practice the prospect of government bond purchases by the ECB would boost risk appetite, and the most likely outcome would be that the higher the spread, the more it would narrow. But the size of the bond market relative to the purchases should have a bigger role between countries with rather similar spread levels. In other words, e.g. Spanish bonds should perform vs. Italy, Finnish bonds should perform vs. Austria.

Germany and Spain would see bigger bond purchases than their share of the market



If a QE programme actually takes place, the market action created by increased expectations would likely be unwound, as the programme became reality. In other words, yields and rates in general would increase and curves steepen, as the programme boosted expectations of a recovery. The support for narrow intra-Euro-zone bond spreads, in turn, should remain in place even amidst the actual purchases.

In the US, the market action ahead of QE reversed during the actual purchases