UBS

10 March 2016

UBS Asset Management Flash Commentary

Update on March ECB Governing Council Meeting

- ECB president Draghi delivers ahead of investors' high expectations
- Added measures introduced to encourage loan growth without weighing on prospects of banking sector
- As investors digest package of measures announced, medium-term impact remains to be seen

What Happened and Why?

In sharp contrast to the December meeting, the European Central Bank (ECB) managed to deliver above expectations, announcing more measures than the market expected.

Instead of concentrating on just one or two actions, the ECB introduced a wider range of measures aimed at improving financial conditions by stimulating lending without penalising banks' profitability. The ECB cut the rate at which banks borrow to 0% (from 0.05%) but it also cut the deposit rate further into negative territory, bringing it down to -0.4% from -0.3% (the minimum that markets were expecting).

The ECB also increased the pace of monthly quantitative easing (QE) purchases by EUR 20bn although it did not extend the end date for QE. Nonetheless, the faster pace of purchases means that the total amount of planned purchases has increased by EUR 240bn. Most surprising to markets was the decision to include investment grade EUR-denominated bonds issued by non-financial corporations. This increases the universe of potential assets that the ECB can buy, and hence creates scope to extend, if required, the QE programme beyond its current end date.

A second surprise was the introduction of a new targeted longer term refinancing operation (TLTRO) aimed at stimulating bank lending by allowing banks to finance themselves for four years at a zero interest rate. If banks can demonstrate an increase in their lending above a benchmark (which can be negative for some banks), they will even pay a negative interest rate (basically they will be paid to borrow from the ECB). Banks will be allowed to finance TLTROs up to 30% of their loans to non-financial corporations and households (excluding mortgages). While the success of any TLTRO relies on banks' willingness to borrow as well as firms' and households' willingness to borrow, the conditions set with the new TLTRO are much more appealing compared to previous iterations.

The market reaction to the announcement was initially very positive, with equities and bonds responding very positively to the new measures. The EUR also fell substantially. However, as he has done in the past, during the press conference President Draghi committed the sin of over-confidence (by market standards). In particular, the markets were not happy with the news that the ECB has basically reached its lower bound on the deposit rate and that further action (which is excluded for the time being) will be concentrated on the other unconventional measures (namely TLTRO and quantitative easing). This led to a sharp reversal of the initial market reaction which more than offset initial moves, causing the stock market to close at a loss, while both EUR interest rates and the EUR itself closed much higher.

Implications for our Fixed Income portfolios

Interest rates across most European markets increased following the ECB meeting and press conference. While the measures announced today exceeded expectations, market participants were clearly disappointed in messaging from the press conference. Corporate bonds were the big beneficiaries with the pledge to include non-financial investment-grade corporate bonds in future QE purchases. The cost of insuring European investment-grade corporate bonds against default dropped the most since October 2011.

At a strategy level, the ECB's latest actions are expected to benefit some of our portfolios, particularly as it relates to corporate credit exposure. In our Global Corporate Bond strategy, for example, we have been overweight European credit versus US and other country allocations in anticipation of such policy measures. Our EUR Corporate strategy should also benefit given our overall long market-beta positioning, and specifically an overweight towards non-financial hybrid bonds which experienced a decent price increase immediately following the press conference. Likewise, our EUR High Yield strategy should also benefit given the overweight to banks. While financials are excluded from the QE purchase program, financial bonds reacted positively to the announcement.

Implications for our Multi Asset portfolios
In our view, the outcome of the ECB's meeting was positive on the one hand and negative on the other. While Draghi delivered ahead of most investors' already high expectations, and sought to foster conditions that are favorable for both loan growth and the banking sector, the downward revisions to the ECB's inflation forecasts reflect the absence of healthy upward pressure on consumer prices and sluggish economic growth in the Eurozone. At a strategy level, our broadly neutral positioning in riskier assets such as equities remains unchanged. We believe that the investment case further up the corporate capital structure in developed market debt over equities is starting to look more compelling.

For details on specific portfolios please contact your usual client relationship manager.