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Asset Management

Holding out for a hero - the euro zone and the ECB

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In Brief

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Mickael Benhaim, Co-head of Global Bonds

- Investors have doubts over the ECB's ability to lift the euro zone economy out of its funk
- Negative deposit rates were widely derided as counter-productive
- But the ECB has plenty of other options available - including the extension of QE to corporate bonds

Euro zone inflation has stayed below 1 per cent for more than two yea rs despite a series of monetary stimulus measures from the European Central Bank. Mickael Benhaim, Co-Head of Global Bonds, outlines the likely next step for the central bank as it tries to kick start credit growth and revitalise the economy.

He was once hailed as "Super" Mario. Now, he seems to be losing that aura of invincibility. In common with many of his counterparts in the developed world, European Central Bank President Mario Draghi looks to have run out of bright ideas to rescue the economy. Indeed, his recent decision to charge private institutions for the privilege of parking their surplus reserves with the ECB was derided as short-sighted in some quarters. While the move was intended to boost consumer and business lending, critics claim it is more likely to do the opposite, chiefly because it will squeeze banks' profit margins.

But there are ways for Draghi to re-establish his credibility with investors and businesses – and his options include further relaxing restrictions on the ECB's government bond purchase programme and buying corporate debt.

Bold steps, clearly, yet moves that would be in keeping with his pledge to do "whatever it takes" to safeguard the euro zone.

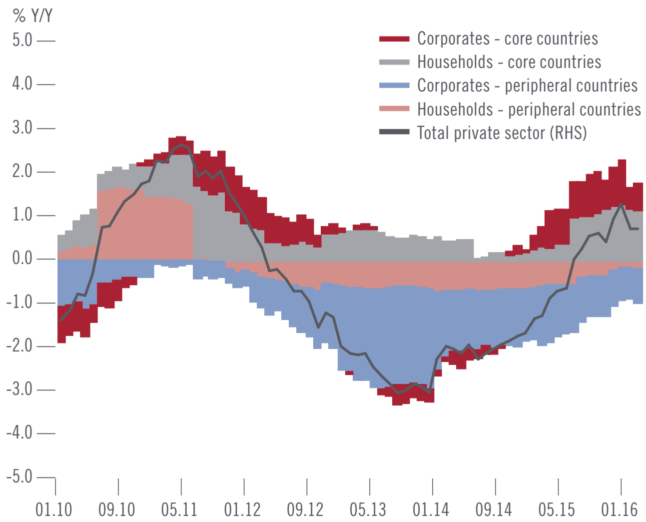
Diminishing returns

Those who claim the ECB is becoming less effective have a long charge list. The euro zone economic growth is slowing: Germany's manufacturing sector, for instance, registered a 1.1 per cent month-on-month decline in output in December. Meanwhile, inflation sits stubbornly below the ECB's 2 per cent target, and has done so for four years. Core inflation slowed to just 0.7 per cent in February while the most widely followed measure of the market's long-term inflation expectations, the five-year five-year forward breakeven inflation rate, recently hit a record low of 1.37 per cent. Then, there is the problem of non-performing loans on bank balance sheets. Italy alone has some EUR350 billion worth of them – and they account for some 17 per cent of the country's total bank loans. This has contributed to an alarming fall in credit growth (see Fig. 1).

For all this, it would be a mistake to assume that central banks have run out of ammunition. Far from it. Like its peers, the ECB still has quite an arsenal at its disposal. And I believe it will use its March 10 policy meeting to breathe new life into its campaign to create the conditions for self-sustaining economic growth.

FIG. 1 - CREDIT NOT GETTING TO THE COUNTRIES THAT NEED IT

Growth in credit, %, year-on-year - euro zone periphery vse core



Source: ECB, Pictet Asset Management

Monetary policy transmission channel

The case for a change in direction is a strong one: hardly any of the policies the ECB is using appear to be working as well as they once did.

A central bank typically affects the economy via several transmission channels.

The first – and usually the most potent - is the *interest rate channel*. By raising or lowering interest rates, central banks affect both the cost and availability of credit to households and businesses, which in turn influences consumption and investment. Yet with interest rates already at or near zero, this channel is no longer effective.

The *asset price channel*, meanwhile, is the one policymakers use to produce a wealth effect. In using measures that boost the capital value of bonds, equities, real estate and other domestic assets, central banks aim to increase the wealth of consumers and businesses which, all things being equal, boosts spending. This channel is of limited use in the euro zone, primarily because households in Europe tend to own fewer financial assets than, say, the US.

The *exchange rate channel* is the route central banks take when they want to affect exchange rates in a way that influences growth (by boosting exports) or inflation. This has largely worked well in the euro zone. The lowering of interest rates has led to a weaker euro, which in turn has helped boost export competitiveness.

Yet, as the euro's real effective exchange rate has fallen close to the bottom end of its historic range and other central banks also focus on weakening their currencies, it would seem that this transmission channel is also becoming blocked.

With these three routes becoming blocked, I think the ECB should now focus all of its attentions on the *credit channel*, through which policymakers seek to turn banks into transmitters of monetary policy.

In an ideal world, the most effective way to do so would be to purchase assets directly from banks, as the US authorities did with the Troubled Assets Relief Program (TARP) in 2008-2009. Under TARP, which is widely considered to have been effective in stabilising the financial system, the US originally committed USD700 billion to purchase illiquid assets and equity from financial institutions.[1]

However, it is a stretch to believe the ECB can ever be as bold. One constraint is the potential conflict of interest that would emerge with a US-like TARP mechanism. There would be enormous resistance to the idea of an ECB that is simultaneously a supervisor of the banking system and a buyer of bank debt.

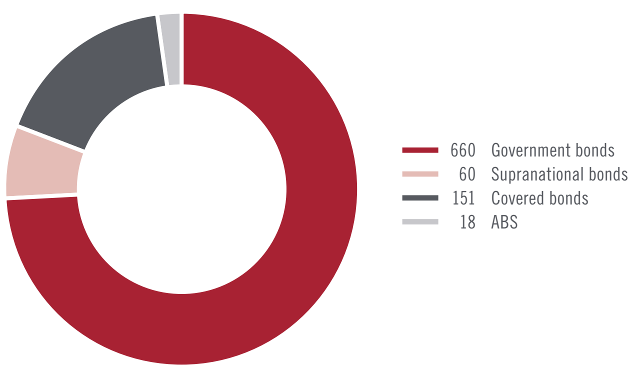
A change in direction

An acceptable compromise, in my view, would be for the ECB to widen the scope of its current bond buying programme. As it stands, the central bank is only able to buy public debt that yields more than its deposit rate. That presents a problem. It forces the ECB into making large purchases of longer-duration debt, the only securities with sufficiently high yields. This, in turn, causes yields on those longer-maturity bonds to fall relative to those on shorter-term securities. This trend - known as a flattening of the yield curve - is a headache for banks as it makes lending less profitable.

One way of solving that problem is to remove the yield floor, widening the yield diffential between short and long-duration bonds, and easing the pressure on bank profit margins.

FIG.2 – WHAT THE ECB HAS BEEN BUYING

EUR, billion



Source: JP Morgan, as of 31.01.2016

The central bank could also quite easily commit to buying, say, EUR5-10 billion a month of company bonds in addition to the EUR60 billion of government debt it is currently buying.

[1] Congress subsequently reduced the size of the TARP programme to USD475 billion

Some worry that such a move would quickly run into problems because the euro zone's corporate bond market is relatively small, particularly when compared to the US. Yet if financial bonds were included, the pool of investible investment grade bonds rises to a not inconsiderable EUR1.2 trillion.

What is more, there is also a way for the ECB to enable purchases of bank debt and avoid a potential conflict of interest. It could simply delegate purchases of bank bonds to a group of asset managers, as it did when asset-backed securities were included in its QE programme. Or it could structure its bond purchases to be in line with the most widely-used investment-grade bond index, at least a third of which is made up of financial bonds.

Another way for the ECB to unblock the credit channel would be to broaden the range of securities it accepts as collateral for short-term loans to banks. It has already raised this as a possibility. Draghi said he would consider accepting as collateral securitised bank assets that included non-performing bank loans, provided such bundled securities carried sufficiently high credit ratings.

As things stand, the market expects the ECB to take a more measured approach. Most investors envisage an additional cut in deposit rates coupled with the introduction of a tiering mechanism under which negative interest rates would be applied to just a portion of banks' surplus cash.

But such measures, in my view, would not meet with much success.

By purchasing a broader range of government and corporate bonds, the ECB can give a powerful message to investors - that it will do what is necessary to bolster economic growth and restore confidence in the financial system.

Mario could be "Super" once more.

GLOBAL BONDS AT PICTET ASSET MANAGEMENT

Pictet Asset Management offers a range of strategies and funds that invest in investment-grade government and corporate debt.

For global and regional bonds we apply a consistent investment approach irrespective of sector or return objective.

We invest with a long-term horizon, based on a valuation assessment which does not depend on any assumptions about likely economic developments. Our approach to risk is equally pragmatic.

Mickael Benhaim, Co-Head of Global & Regional bonds

Mickael Benhaim joined Pictet Asset Management's Fixed Income team in 2006. Before joining Pictet, he was Head of Euro Aggregate Fixed Income for AXA Investment Managers where he worked for five years. Mickael has more than 20 years' professional experience that includes working at the Dresdner Group and BNP Paribas Group.Mickael holds a MSc in Mathematics and a post-graduate degree in stochastic models from the University of Paris Jussieu and Paris Panthéon-Sorbonne.

Contact details

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