ECB goes for broke to drive inflation higher

A marked improvement in risk appetite has been a noticeable feature of financial markets this month, leading to a sharp rise in bond yields with equities making good ground. It has also seen a noticeable scaling back of interest rate cut expectations in all the main markets.

This is despite the fact that the ECB certainly delivered on the policy easing front last week. It cuts its key deposit rate by 10bps, reducing it from -0.4% to -0.5%. It also announced that it was restarting an open-ended QE bond purchase programme and would also provide more generous terms for some liquidity operations. In addition, it strengthened its forward guidance on policy remaining loose by indicating than rates could go even lower. However, the positive response in bond markets to the ECB announcements did not last that long as the underlying trend of rising yields re-emerged.

The improved market sentiment is due to a couple of factors, including data in the US and UK economies starting to come in ahead of expectations, having disappointed year-to-date, as well as some downside risks to growth receding a little. In this regard, there are some signs of progress in the US-China trade talks, while a no-deal Brexit is seen as having been taken off the table for end October by the UK Parliament. Indeed, there are growing hopes that the EU and UK might even be able to agree a Brexit deal next month.

This week sees the US Federal Reserve, Bank of Japan and Bank of England all holding important monetary policy meetings, with another 25bps cut by the Fed fully discounted by markets. However, the reaction of bond markets to the ECB meeting last week shows that even if the Fed delivers, traders may not be impressed.

Overall, it would seems that markets had gotten too far ahead of the economic data in pricing in extensive monetary easing. The big picture on monetary policy has not changed, though. It is clear from the forward guidance of the ECB that monetary conditions are set to remain extremely loose for a long time in the Eurozone. The ECB is commencing an open-ended QE programme and has also indicated that rates could be cut further.

The ECB has also indicated that policy tightening will not come on to the agenda until it sees the outlook for underlying inflation "robustly converge" with the 2% inflation target. Core inflation has been stuck at around 1% in the Eurozone for a long time now. Expecting it to rise to 2% could prove to be a bit like waiting for Godot. Indeed, based on the ECB's own inflation forecasts, it is years away. Not surprising then, futures contracts indicate that the deposit rate will still be negative at around -0.2% in 2025.

A prolonged period of negative interest rates combined with QE, all in the difficult pursuit of an elusive inflation target, brings its own problems. Indeed, the ECB also announced last week that it would introduce a tiered system of deposit rates so that less of banks holdings of excess liquidity would attract the penal negative deposit rate of -0.5%.

However, negative bond yields, which are now pervasive in the euro area, remain a major headache for pension and other investment funds, insurance companies and banks. They are all required to maintain substantial holdings of long-term fixed income assets. It is no wonder that some institutional investors are becoming more directly involved in the property market, attracted by its relatively high yields.

Oliver Mangan

Chief Economist,

AIB

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