AQUILA

Flash

ECB has to buy bonds aggressively if it is to meet its QE targets

Over the next 18 months the ECB will pump 1'100 billion euros into the financial markets. Given the size of the ECB's program, the already record low bond yields and the reticence of existing bond-holders to sell, the ECB will have to buy aggressively if it is to meet its QE targets. European equity markets will benefit from the flood of money set to be pumped into the system.

In the next 18 months the ECB will pump over 1'100 billion euros into financial markets.
At its latest press conference the ECB announced that March 9 would be the starting date for its QE, or bond-buying, program. Moreover ECB President Draghi stated that the program would involve 60 billion euros of purchases a month until at least September 2016 and that if necessary the program would continue thereafter, until inflation looks like being in line with ECB targets on a sustained basis. The ECB has also made public the details of the program. It will include Pfandbriefe and other asset-backed bonds of the highest quality, bonds issued by European supranational institutions such as the EIB, as well as Eurozone government bonds. Qualifying government bonds must have a term to maturity of between 2 and 30 years. Barclays Capital estimates that Eurozone government bonds will account for two thirds of the program, with Eurozone covered bonds and the bonds of European supranationals and agencies each accounting for a sixth.

One wonders how easy it will be for the ECB to implement its plans.
Given the sheer size of the ECB's program one has to wonder how it can be implemented. Concerns relate to three issues. First the relationship between the size of the program and the size of the bond markets affected. Second, as the ECB will only buy bonds yielding better than -0.2%, the yields available in the market will be a critical factor. Third, will existing bond holders be willing to sell to the ECB?

The ECB will force other buyers out of the market.
Outstanding Eurozone government bonds with a term to maturity of between 2 and 30 years total around 4,500 billion euros. Given scheduled increases in borrowing by Eurozone governments this total might rise by around 500 billion euros over the next 2 years. According to Barclays Capital, ECB demand for such bonds will amount to over 700 billion euros, thus exceeding the volume of new issuance by Eurozone governments. Moreover, ECB bond purchases will represent some 15% of all Eurozone government bonds outstanding, although equivalent percentages regarding the less liquid markets for Eurozone covered bonds and European supranational bonds are not quite so high. Overall, these markets do seem large enough to accommodate the ECB's plans but those plans will depress yields even further.

Record low yields in the Eurozone will soon limit the ECB's room for maneuver.
Because the ECB will only buy bonds which yield better that the ECB's own deposit rate of -0.2%, the range of bonds suitable for the central bank is even further restricted. At present this -0.2% hurdle is only relevant to 2 year German Bunds. But a glance at the yields now available on Eurozone government bonds makes it clear that the ECB's room to move might quickly become very restricted. Already a third of the bonds represented in the Bloomberg Eurozone Sovereign bond index now carry negative yields. Indeed, the government yield curves of Germany, Austria, Finland and Holland now show negative yields out to 5 years. The same is true for the bonds issued by European supranational institutions such as the EFSF, the ESM, the EIB and Euratom, the European Atomic Energy Community. At around 5 years to maturity, however, European agency paper starts to show a marginally positive yield, while

government bonds for Eurozone peripheral countries offer the ECB more scope for buying. Thus Italian government bonds now indicate a 0.5% yield on 5 year paper, while 10 year and 30 year Italian government bonds yield 1.3% and 2.3% respectively. Spanish government bonds show a similar picture and Portuguese government bonds offer a yield premium of around 0.3% relative to those of Italy and Spain. Overall, we believe that the combination of already record low yields and the ECB's massive program of bond-buying will likely result in a general levelling of yields around the -0.2% mark.

Banks and insurance companies will not be pleased if they are forced to sell their government bonds.

Given the strong demand for "safe haven" paper and the record low investment yields, bond holders are reluctant to sell, in part because of the difficulty of reinvesting any sales proceeds at an acceptable yield. The ECB's purchase program will only aggravate this problem. Also, should yields tend to move down to the -0.2% level, as we predict, then existing bond holders will achieve a capital gain if they hang on to their investments for now. Meanwhile, regulation encourages important investors to stay put. Thus banks and insurance companies face much less onerous capital requirements on their investments in government bonds than on their other investments.

The ECB's bond-buying schedule will boost European equity markets powerfully.

We assume that the ECB will have to be an aggressive buyer of bonds if it is to achieve the purchase targets of its "Public Sector Purchase Programme" (PSPP). This means that yield differentials between those bonds which qualify for ECB purchase will quickly compress, with yields tending to level out at around the -0.2% mark. However, it is quite possible that the ECB will further lower its deposit rate. This move would increase its scope to buy bonds, although itis limited by the fact that negative yields imply investment losses. But, should the ECB encounter greater than expected difficulty in implementing the PSPP, it might well decide to extend the program to cover equities. The PSPP looks set to boost European equities in any event through its depreciating impact on the euro but the boost could be even more powerful were the program extended to include equities. We note in this context, that the euro's recent weakness has been principally against the dollar and that the euro has latterly been able to hold its value against the Swiss franc without the intervention of the SNB. Since the ECB announced last November that it would expand its balance sheet by 1000bn. euros the Euro-Stoxx50 equity index has risen a nice 17%. But this gain is dwarfed by the 50% rise in the Nikkei since the Bank of Japan announced its bond-buying program in April 2013. With such considerations in mind we remain overweight in European equities, especially relative to US equities.

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