HIGHLAND

ECB BRIEF

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EUROPEAN CENTRAL BANK: PUSHING ON A STRING

While investors in the U.S. and abroad remain enamored with the Federal Reserve (Fed) and its latest actions, we thought it was important to provide an update on the Fed's European brethren, the European Central Bank (ECB). On a GDP-weighted basis, the European economy as a percent of total global GDP is on par with the U.S. Alas, the European economy has been reeling from China's slowdown and a drop in automobile sales, as well as the specter of the trade war. Its largest economy, Germany, which derives 25% of its growth from exports, looks to be on the precipice of a recession. However, the central bank is caught in the proverbial "box." It has acknowledged that there are limits to what monetary policy can accomplish while vocally pushing for fiscal policy to grab the baton.

In one of his last meetings as the head of the ECB, Mario Draghi noted that more must be done to aid the economy. Since it doesn't appear that significant fiscal policy is on the way, the ECB announced the following measures:

- 10 bps cut to the deposit rate (from -0.40% to -0.50%).
- On forward guidance, the ECB changed its guidance for considering a future rate hike. It will now need core inflation to "robustly converge" to close to, but below, 2% (previously was headline inflation).
- Tiering of negative deposit rates (two tiers of deposits, one at -0.50% rate and another portion at zero rate). This is for bank reserves held in current accounts and is implemented to offset the costs to the larger banks.
- Asset purchase program: €20 billion per month of net asset purchases (beginning in November). No timetable provided on when these would end.
- Changed the TLTRO Program, or its loan facility for banks, which allows banks to get cheaper loans from the ECB, which can be lent out at higher rates.

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While some of these measures were expected, the fact that there is no timetable set on the asset purchase program was seen as a nice surprise to the markets. The explicit benefit of all of these measures is to keep policy very accommodative for the foreseeable future. The implicit benefit is this should keep the Euro weaker. However, it is important to take a step back and note how this compares to what the ECB has already delivered post-crisis:

- €2.6 trillion of asset purchases
- Over 500 bps in interest rate cuts

It's hard to see how this is going to change the outlook for Europe and really amounts to not much more than tinkering around the edges. With former Chairman of the International Monetary Fund Christine Lagarde taking the reins as President of the ECB in November this year, it is expected that the current monetary policy will remain in effect. Lagarde has indicated she will continue Draghi's easy-money policies while fine-tuning them and reassessing their costs. In other words, more tinkering with policy. At our client conference in March, Blackrock's Rick Rieder called on the ECB to add the purchase of equities to its arsenal. While following Japan's lead and buying equities regardless of price should help equities, it is difficult to see how that would translate into sustainable higher economic growth. This is why Draghi has stated monetary policy would be more effective if other policy areas contributed to raising the longer-term growth potential.

When asked during his press conference about the effectiveness of monetary policy, Draghi stated, "Now, it's high time for fiscal policy to take charge." Monetary policy works best in consortium with an effective fiscal policy. The European Union, or at least Germany and the northern countries in the union, do not seem willing to open up the purse for more government spending. It is this unwillingness that gives us pause for increasing our allocation to Europe. The valuations are cheap on both an absolute and relative basis to U.S. However, its reliance on exports at the time of a shift toward deglobalization leads us to continue to remain underweight relative to our own domestic markets.