

MARKIT RECAP

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Credit investors will remember the summer of 2012 as the turning point of the eurozone sovereign crisis. Mario Draghi’s “whatever it takes” intervention caused a decisive shift in sentiment and triggered a long rally that has lasted to this day.

But in 2014 the ECB felt the need for further radical action, this time prompted by persistently low inflation that threatens to become deflation. Draghi announced on June 5 a package of measures aimed at boosting the price level. As expected, the deposit rate was cut to -0.1%, the first time it has been in negative territory. Bond purchases through the Securities Markets Programme (SMP) will no longer be sterilised. Two new four-year LTROs will be held later this year, with a total entitlement of €400bn. And the ECB said it is “intensifying preparatory” work on buying securities in the ABS market.

The measures went further than many expected, and the markets welcomed the news. The Markit iTraxx Europe tightened 3.5bps to 61bps, and was trading just 0.5bps wider than its US counterpart the Markit CDX.NA.IG. The latter index hasn’t traded wider than the former since August 2010. Given the differing directions of US and eurozone monetary policy, we may soon see this relationship reversed.

But the ECB stopped short of announcing quantitative easing, the policy that the markets really want to see implemented. We know from experience that QE boosts risk assets and drives down spreads. The central bank reiterated that QE remains an available option, though its introduction is unlikely to be anytime soon.

Of the measures that were launched, the negative deposit rate was probably the most eye-catching. However, it may turn out to be the least important. The experience of Denmark shows that negative rates – effectively a tax on deposits – had little effect on lending. In fact, lending went down after rates were cut below 0%.

The €400bn LTRO is likely to be more effective in easing credit in the real economy. Unlike previous LTROs, this will be targeted at the non-financial private sector, and the interest rate will be fixed over the life of each operation. The ECB is no doubt aware that previous LTROs were used to profit from the sovereign carry trade (lend from the ECB, buy peripheral debt). Draghi's insistence that this won't be repeated probably secured the support of the more hawkish member of the governing council.

But we don't know how much of the LTROs bank will choose to take up, and the demand for credit from the corporate sector is uncertain. The ECB's probable intervention in the ABS market is certainly welcome, and could further ease credit conditions for SMEs. But there is a shortage of non-RMBS securities in Europe, and current capital requirements deter interest from banks. The structural challenges could limit the effectiveness of any asset purchase programme.

Overall, the ECB's measures are positive, but they are unlikely to be the game changer that Draghi's "whatever it takes" statement so memorably was in 2012.



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