Weekly Market Summary

11th of March 2016

ECB Delivers on March 10th….. Markets Now Await the US Fed Decision on March 16th
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ECB Pulls All The Levers…ECB takes Bold Steps to Stimulate the Eurozone Economy …. ECB Fires the proverbial "Bazooka" …. *Hip Hip Hooray!!*

ECB President Mario Draghi has rediscovered his mojo! Whilst he may have underwhelmed investors in December (by delivering modest easing at the ECB December 3rd meeting), Mr. Draghi - faced with a Eurozone economy stubbornly resistant to revival - bounced back last Thursday by announcing an aggressive package of quantitative easing measures that incited a big market rally (including a sharp rally in the Euro versus most G-10 peers after an initial selloff, as the ECB President said the ECB sees no need for further rate cuts at this point in time) . The problem: He may be encouraging excessive risk-taking without being able to increase inflation.

Stock and bond prices shot up while credit indexes tightened sharply after Mr. Draghi increased the value of monthly European Central Bank asset purchases by one-third to € 80 billion (from € 60 billion previously). He also said non-bank investment grade corporate bonds would qualify for the buying program, which aims to spur economic activity by cutting borrowing costs. In addition, Mr. Draghi unveiled plans for new four-year loans for European banks, with those carrying interest rates as low as the deposit rate (cut by 10 basis points to minus 0.4%). That would effectively mean paying commercial banks money to borrow central bank funds!! The central bank also cut its benchmark interest rate, the main refinancing rate (repo rate), to zero from -0.05%.

The plan to buy corporate bonds is a radical departure for a central bank that was far more conservative than its peers during the financial crisis. First, although bonds issued by banks still do not qualify for purchases by the central bank, Mr. Draghi is helping them by indirectly cutting their funding costs. As yields on other corporate debt fall as a result of the bank's buying, investors will turn to bank debt and subordinated bonds. Second, negative rates for long-term loans would mean the central bank effectively pays banks to borrow. This would mitigate any damage done to bank margins by the more-negative deposit rate. No wonder the Euro Stoxx Banks index rose 4.9%, outperforming the wider market.

But all this light and joy cannot distract from a couple of rather big clouds. Given that Eurozone inflation has failed to respond much to past easing (despite the bank's stimulus measures to date, inflation in the 19 countries of the Eurozone has been stuck near or below zero for more than a year), it is unclear whether Mr. Draghi's new measures can spur consumer prices. Worse, the central bank chief just gave investors a new reason to disregard fundamentals when buying corporate bonds.

Whether the broad and even radical set of measures will have an effect, only time can tell! However when the central bank's easing party finally ends, the excessive risk-taking it is encouraging could leave an even bigger hangover!!

All attention will move this week to the Federal Reserve's 2-days policy meeting starting tomorrow (final rate announcement will take place on Wednesday 16th at 9:00 pm Bahrain time), particularly after the stimulative measures taken by the European Central Bank last week. Here are some steps that U.S. central bankers – most likely - will and won't take, and particularly those of greatest interest to financial markets:

- The Federal Open Market Committee (FOMC) will leave the Fed's interest rate as is (Fed fund rate at 0.25%--0.50%), and will make no changes to the policy governing the use of its balance sheets.
- Fed officials will guide markets toward the possibility of more interest rate increases than are currently priced in by traders and investors (possibly 3 rate hikes in 2016 and 2017, versus market pricing for 1 rate hike per year over coming years)
- Fed officials will note the continued recovery of the U.S. economy, led by strong job creation, but without sounding the all-clear on wages and inflation (both remaining under control).
- Fed officials will reiterate concerns about global economic weakness but refrain from upgrading the risks of spillover onto the real economy at home. They will seem somewhat comforted by the return of relative financial stability, especially after the volatility a few weeks ago that again illustrated the fragility of investor sentiment both in the U.S. and elsewhere.

Putting this all together, the Fed once again will emphasize both its dependence on data and its policy conditionality. This, however, will be accompanied by careful signals that -- unlike other systemically important central banks in China, Europe and Japan -- the Fed remains inclined to cautiously pursue its path of gradually higher interest rates and monetary policy normalization. We will surely keep you posted with the final outcome.

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