Weekly Market Summary

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Fulfilling Promises but Missing the Chemistry!!

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On July 25th, the European Central Bank opted to keep its key rates unchanged though president Mario Draghi managed to set the stage for the ECB to deliver another round of monetary stimulus at its next meeting on September 12th to combat the Euro area's severe economic slowdown. "*The outlook is getting worse and worse in manufacturing, especially, and it's getting worse and worse in those countries where manufacturing is very important,*" Draghi noted in his ensuing press conference. At that time, officials also signalled they will re-start their bond-buying program if needed; "*The Governing Council has tasked the relevant Euro system Committees with examining options, including ways to reinforce its forward guidance on policy rates, mitigating measures, such as the design of a tiered system for reserve remuneration, and options for the size and composition of potential new net asset purchases*."

With European bond markets fully priced for a very dovish outcome following their astounding August rally, Thursday's ECB meeting was shaping up to be critical! Mario Draghi - the soon-to-depart president - was simply torn between delivering on his previous dovish promises, and taking into consideration the hawks on the Bank's governing council who were pushing back against the restart of quantitative easing (recent hawkish statements and complaints made by German, French, Dutch and Austrian delegates regarding the resumption of a largely "meaningless" QE program in Europe that would prove to be ineffective in reviving the sharp drop in manufacturing export orders). "*The European Central is under market pressure to cut interest rates further into negative territory this month and to resume large-scale asset purchases in the next few weeks. With investors having already priced-in such steps, failure to follow through would most likely cause financial volatility that risks undermining an already fragile regional economy,"* Mohamed El-Erian – chief economic adviser at Allianz – had suggested in a previous report. While the outcome will most likely satisfy those looking for the world's two most influential central banks (referencing upcoming ECB & Fed meetings) to further loosen monetary policy*, "it will most likely do little to improve what has been a steadily darkening outlook for the global economy... And it will without a doubt disappoint those, both inside and outside the central banks, who are looking for the spotlight to pivot away from monetary policy to structural reforms and, for some European countries, fiscal tools that are better suited for the task at hand,"* El-Erian added.

And Disappointing It Was!!

At yesterday's ECB much anticipated meeting, Mario Draghi unveiled a sweeping package of measures to stimulate the Eurozone's economy; That included lowering the benchmark deposit interest rates (from -0.40% to -0.50%,even more in negative territory!), providing aid for banks through the introduction of a two-tier system for bank deposits (effectively allowing banks to keep up to 6x their required reserve levels in the ECB current account facility at 0%), and a resumption of quantitative easing asset purchases with no fixed closing date (€20 billion in monthly European bond purchases for "*as long as necessary*"). Markets' initial reaction was in line with expectations, with German Bund prices pushing higher (10-year yields lower by roughly 8 bps) and the EUR/USD currency pair moving lower (quick drop from 1.1035 to 1.0930). That in turn prompted, within minutes, the following mad reaction from President Trump: "*European Central Bank, acting quickly, Cuts Rates 10 Basis Points. They are trying, and succeeding, in depreciating the Euro against the VERY strong Dollar, hurting U.S. exports.... And the Fed sits, and sits, and sits. They get paid to borrow money, while we are paying interest!*" (Take time to appreciate Tump's "expressive & genius" usage of capital letters across the tweet! NoT ☹).

But before much longer, the foreign exchange market had changed its mind, with many suggesting that the low was in! And by the end of the trading session, the Euro had actually strengthened versus the dollar (last this morning at 1.1090); German 10-year bund yields also pared earlier losses and closed 6 bps higher on the day (last at -0.50%).

The culprit for this sudden change in investors' sentiment?

Emerging news that Draghi's final move had lacked the support of the Netherlands, Denmark and – critically - Germany. The limits on the ECB move had suddenly become more clear: The cut in interest rates was only 10 basis points, not the 15 to 20 bps as few had hoped; And whilst the ECB had resorted to asset purchases once again, it was doing so in smaller quantities than had been expected - most likely because the ECB's chiefs could not agree on broadening the range of assets that the Bank can buy! In other words, European monetary policy had run its course and was now reaching the point where it is limited by fiscal policy (the need for governments to borrow more before it can become truly expansive!). The final nail in the coffin for yesterday's sharp market reversal was Draghi's closing formal words as head of the ECB, as he acknowledged late in his press conference that monetary policy has done as much as it can. Therefore, in order to reap the full benefits from the ECB monetary policy measures, other policy areas must now contribute more decisively to raising the longer-term growth potential and supporting aggregate demand!

Mr. Draghi will soon be replaced at the helm of the European Central Bank by Christine Lagarde, having possibly done his utmost best to spur Eurozone growth: From his famous July 26th 2012 speech during which he promised to do "*whatever it takes – and believe me, it will be enough*" to save the Euro up until yesterday's parting indefinite package that also appears to have been an attempt to do whatever it takes to spark the region's economy back into life, Draghi can only be remembered as the policy maker who put all monetary instruments on the table and made full use of those! (In contrast, Edward J. Smith's, the captain of the Titanic, last words to the crew were as follows: "*Well boys, do your best for the women and children, and look out for yourself" ☺*). Whether Draghi did enough or did the right thing (this morning's market verdict is that he has put the ECB in a serious dilemma!) will only be known in coming months/years. Clearly now the baton has passed from monetary to fiscal policy, and all eyes will soon turn to Germany for fiscal action.

To end this weekly piece on a happy note, worth mentioning that John Bolton (beaver who wish to be a real boy – Late Show with Stephen Colbert ☺) - the most vocal hardliner from President Trump's inner circle - was dismissed last Tuesday as US national security advisor. Bolton was a "neo-conservative", war hawk and a strong advocate for regime change in North Korea, Venezuela, Iran, Libya, Syria and Yemen. Prior to that, he was a strong supporter of the Iraq War and continues to back this position till today! However, according to the Hill, it was Bolton's bushy moustache, and not his support of the Iraq War, that had President Trump wavering about offering him the job as early as 2016! Hopefully with his departure, the world can breathe a sigh of relief!

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