Weekly Market Summary

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Super Mario Bows Out with a Warning! A Hero Like the Character in the Nintendo Game?

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Eight years after he took over from Jean-Claude Trichet, Mario Draghi held his last Governing Council meeting on Thursday before Christine Lagarde takes over on November 1st. Draghi used his final press conference to warn that low rates are here to stay and stuck to the existing package of loosening measures he announced last month. He also offered a few other thoughts on the details of the monetary policy outlook and the fiscal governance of the euro area.

The central bank's governing council repeated its guidance that interest rates would not rise "*until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2 per cent within its projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics*".

Mr Draghi added that the global economic paradigm had recently changed and policymakers at the IMF and elsewhere now accepted that interest rates would remain low for a long time to come. With consumer and business confidence low and trade with the US hit by Donald Trump's latest raft of import tariffs, risks were all "*to the downside*", said the Italian economist. "*The incoming data since the last governing council meeting in early September confirm our previous assessment of a protracted weakness in the euro area growth dynamics, the persistence of prominent downside risk and muted inflation pressure*". Germany's economic activity slump has persisted into the fourth quarter. The IHS Markit purchasing managers' index showed that German manufacturers reported a 41.9 reading in October, marginally higher than last month's 41.7 reading but still pointing to deteriorating activity. In addition, the eurozone economy started the fourth quarter mired close to stagnation, with the flash PMI pointing to a quarterly GDP growth rate of just under 0.1 per cent.

Draghi declined to be more specific on how euro-area fiscal policy should move beyond advocating a change to the governance of fiscal policy in the euro area, noting the need for central fiscal capacity in the euro area. He refrained, as he has done in the past, from naming individual countries that should spend more.

He also confirmed the outlook for QE2 with two small clarifications: Firstly, he sounded confident about the possibility of increasing the issue and issuer limits (the 33% limit). Like in Sintra, he recalled the ECJ's December 2018 ruling and the fact that it gives the ECB wide room for manoeuvre. Secondly, he highlighted that the capital key targets are in terms of volume, not monthly flow; this means that as Germany and the Netherlands were slightly overpurchased under QE1, the ECB can slightly under purchase them under QE2 to strictly comply with the capital key.

So now that Super-Mario is pulling the plug on his time at the ECB - his eight-year term is ending, how does his record look? And what kind of legacy will he leave his successor?

During his 8-years in charge, the Euro Area eventually emerged from a period of sovereign debt crises and saw unemployment drop to 7.4% (11 million European jobs were created since 2013), its lowest since May 2008. However, inflation proved too stubborn to return to target (averaging 1.19% over the period). Peripheral countries' spreads shot up to historic highs as investors became fearful that they would be unable to finance their rising debt levels or stimulate their struggling economies.

Aldo during Draghi's term, the ECB expanded moral hazard to an art form, setting a price guarantee not only for government bonds but also backstopping corporate debt (It accumulated €2.6tn of assets, including nearly a quarter of member states' outstanding bonds). The result: the ECB balance sheet has hit level that can never be unwound without triggering a new crisis.

How did European assets perform during Mario's tenure?

1) The euro has weakened by 18.8% against the dollar since November 1st, 2011 which likely reflects the relative shifts in monetary policy and growth over the period.
2) The Stoxx 600 (c.121% local, 79% dollar adjusted) has lagged the top global performers namely the NASDAQ (+244%), Nikkei (198%) and S&P 500 (191%), even though his era succeeded in pushing it back to its all-time high.
3) Even though Bunds have seen yields collapse deep into negative territory, 10-years were already as low as 1.77% at the start of his reign so the 26% return (2% in dollar terms) is not actually that spectacular and is only slightly higher than Treasuries (19%).

What's concerning however, is the fact that the ECB is now out of tools. The deposit rate is at a record-low minus 0.5%, with a pledge to cut again if needed (although that's unlikely as Europe's reversal rate will likely be hit shortly) and won't rise until inflation "robustly" converges with the goal. QE will start next month with asset purchases of 20 billion euros ($22 billion) a month and won't end until "shortly" before the first future projected rate hike; a hike which if the Draghi regime is any indication, will never come.

In short, Draghi leaves Europe in a recession, the ECB without ammo, a wealth divide unlike any seen since the Great Depression, and his successor facing an unprecedented revolt across the ECB's governing counsel. But not to be too harsh on him, trying to prop up a perpetually ailing currency bloc, he did bring determination to calm market turmoil and succeeded in stabilizing Europe's economy and capital markets although it came at a huge cost.

"Whatever it takes", lets wish Mario a happy retirement!

Source: FT

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