Market Bulletin

7 March 2019

European Central Bank adds to dovish central bank chorus

Following a significant pivot from the U.S. Federal Reserve in recent months, today the European Central Bank (ECB) followed suit by providing ongoing liquidity support to the eurozone's banks. Key policy rates were also left unchanged, but it changed its forward guidance such that rates will remain at their current levels at least through the end of 2019 (previously announced as past summer 2019).

Given markets already expected rates to be on hold through this year, the more significant news is the extension of the liquidity the ECB provides to the banking system via its Targeted Longer-term Refinancing Operations (TLTRO). The TLTRO initiative was initially announced in 2014 and is an over EUR 700 billion programme to incentivise eurozone banks to lend to non-financial corporations and households, by lowering the banks' marginal funding costs. These loans, of which Italian and Spanish banks hold 60% of the total value, would have started maturing in June 2020, and so the announcement of a new two-year TLTRO initiative should help prevent liquidity conditions from tightening, particularly in the periphery. Whilst these loans may be aimed at encouraging lending to the private sector, the additional liquidity is also likely to support the government debt markets. One of the big beneficiaries of today's announcement has been the Italian government bond market.

EXHIBIT 1: European Central Bank staff macroeconomic projections for the euro area

	Real GDP (y/y)			HICP inflation (y/y)		
Meeting	**2019**	**2020**	**2021**	**2019**	**2020**	**2021**
Dec-18	1.7%	1.7%	1.5%	1.6%	1.7%	1.8%
Mar-19	1.1%	1.6%	1.5%	1.2%	1.5%	1.6%
Change	-0.6%	-0.1%	-	-0.4%	-0.2%	-0.2%

Source: European Central Bank, J.P. Morgan Asset Management. Data as of 7 March 2019.

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The downgrade in the ECB's economic forecasts prompted the additional stimulus. The ECB significantly downgraded its forecast for real GDP growth in 2019, from 1.7% y/y previously, to 1.1% y/y, and expects this growth slowdown to be more persistent than previously anticipated. Inflation was also downgraded and is now expected to be just 1.6% y/y at the end of the forecast horizon. This is a substantial ongoing undershoot of its target.

ECB President Mario Draghi reiterated that the risks to the growth outlook continue to be tilted to the downside. This is primarily due to external factors including the ongoing threat of protectionism, geopolitical risk surrounding Brexit, vulnerabilities in emerging markets and a slowdown in Chinese growth. While Draghi highlighted these risks, economic data paint a more resilient picture for domestic demand, in particular with regards to the consumer, falling unemployment and rising wages.

Whilst additional support—particularly on liquidity—was expected at some point this year, the market is welcoming this proactivity. In the immediate aftermath, the euro exchange rate is down, alongside European government bond yields—the Italian 10-year government bond yield is down to 2.5% after reaching almost 3.7% last year.

This stimulus should help stabilise sentiment and activity in the eurozone. But for a meaningful turnaround in Europe we look further afield to what's happening in Beijing. In our view a notable rebound in activity in China is required to see a significant reacceleration in Europe over the course of the year.