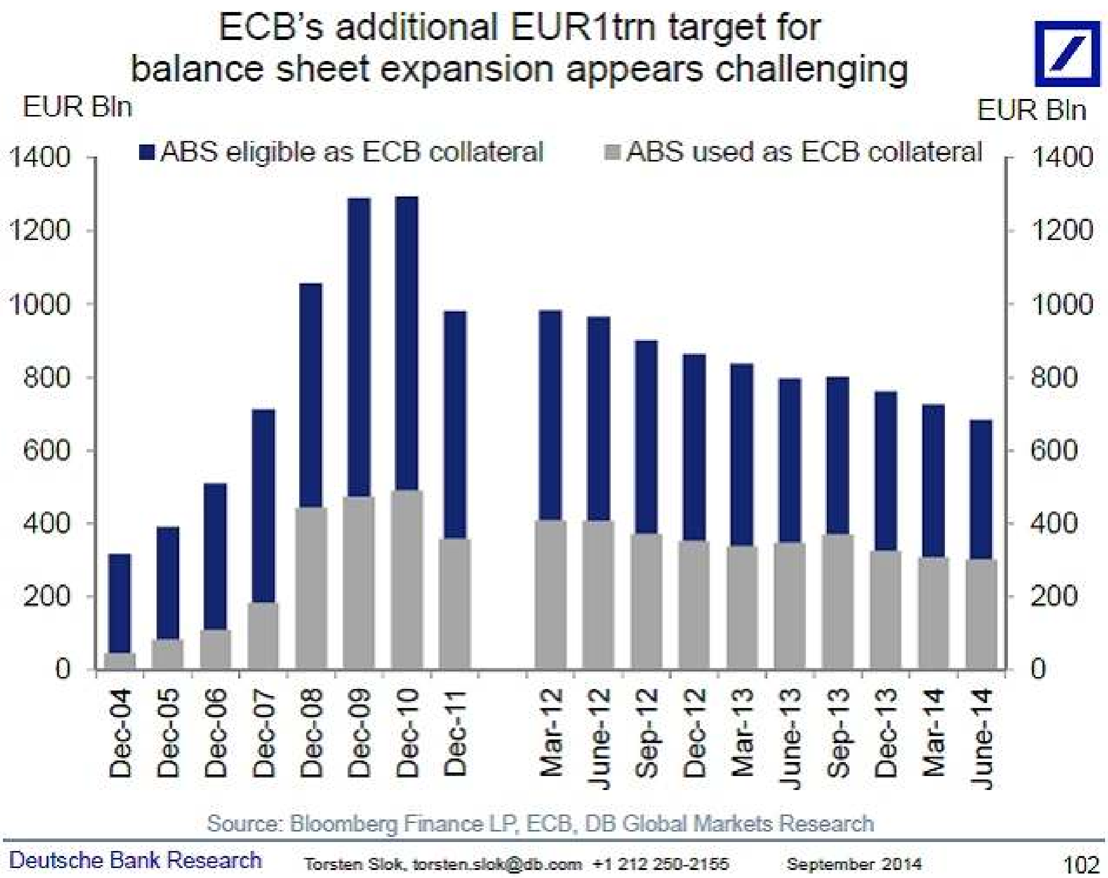
As we expected, the ECB announced private QE this week. The ECB plans to start purchasing ABS and covered bonds from October. The objective is to expand the ECB balance sheet to early 2012 levels, implying a Eur 1tr expansion. If achieved, the impact on the euro exchange rate could be enough to push inflation to the ECB target level in 2017, shortening the period of sub-target inflation. The question is whether a Eur 1tr net expansion of the ECB balance sheet is credible. In our view, the ECB would have to be aggressive to go significantly beyond half this number. ABS/CB purchases buys time, but Draghi was careful to maintain insurance. Public QE was discussed this month.

The final August PMIs saw a 1.2-point monthly decrease in the euro-area composite index to 52.5, adding to the recent disappointing data trend. The euro area GDP details showed investment and inventories were to blame for the stagnation in Q2, supporting the geopolitics confidence shock explanation. News of a ceasefire agreement in Eastern Ukraine is a tentative positive.

We have scaled back our German GDP forecast for 2014 from 1.8% to 1½%, as we now expect weaker growth in H2. This also reduces our forecast for 2015 from 2.0% to 1.8%. The risks that this still constitutes an overly optimistic forecast have increased significantly. The German investment cycle will likely be more subdued than expected due to the ongoing weakness of world trade and increasing geopolitical strains. Even the hitherto still robust private consumption is emitting its first warning signs.



EU countries share of global Foreign Direct Investment inflows has fallen from 50% in the early 2000s to less than 20%. FDI activity is very uneven across the euro area. In 2013, the largest inflows were recorded for Spain and Ireland, offering an important source of corporate funding when the flow of bank funding is constrained. While Germany and Italy experienced an increase in FDI inflows compared to 2012, they decreased strongly in France.

The question is if they can find enough ABS and covered bonds to buy, see also the chart below. The direct impact on economic activity of balance sheet expansion is very limited. Instead, the main transmission channel of monetary policy here is via a depreciation of the euro. Expect EUR/USD to continue to grind lower, this is good for European exports and for European inflation and hence also for the ECB.