

## THE WEEKLY VIEW



From right to left:

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## **ECB Commits to Fight Deflation**

Based on Eurozone stocks' rise and the fall in both the euro and Eurozone bond yields, the European Central Bank (ECB) exceeded market expectations with last week's announcement of the details of their highly anticipated quantitative easing (QE) program. In a nutshell, the ECB has agreed to buy €60 billion a month of private and public debt at least through September 2016 in a bid to prevent inflation falling further.

Perhaps most importantly, ECB Chairman Mario Draghi stated a willingness to keep the program going beyond that date if inflation targets were not being met, learning from the Federal Reserve that open-ended policies send a stronger message. It is now clear that Draghi has the support to use monetary tools to promote growth and fight deflation.

Regarding 'risk sharing' (national central banks assuming some responsibility for potential losses) the ECB announced that it will share up to 20% of any loss, a concession from the Germans and other nations that have resisted a QE program. In deference to this group, there is a cap on the percentage of any country's debt the central bank can own; thus, Greek debt will not be initially included in the purchase program and will depend on negotiations with the newly elected government in Greece (more below).

Following the ECB purchase announcements, the euro fell to an 11-year low of \$1.12 per euro and the S&P Europe 350 index broke out to a new high. With ECB QE just beginning and with the Federal Reserve likely to tighten monetary policy this year, expectations are increasing that the euro can fall further towards 'parity' (\$1 per euro). We agree and therefore continue to hedge almost all of the euro exposure in our portfolios. This has been critical for US investors, because the decline in the euro has offset the rise in local stock markets.

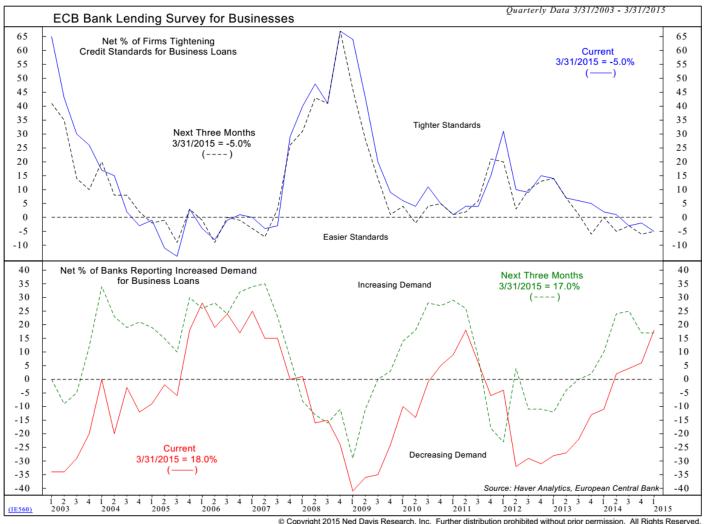
With the program now announced, the debate between bulls and bears turns to whether it will lead to increased share prices and help Europe break out of its current economic slump. ECB President Mario Draghi remarked last Thursday: "What monetary policy can do is create the basis for growth. But for growth to pick up, you need investment; for investment, you need confidence; and for confidence, you need structural reform." We agree. With all QE programs thus far, the initial beneficiaries have been investors (through higher prices) and borrowers both corporate and individual (through lower borrowing costs). When QE is combined with the cyclical benefits of a weaker currency and lower oil prices, we expect corporate earnings growth to accelerate, especially for multinational companies. Regarding 'investment and confidence,' we are encouraged to see the growing demand for lending and the increasing willingness of the banks to lend (see our Weekly Chart on page 2).

Structural reforms have proven difficult in certain parts of Europe. Following in Germany's structural reform footsteps, which began early last decade, we believe Ireland and Spain are on the path to raising their competitive profiles, and we are also starting to see some encouraging signs from Italy and France. The victory of the Greek left-wing Syriza party in Sunday's election means the beginning of a tense standoff with the 'troika' — the

European Union, the ECB, and the IMF (International Monetary Fund). Syriza campaigned on a pledge to re-negotiate the terms of the 2012 debt restructuring 'bail out.' The possibility of Greece exiting the Eurozone cannot be ruled out, but it is hard to handicap. Bond markets appear to have taken a provisional view of a possible exit; Greece's 10-year bond yield rose to more than 10% in early January from under 6% last September, but it has since moved back to above 8%. Syriza says they want to stay in the Eurozone, but would like to renegotiate with the troika to make structural reforms less punitive and more rehabilitative. As long as Greek bond yields remain high in isolation, Greece's bargaining position is weakened and thus its issues remain local. It was the reality of contagion that strengthened Greece's hand when the current debt plan was negotiated in 2012.

The bottom line for us is that while structural reforms will vary between countries, there is enough skepticism regarding a cyclical economic rebound that stock prices will continue to rise if it the data improves. Thus, we are encouraged by the survey below showing European banks willing to lend and loan demand increasing.

## THE WEEKLY CHART: LENDING DEMAND RISING



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