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Draghi's Last Dance: Where Does ECB Policy Go from Here?

After eight years at the helm of the European Central Bank (ECB), Mario Draghi ends his tenure as ECB President this month, concluding his final policy meeting and press conference earlier today. It is fair to say that he has faced significant challenges throughout his tenure at the central bank, during which he has fought to stave off a Eurozone breakup and the threat of deflation.

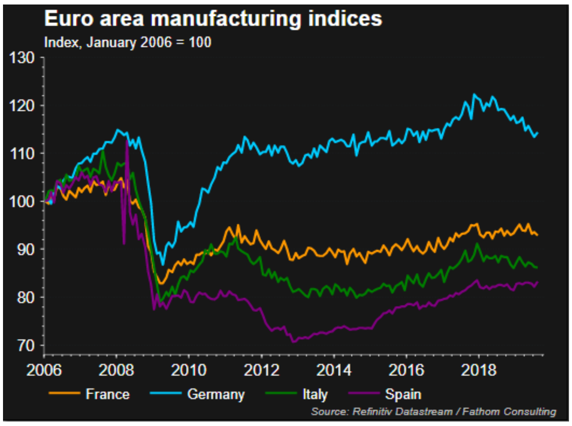
Draghi's final weeks are likely to be plagued with questions about the region's embattled economy. He leaves the ECB helm with his primary mandate of ensuring price stability unfulfilled, and the Governing Council split over strategy. His recent announcement of a comprehensive stimulus package for the Eurozone economy indicates that a rate hike is unlikely to come until late 2022, locking in the current policy stance until well into his replacement Christine Lagarde's term as the President of the ECB. Despite his departure, Mr Draghi will not escape inquiries on how much more mileage the central bank has ahead before it runs out of steam, as deteriorating economic data continues to stoke recessionary concerns in the region.

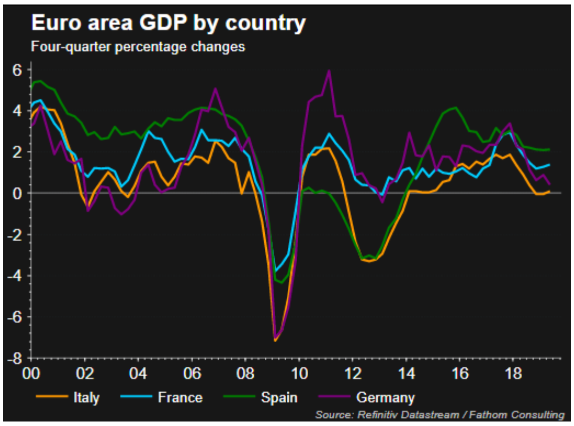
In today's meeting, Draghi reiterated recent calls for fiscal policy to play a larger role in attempting to stimulate ailing economies. As he is now departing from office, he could have chosen to single out countries which need to act, but instead kept his calls for fiscal stimulus and economic reforms more general. After announcing a large stimulus package in his previous meeting, no further details on monetary policy were expected, with the meeting largely symbolising the end of Draghi's tenure.

Stimulating the EU Economy

Despite unprecedented amounts of monetary stimulus, Draghi has been ineffective in managing the inflation rate, falling well short of the goal of close to 2%. The rate was 0.8% in September, the lowest in almost three years. As a result, officials have pledged to pursue low interest rates and asset purchases until price growth is in line with the target, which is not expected until after 2021, dominating policy 2 years into Christine Lagarde's term. Given recent economic weakness which has been exacerbated by slowing global growth and ongoing trade uncertainty, investors are trying to ascertain whether further cuts will be required further down the line, and how long the bank can run its quantitative easing programme before hitting limits on how much debt and the type of debt it can buy. This is likely to be one of Lagarde's key challenges during her term as President, as any move to raise limits would almost certainly provoke another split in the Council. Current estimates suggest that the programme could run for 18 months before nearing current limits.

Recent data suggests that the Eurozone economy is slowing faster than first anticipated amid global trade tensions, with consumer confidence is at its weakest this year, while PMI data indicates that the economy remained close to stagnation at the beginning of the fourth quarter.





It is expected that growth forecasts will be downgraded further for the bloc in December, as data suggests that the region's manufacturing recession may be spreading to the services sector, however given last month's announcement of the stimulus package which divided the council, there is little appetite to add further stimulus before the end of the year. The minutes from the last meeting showed that a third of the council opposed restarting QE, while members also were reluctant to cut the interest rate further below zero. It is likely that Lagarde will now spend her first few meetings in her new role as ECB President trying to restore harmony among the council after Draghi's forceful push for stimulus resulted in the dissent of key members.

Lagarde Takes Control

It is the ECB's view that the interest rate cut and quantitative easing pushed through by Draghi in his penultimate council meeting will be enough to see the Eurozone through its slowdown unless it's hit by shocks such as escalating trade tensions or a no-deal Brexit, therefore Lagarde is not expected to make significant changes to the current policy early in her term. She is expected to be pressured to review the ECB's strategy for achieving price stability, reviewing issues such as inflation targeting following suggestions that the 2% target may now be outdated. Additionally, she is expected to continue Draghi's push for country-specific fiscal stimulus. It is key to remember that within the bloc, economic conditions vary by country, therefore fiscal stimulus allows governments to combat country-specific issues in order to boost growth. At the same time, it can also be argued that the Eurozone's issues have been brought about by external factors such as slowing external demand and trade uncertainty, therefore fiscal stimulus may prove to be ineffective in stimulating growth while the external issues persist.

What next from here?

Changes to the ECB's forward guidance are anticipated in 2021, however a deterioration of the economic outlook could force policy makers' hands sooner. As it stands, Christine Lagarde starts on 1st November with the deposit rate at a record low -0.5%, with QE re-starting with asset purchases of 20 billion Euros.

Positioning

Based on the economic data and stimulus expectations for the Eurozone, it remains our view that the risks are significant, and while European equities are not that expensive relative to historical price levels (indicating that they may not have as much to fall as US and UK equities), we continue to see weakness ahead for European equities as the data deteriorates further, with the manufacturing weakness now feeding into services and corporate earnings across the bloc. According to Markit data, Europe's downturn is showing no signs of ending, with forward looking indicators remaining worryingly subdued, and the recent stimulus is unlikely to have an impact in the near term as external drags remain. As a result, we maintain the current long/short European exposure within the portfolios which seeks to benefit from a more defensive shift in equity exposure and an eventual decline in the indices, with the data continuing to reinforce our negative outlook on European equities.