

# OCM Asset Management

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## **Market Update: 27<sup>th</sup> November 2019**

### **Does the ECB have enough left in the tank to support an ailing Eurozone economy?**

In her first major speech as the President of the European Central Bank (ECB) earlier this week, Christine Lagarde highlighted the need for a new policy mix, calling on governments to step up public spending to ease the burden on monetary stimulus and ensure that the region can thrive in an uncertain world. Lagarde insisted that the ECB will continue to support the Eurozone economy via continued monetary stimulus in line with the package announced in September, but also argued that fiscal policy is a key element for overcoming the challenges of changing global trade and declining domestic growth. She called on Eurozone governments to think big to overcome self-doubt and instead show strength and resolve.

Lagarde's calls for government action came alongside fresh economic data which showed the Eurozone slowdown worsening as a result of external and domestic challenges. Purchasing Managers Indexes showed the economy weakening in November, with a downturn in services activity. This suggests that the manufacturing decline which is most pronounced in Germany is spreading to other sectors. Despite signs of improvement in the data in France and Germany, IHS Markit's composite Purchasing Managers' Index fell to 50.3 in November, missing all estimates. Orders declined for a third straight month, employment growth slipped to the lowest in almost five years, and price pressures cooled, raising concerns that the rest of the region has slipped into decline for the first time since 2013.

### ***Calls for fiscal stimulus***

At her first policy meeting on 12<sup>th</sup> December, Lagarde is expected to address the continued decline in the data, while providing some clarity on the ECB's thinking on current risks such as low inflation and below-potential growth. So far, her predecessor Mario Draghi has already set a course for her tenure at the helm of the ECB, with a commitment to a QE programme and negative interest rates until 2021, so she is unlikely to make waves in her first meeting, but instead is likely to reinforce the message that governments must do more to support domestic economies.

The ECB is not alone in its calls for European Governments to increase investment, with the European Investment Bank (EIB) urging governments to invest to nurture competitiveness and shore up economic expansion. In its annual investment report, the EU lender highlighted glaring gaps across the Eurozone- from infrastructure and climate change to workers' skills- which are restraining growth. It also warned that a number of companies are planning to cut spending, urging governments to respond quickly to unlock stronger domestic demand.

Earlier this week, Goldman Sachs also suggested that Germany and China in particular should embrace large fiscal expansions, before noting that this appears unlikely to happen. In its "Top of Mind" report, Goldman evaluates the effectiveness of monetary policy tools which are nearly exhausted in major economies, and highlights that low interest rates increase the room to use fiscal stimulus, with the

ability for governments to front-load the investment via increased borrowing. The OECD warned this month that unless governments revolutionise policies and how they invest, the global economy will remain stuck in a rut.

While most economies are not currently considering fiscal stimulus measures, the argument against increasing fiscal stimulus and debt requires a long term perspective. Interest rates may be low now, however they won't be low forever, and when they rise again, the cost of debt will increase.

### ***A reliance on Monetary policy***

After years of unprecedented stimulus, fears are growing over consequences of exhaustive monetary policy such as rising real estate prices and excessive risk-taking by investors in search of higher yields. Policy makers around the world have recently been raising cautionary flags at potentially unsafe investing stoked by their efforts to flood economies with ultra-cheap money. Stock markets from the US to India are at record highs while the fundamentals have been declining sharply, and low sovereign bond yields have pushed funds into property seeking better returns. The ECB noted its concerns over the promotion of risky investor behaviour in its Financial Stability Review this week, with Lagarde noting that the ECB will "continuously monitor the side effects" of its policies.

After the committee divided on the comprehensive stimulus package pushed through by Mario Draghi in his final weeks as President, Lagarde has already started building bridges, taking the 25-member Governing Council on a retreat earlier this month to discuss their decision-making processes and communication. She is also expected to announce a strategy review, appeasing members such as the Bundesbank President Jens Weidmann, one of the most vocal opponents of the recent package and critic of QE.

### ***Our outlook***

As it stands, the outlook remains gloomy for the Eurozone, with lower growth expectations based on heightened uncertainty over key issues such as Brexit and ongoing trade wars. After policy makers stepped up monetary stimulus in September, they've increased their calls on governments to act, with monetary policy stimulus unlikely to provide sufficient stimulus to boost the Eurozone economy out of its current rut. Until certainty is provided over external issues, it's tough to see the Eurozone rebounding in the coming months, particularly given the exhaustion of monetary policy tools, therefore we maintain a very low exposure to European assets. Should we gain greater certainty over these issues, or should the respective Eurozone economies answer Lagarde's call for fiscal stimulus, we would consider adding domestically focussed small and mid caps, which are best placed to benefit.

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