Causeway Insights:
European Central Bank Stimulus Program
January 22, 2015

Adhering to its goal of near 2% inflation in the Eurozone, the European Central Bank (ECB) announced its monetary stimulus package today. By purchasing €60 billion of Eurozone government, agency, asset backed and covered bonds (of maturities ranging from 2-30 years) each month from March 2015 to at least September 2016, the ECB's "Quantitative Easing" (QE) program should create approximately €1 trillion of liquidity. That is about twice the amount expected by the consensus of economists polled by Bloomberg in the weeks leading to today's ECB announcement. While the scale of the bond purchases appears modest relative to similar QE programs in the US, Japan, and the UK, the ECB showed its commitment to price stability, with the useful byproduct of a weaker euro. From its peak in April 2011 to present, the euro has declined 23% versus the US dollar. In the past twelve months, the euro has declined 17% versus the US dollar. This devaluation of the euro should help to spur economic growth and offset some of the region's deflationary pressure.

The recent plunge in oil and gas prices may have precipitated the ECB's actions, as this price decline adds urgency to the bank's objective of price stability. With deflation encroaching on various Eurozone countries, the ECB's efforts to lower interest rates are negated by a rise in real bond yields. With core inflation (which excludes food and energy) at only 0.7% year-over-year in December 2014, and an unemployment rate of 11.5%, the Eurozone needs a significant QE program plus a package of substantial labor, market and regulatory reforms and economic incentives to spur business investment. The ECB remains hopeful that its QE program will improve lending activity between financial services companies and households/businesses. However, bank risk aversion remains elevated, credit demand is weak, and falling sovereign bond yields signal economic stagnation. The threat of a Greek exit from the Eurozone and more conflict in the Ukraine adds to risk aversion. Positives for the Eurozone include looser credit in Spain and France, as business demand for lending is climbing slowly, as well as a modest upturn in consumer demand for credit and mortgages.

Monetary liquidity should support equity prices, as investors search for investment income and find dividend yields to be competitive with ever lower bond yields. We expect the flattening yield curve in Europe to crimp net interest margins for banks, making lending and asset purchases barely profitable. However, as we expected, banks have shifted resources to the development of the European capital markets, with an emphasis on the issuance and trading of corporate bonds. And unlike the Japanese banks at the onset of their country's QE program, the European banks already trade near tangible book value, making their valuations attractive, and are further along in the recognition of credit losses. The euro devaluation has an especially beneficial impact on the European exporters who will experience a further boost to earnings though enhanced competiveness and translation gains. Lastly, we expect the Eurozone to be one of the main beneficiaries of lower oil prices, and that – if sustained for two years – should add 1.5 percentage points to the region's gross domestic product, according to the International Monetary Fund.

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