

Capital Markets Memorandum

Capital Markets and Asset Allocation insights from Frontier Advisors

European Central Bank (ECB) policy update and portfolio strategy implications

January 2015



European Central Bank Announcement

1 The announcement, its rationale and details

Overnight, ECB president Mario Draghi announced the European Union's version of quantitative easing (QE). Described as an "expanded asset purchase programme", the operation will:

- Expand the ECB's current (private sector) asset purchasing program to include sovereign bonds issued by euro area central governments, agencies and European institutions
- Combined monthly asset purchases will amount to €60 billion (in public and private asset purchases), and are intended to be carried out until at least September 2016

1.1 Why has the ECB done this?

To combat the risks of prolonged low inflation

In explaining the rationale for the expanded program, the ECB said that the programme is designed to fulfil the ECB's price stability mandate which, in the current environment, suggests that the program is designed to raise inflation expectations from their current very low level. A key aim was the ECB's desire to address "the risks of a too prolonged period of low inflation".

The ECB noted that the decision was taken "in a situation in which most indicators of actual and expected inflation in the euro area had drifted towards their historical lows. As potential second-round effects on wage and price-setting threatened to adversely affect medium-term price developments, this situation required a forceful monetary policy response". The timing of the program's finish is open-ended, with inflation being a key determinant of its duration – until the ECB sees "a sustained adjustment in the path of inflation that is consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term".

To assist in supporting investment and consumption

According to the ECB, "asset purchases provide monetary stimulus to the economy in a context where key ECB interest rates are at their lower bound. They further ease monetary and financial conditions, making access to finance cheaper for firms and households. This tends to support investment and consumption, and ultimately contributes to a return of inflation rates towards 2%".

1.2 Details of the program

The programme will encompass the asset-backed securities purchase programme (ABSPP) and the covered bond purchase programme (CBPP3), which were both launched by the ECB late last year.

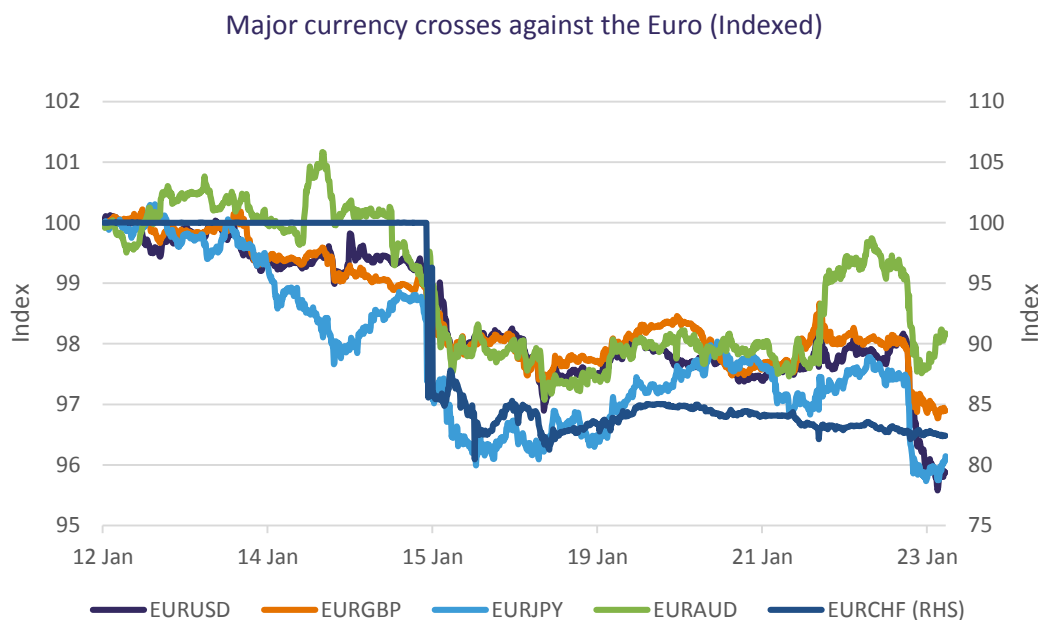
The ECB will buy bonds issued by euro area central governments, agencies and European institutions in the secondary market using central bank money, which the institutions that sold the securities can use to buy other assets and extend credit to the real economy.

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2 Market reaction

2.1 Currency markets

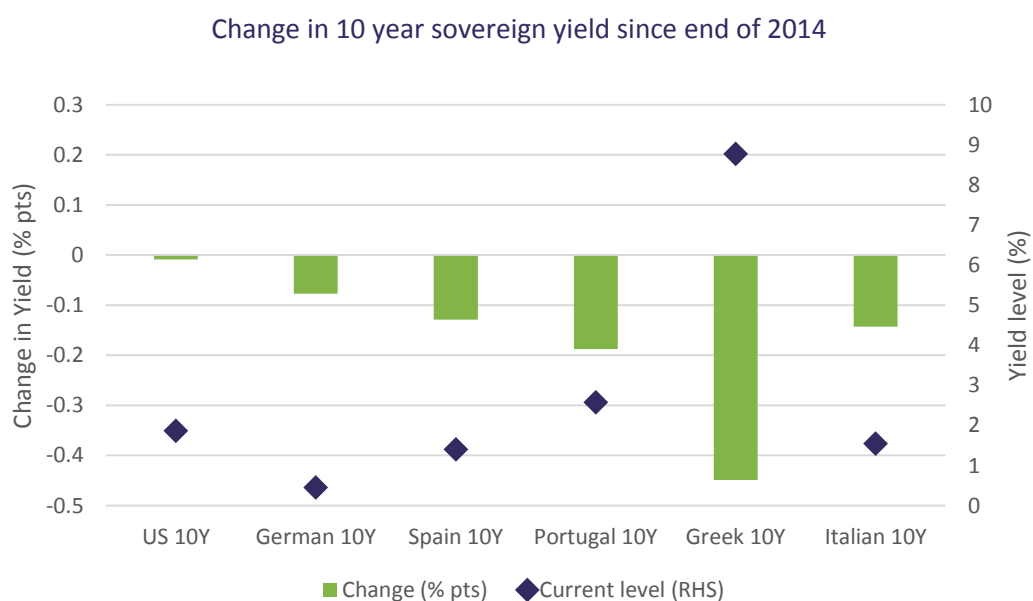
The Euro has weakened further in overnight trading.



Source: Bloomberg, Frontier

2.2 Bond markets

The largest reactions to the ECB policy announcement have been witnessed in peripheral European sovereign bond markets – Greece and Portugal – but all European bonds have rallied overnight. US yields, in contrast, were little changed in overnight trade.



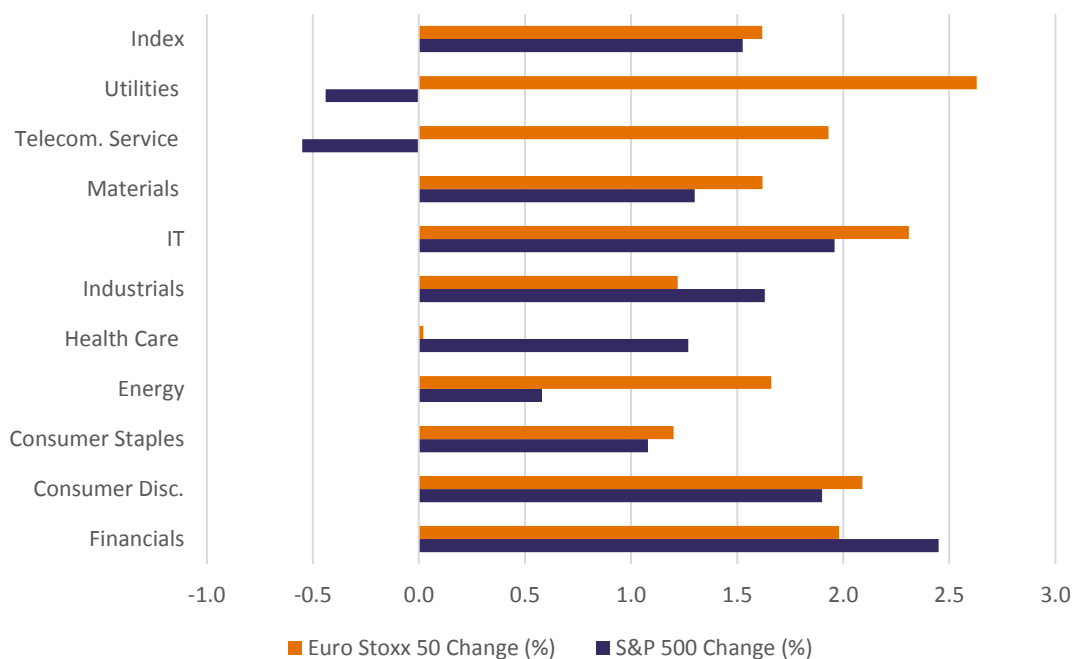
Source: Bloomberg, Frontier

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2.3 Equity markets

All key equity markets have rallied overnight, with strongest performances occurring in peripheral European markets – Italy and Spain. Sector performances in most markets have generally seen defensive sectors such as consumer staples and healthcare perform least positively. But, interestingly, the key cyclical sectors such as materials and industrials have not performed best.

US and European equity and equity sector performance overnight

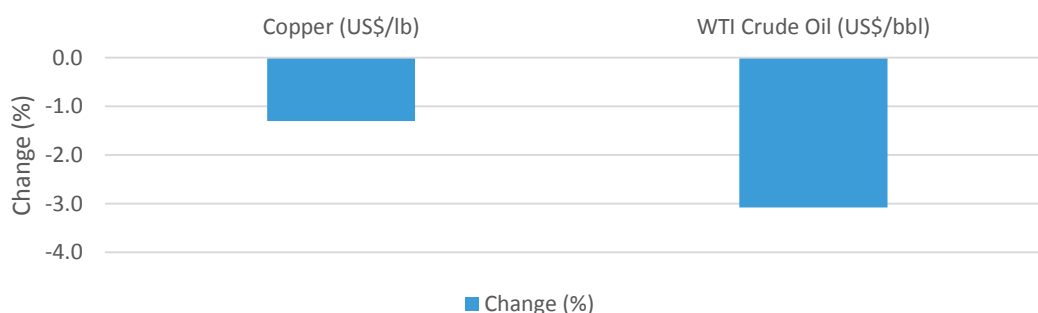


Source: Bloomberg, Frontier

2.4 Commodities

This lack of clear outperformance by cyclical equity sectors is not inconsistent with the poor performance of commodities overnight. Although partly due to the stronger dollar, growth-sensitive commodities such as copper and oil have recorded falls in US markets overnight.

Overnight Performance in Commodities Prices



Source: Bloomberg, Frontier

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3 Strategy Implications

The ECB's announcement overnight is consistent with the ongoing trend of policy makers pursuing policy prescriptions designed to support growth (and growth asset markets).

The similarity in the programs being run by most key developed market central banks, and their underlying aim to boost growth expectations, has been a strong driver of equity market performance. While these developed market economy central banks maintain their clear preference and aim to boost economic growth prospects, it is likely that a supportive environment for growth assets will continue.

Report prepared by:

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