January 20 2015

TAKING A PAGE FROM THE FED

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KEY TAKEAWAYS

The ECB is widely expected to announce a Fed-style outright government bond purchase program this week.

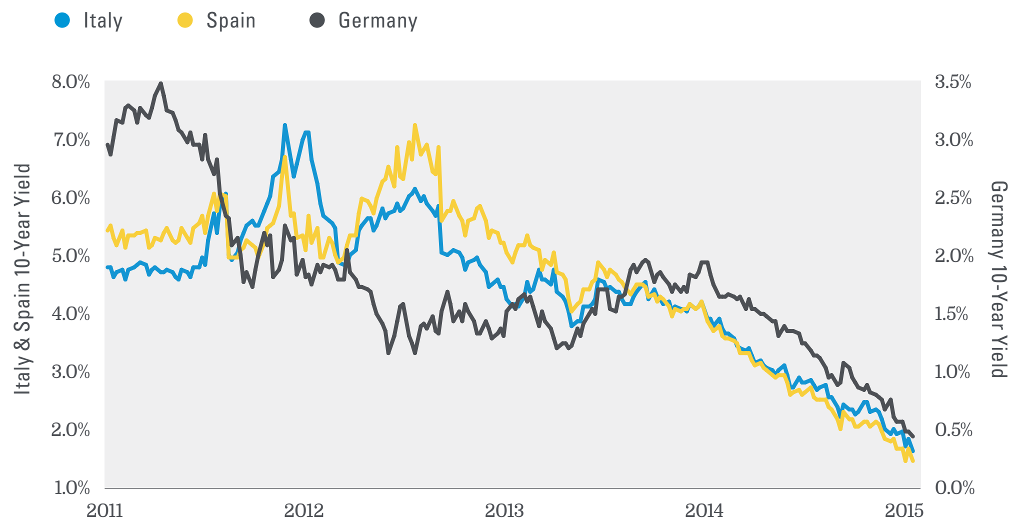
A large and bold plan may arrest the rise in global government bond prices, but anything else may reinforce the record low-yield environment.

The European Central Bank (ECB) is expected to take a page from the Federal Reserve (Fed) on Thursday, January 22, announcing its first outright government bond purchases, known as quantitative easing (QE). Hints and suggestions of QE coming from a reluctant ECB, which appears to have exhausted all other measures, have been heard for months, culminating in more specific comments from ECB President Mario Draghi over the last several weeks and in the final months of 2014.

Although the ECB is currently purchasing bonds (asset-backed and covered bonds) and has enacted bank lending programs and other forms of stimulus in recent years, Thursday's announcement is expected to include details of the ECB's first foray into outright government bond purchases.

The ECB has purchased government bonds in the past, including Portuguese, Italian, and Spanish government debt, to help support these weaker bond markets during the height of the European debt problem. However, such purchases were offset by lending operations (in the form of interest-bearing deposits) to European banks from the ECB. The ECB's balance sheet did not expand in response to these purchases, in contrast with the Fed, which started

1 ECB QE EXPECTATIONS HAVE AIDED THE RALLY IN EUROPEAN GOVERNMENT BONDS



Source: LPL Financial Research, Bloomberg 01/20/15

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outright purchases in late 2008. Operation Twist, where short-term bonds were sold to facilitate the purchase of long-term bonds, was the only Fed purchase program with similar offsetting measures.

MAKE-OR-BREAK MOMENT

Expectations of QE from the ECB have aided the rally in European government bonds [Figure 1]. Economic slowdown and the threat of another recession, along with the onset of deflation, have also helped boost European government bond prices. But forward-looking financial markets will now turn their attention to the potential impact of possible ECB bond purchases.

Although ECB QE is viewed as almost a foregone conclusion, high uncertainty remains around the details of any bond purchase program. The overall dollar amount, bonds subject to purchase, and mechanics of bond purchases remain big question marks. A purchase program of €500 billion may be viewed as too timid and disappoint financial markets. Bond prices may be little changed in response to such a program, as investors may view it as unlikely to stimulate the Eurozone economy out of its current funk or reverse initial readings of deflation.

Conversely, a purchase program of €1 trillion or more may be viewed as robust and may even spark lower bond prices and higher yields. Bond yields moved higher following the Fed's first two rounds of QE [Figure 2]. Bond investors viewed the Fed's actions as a positive for economic growth and a potential catalyst for inflation. However, the reaction was more muted in each successive case of QE, and QE3 did not witness a rise in interest rates—other than a limited increase following QE3's expansion in December 2012. It was not until the taper tantrum of mid-2013 that yields ultimately moved higher, accompanied by better economic data from Europe.

In the United States, the size and impact of QE diminished over time. A total of $1.3 trillion in QE1 amounted to 9% of U.S. economic output (as measured by gross domestic product [GDP])

2 A BOLD PLAN FROM THE ECB IS LIKELY NEEDED TO GENERATE A RESPONSE SIMILAR TO WHAT FOLLOWED THE FED'S QE1 AND QE2

Source: LPL Financial Research, Bloomberg 01/20/15

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in early 2009. The $600 billion in QE2 bond purchases totaled less than 4% of GDP. QE3 ultimately totaled more than QE2, relative to GDP, but the open-ended nature of purchases meant the ultimate amount was unknown initially.

A €1 trillion ECB purchase plan, if announced, would amount to roughly 7% of Eurozone GDP, while a €500 billion would be half of that and come closer to resembling the Fed's QE2. As a whole, the Eurozone economy is slightly larger than that of the United States. The ECB will likely need to announce a larger amount for its purchase plan if it hopes to move markets in a similar fashion as the Fed did.

U.S. bond markets will potentially key off events in Europe this week. Inflation data released Friday, January 16, 2015, were weaker than expected and implied interest rates remaining lower for longer. Timing of the Fed's first expected interest rate hike was pushed back from September 2015 to November 2015, according to Fed fund futures pricing. However, futures pricing shows the bond market remains very pessimistic, with an implied overnight lending rate of 2.3% in five years' time, a much lower rate than the Fed has suggested. The slow growth/very low inflation view has been extrapolated well into the future by the bond market. In our view, this pricing is too pessimistic, and this week's ECB meeting may reinforce or question such expectations. ■

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INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

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