



Weekly Insight

Banks are pivotal to Europe's growth prospects

In many ways, the European Central Bank (ECB) more than delivered on its latest stimulus package. The deposit rate was cut by ten basis points and the main refinancing and marginal lending facility rates were each reduced by five basis points. These reductions were within the market's expectations, but the ECB positively surprised with a larger than expected expansion of the asset purchase programme from €60 billion to €80 billion per month.

Significantly, asset purchases will now include non-financial investment grade corporate bonds, signalling that the ECB is willing and able to widen the range of its purchases to include private-sector assets. Longer term, this shift could pave the way for other non-government or unsecured risk purchases, allowing more room to expand the asset purchase programme if needed.

Will the latest ECB measures stimulate growth?

Central banks around the world have been buying assets, reducing interest rates and flattening yield curves (i.e. lowering longer-term interest rates) to stimulate economic activity and push inflation higher. And yet despite these herculean efforts, ECB staff projections barely expect to see positive inflation this year. Forecasts were revised lower to 0.1% year-on-year from 1.0%. Annual GDP growth has also been downwardly revised for this year and in 2017.

Banks are the transmission mechanism through which ECB policy can impact the real economy. Europe needs a banking system that functions. Notwithstanding the improvements in European banks' balance sheets in recent years, the flow of credit into the real economy continues to be the bottle neck in the euro-area. While the credit cycle turned positive in April 2015 after a three-year period of contraction, bank lending to the private sector remains at relatively anaemic levels. Moreover, as the ECB pushes further into negative interest rate territory, concerns are building around banks' profitability and the negative impact

this would have on the cost of lending to households and corporates.

In our view, the ECB's decision to launch a new series of targeted longer-term refinancing operations (TLTRO II) goes some way to ease concerns. Starting in June of this year, the programme will have four tranches and provides low cost financing to banks of four years' maturity at a fixed rate of currently zero percent. This is meaningful because banks can potentially lock in zero percent financing into the next decade (i.e. until March 2021), providing ample stimulus to the economy.

Incentivising banks to lend

A second important feature of this programme is that banks are incentivised to lend. TLTRO II has been designed so that if banks' net lending surpasses a set ECB benchmark, the interest rate applied can be set as low as the deposit rate, which is currently minus 0.40 percent. In other words, the ECB could effectively be paying the banks to borrow, as a way to offset the damaging impact on their net interest margins when lending into the real economy.

Currency and bond markets were disappointed in their initial reaction to the ECB's announcement. Of course, investors are worried more generally about global central bank efficacy, and whether policymakers have enough ammunition to support growth and fight deflationary headwinds. If TLTRO II is taken up, we believe these measures will help the flow of credit within the euro-area, while not inadvertently increasing costs for borrowers. As financial markets digest the longer-term effects of these measures, we expect European assets will find support, including equities and investment-grade corporate bonds.

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Risk Warnings:

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