# ECOWEEK

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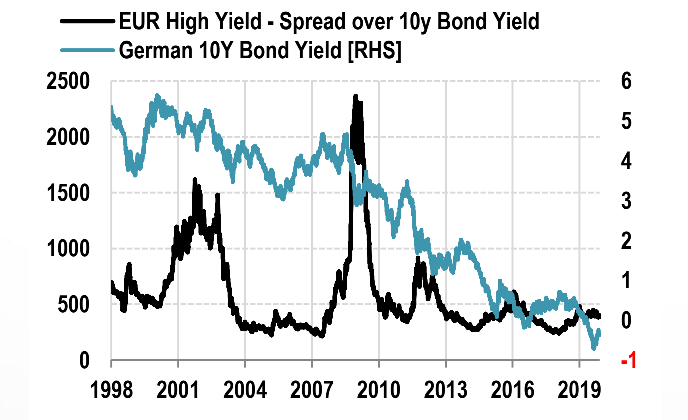
# Eurozone: QE and market instability risks

**■ The ECB's monetary policy meeting account illustrates the dilemma it is facing: inflation is subdued and risks to growth are tilted to the downside, yet the financial stability implications of the very accommodative policy need to be closely monitored ■ These implications are covered in sobering detail in the ECB's Financial Stability Review ■ A possible side effect of very low to negative interest rates is that borrowing and spending become more procyclical ■ Quantitative easing (QE), by modifying the risk structure of investment portfolios (less government bonds and more exposure to assets with a higher risk), will probably increase the sensitivity of portfolio returns to the business cycle.**

Many people would probably enjoy having a glass of wine (or beer) in the evening now and then. Two glasses may make them feel even cheerier. Having too much of a good thing, however, causes a hangover the following morning. There are similarities with a prolonged period of very accommodative monetary policy. First, there is joy about the boost to growth and ensuing job creation. Then, concerns mount about the side effects, a euphemism for the unintended consequences.

As a coincidence, last week saw quite some communication on this topic. Bundesbank President Jens Weidmann, speaking at a conference in Frankfurt, neatly summarised the issue: "*Beyond its impact on bank profitability, a prolonged period of low interest rates may also induce investors in search of yield to take on undue risks that could sow the seeds of financial imbalances. Eventually, this could undercut the central bank's ability to maintain price stability.*" A similar point was made in the ECB monetary policy meeting account: "*It was noted, however, that the financial stability implications needed to be monitored closely as declining bank lending rates could squeeze banks' margins beyond adequate risk coverage. Moreover, the point was made that more attention needed to be paid to the non-bank financial sectors, where looser market-based financing conditions and the search for yield also posed risks*." Nevertheless, "*there was broad agreement that monetary policy had to remain highly accommodative for an extended period of time in the face of a protracted weakness in the economy and subdued inflation developments*." It illustrates to what extent the ECB is between a rock (risk of unanchoring of inflation expectations) and a hard place (risks to financial stability).

EUROZONE: CORPORATE BOND SPREAD AND GERMAN BOND YIELD




Source: Datastream, Bank of America Merrill Lynch, BNP Paribas

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Concerning the latter, the latest ECB's Financial Stability Review, also published last week, makes for sobering reading. Focussing on the specific area of financial markets, the Review offers a long list of attention points[1]. These can be summarised into one sentence: a prolonged period of very expansionary monetary policy increases the procyclicality of the economy because investors are pushed into taking more risk when chasing returns whereas debt issuers are seizing the opportunity of declining borrowing costs to increase leverage and return on equity, which in turn supports equity valuations. A subdued inflation outlook means that these mutually reinforcing dynamics will not come to an end because of increases in official interest rates but rather by worries about the earnings growth outlook.

Investment portfolios are also subject to procyclicality as a consequence of quantitative easing. Remember that an intermediate objective of this policy is to lower government bond yields by driving down the term premium. As an example, when the ECB buys bonds from an insurance company, the duration of the latter's assets drops. This is called 'duration extraction'. It implies that a source of return (the extra yield over and above the short term interest rate) has gone. This obviously forces the insurer to increase exposure to other sources of risk. In doing so, it seeks to maintain the expected return of its portfolio. This is called the 'portfolio rebalancing channel', which is another key transmission mechanism of QE. Examples of other sources of risk are credit risk (by investing in corporate bonds) or equity risk[2]. At first glance, it looks as if credit or equity risks are simple substitutes for duration risk. However, they behave very differently depending on the phase of the business cycle. When growth is accelerating and expectations of monetary policy tightening are increasing, government bonds suffer far more than corporate bonds (the corporate bond spread narrows) whereas equities thrive due to an improved outlook for corporate earnings. At present, we should however be more interested in what would happen should growth severely slow down. In that case, government bond yields decline and government bond prices rise significantly, but asset owners who have sold part of their holdings to the ECB benefit less than before. On the other hand, they suffer more than before from the decline in corporate bonds (due to spread widening) and equity prices considering the purchases they had made after having sold their government bonds to the ECB.

To conclude, duration extraction, which results from central bank asset purchases, causes a substitution of duration risk with other sources of risk. Investment portfolios become less diversified, due to reduced exposure to government bonds, and the procyclicality of portfolio returns increases. In case of a severe growth slowdown, this implies increased downside risk, which investors may seek to pre-empt by reducing positions in risky assets, thereby accelerating their decline.

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[1] Source: ECB, Financial Stability Review, November 2019. Some quotes: *"markets currently assess the risk of a sudden increase in interest rates as being remote. At the same time, pricing in riskier financial market segments (e.g. equities) is increasingly based on expectations of low future benchmark rates, with a limited perceived risk of upward surprises", "Equity and corporate bond prices continued to appreciate, despite short-lived fluctuations in response to uncertainty surrounding trade tariffs.", "the strong performance of equities, corporate bonds and lower-rated sovereign bonds this year has so far surpassed measures of expected earnings growth or business sentiment", "model estimates suggest economic developments in the year to date have only had a limited impact on riskier asset prices. Indeed, the risk of an imminent recession in the euro area implied by financial market variables continued to increase over the summer", "Low or negative interest rates are expected to lead to search-for-yield behaviour and higher riskier asset prices, as investors seek a higher return from assets with lower credit quality and longer maturities", "the persistence of a low yield environment can lead to some valuations becoming misaligned, and therefore being at risk of abrupt correction in the future", "valuations of riskier assets are consistent with, but highly dependent on, the historically low level of the benchmark yield curve.", "Low funding costs incentivise higher levels of corporate leverage, which might amplify market corrections in a severe economic downturn", "high levels of corporate leverage may prove unsustainable if the earnings outlook deteriorates in a more protracted manner", "With increasingly limited scope for euro area benchmark rates to decline to the extent seen over recent years, equity and credit valuations are becoming more sensitive to deteriorations in the macroeconomic outlook or in investor risk appetite."*

[2] The ECB Financial Stability Review reports that *"insurers' holdings of high-yield and BBB securities account for 3% and 37% of their total bond holdings, compared with 4% and 27% at the end of 2013."*