BERMAN CAPITAL ADVISORS

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QE in Europe: Implications for Investors

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What Happened?

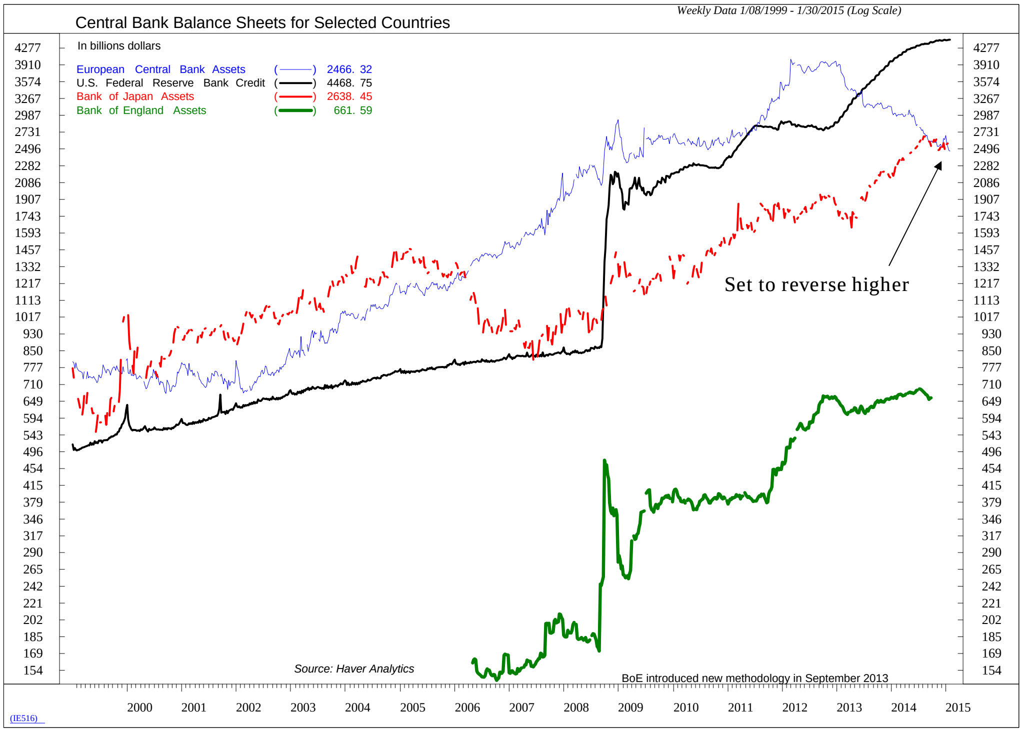
In late January, the ECB (European Central Bank) committed to purchase €60B per month of bonds. This program of bond buying is known as "quantitative easing," or QE for short. With this program, the ECB is joining the Bank of Japan, England and our own Federal Reserve with a more aggressive step to fight deflation in Europe. The ECB will be purchasing the government debt of member states, as well as the debt of European agencies and institutions. The program will continue until at least September 2016, meaning at least a €1 trillion Euro expansion of the central bank's balance sheet. Crucially, the ECB is committed to continue until the "path of inflation rates" shows evidence of meeting the 2% long term inflation goal.

How does QE Work?

The basic idea of QE is to lower interest rates and push investors (banks, institutions and individuals) out of government bonds in the hopes they will use the money in some other way, which in turn should stimulate the economy and underpin confidence. QE theoretically operates through the following channels:

- Directly boosts the prices of bonds and lowers yields (interest rates) to reduce financing costs and spur borrowing.
- Increases liquidity by forcing cash into the economy. The hope is some will be lent out or invested in the economy.
- Some investors will replace government bonds they sold to the ECB with riskier securities, supporting financial asset prices.
- QE adds downward pressure on the Euro exchange rate, stimulating exports and in turn GDP growth.
- As QE boosts investors' investments, it should spur incremental spending through the "wealth effect."

Size of Central Bank Balance Sheets



Why is this Important?

Pressure has been building on the ECB to take action as evidence of deflation, or falling prices, mounts in the Eurozone. Investors fear that a similar deflationary “trap” has occurred in Japan could happen in Europe, as well. Once consumers expect prices to fall further, it creates an incentive to hold off on spending, which in turn weakens the economy, perpetuating the downward price spiral.

For much of the last five years, Europe has been beset by political disagreements and insufficient policies to tackle the crisis. In other words, there has been a lot of “muddling through” in the European policy response. However, when push has come to shove, the ECB has intervened with extraordinary measures, including ECB head Mario Draghi’s famous 2011 pledge to do whatever it takes to keep the Euro intact. The ECB’s action demonstrates a renewed commitment to defend the Euro currency.

The announcement was hailed by the markets, as it was above expectations in some important regards. In our opinion, it is an aggressive program that should affect the financial markets positively, as it did in the U.S. Crucially, the ECB pledged to continue on until the path of inflation rates approaches the 2% long term inflation goal. With this commitment, the ECB is essentially making the program open-ended.

A problem with QE 1 and 2 in the U.S. was that they had either set dates (QE 1) or pre-announced amounts (QE 2). This lead to questions about the Fed's resolve, and created fears of what would happen afterward. Only after a third round of QE accompanied by a clear improvement in the U.S. economy was the Fed able to back off. The ECB's formulation avoids this problem.

The program also has an important psychological effect that could alter expectations: the ECB is indicating it will not allow the Euro to come apart. European QE should boost the credibility of the ECB (or at least induce more fear in short sellers). Since QE "worked" in the U.S., investors may begin to expect risk-taking in European financial assets will work as well, which could restore short term momentum to European markets.

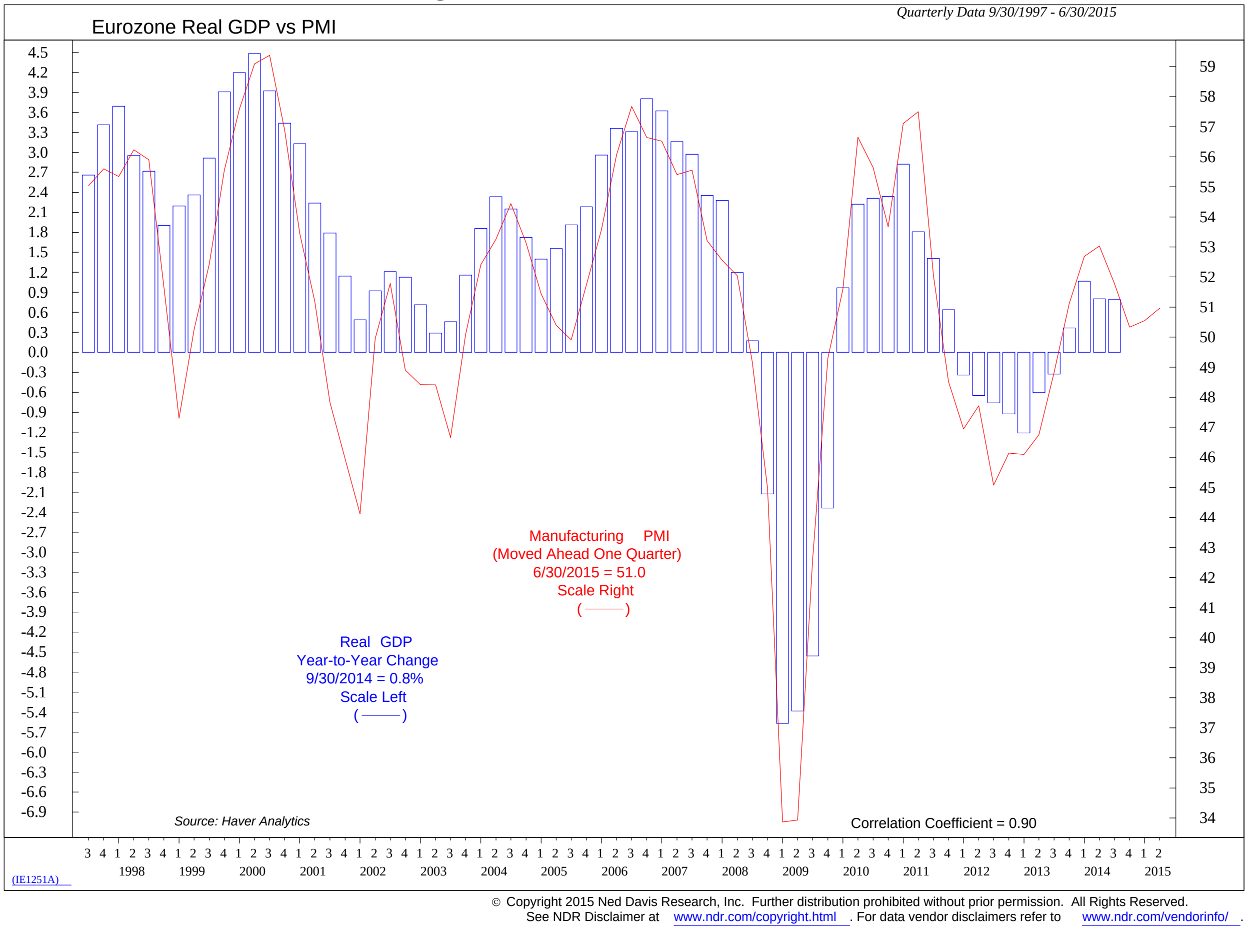
QE of course will not be a panacea: Europe's demographic and regulatory problems are well known and are not new. Many struggles remain, including the recent rekindled fears of a Greek exit from the Eurozone and its potential spillover effects. Still, on balance this is a very positive announcement.

The European Economy: Better than Advertised?

Despite some justifiably bad press, Europe may be in a better economic environment than is commonly appreciated. Europe is an export-driven economy, and the currency has already been falling. There are signs this is already beginning to boost exports. Europe is also a net energy importer, and has benefitted from falling oil prices. Also, while growth is quite poor, leading indications such as bank lending standards are showing signs of improvement. These factors together could result in better than expected growth.

I'll conclude with a small bit of evidence. The chart below shows the European Purchasing Manager's Index, a gauge of business orders that often leads GDP. While not strong, it shows a clear improvement from the recent trend. While we do not yet see a need to increase clients' allocation to Europe, we see this as an important development for our analysis.

Eurozone PMI as a Leading Indicator of GDP



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