

Draghi's Verbal Intervention: Euro Falls and Stocks Rise

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The European Central Bank (ECB) met on September 3, and the press conference afterwards reaffirmed the ECB's commitment to provide continued monetary policy support until its inflation target of 2% is met. The continued plan for the ECB's quantitative easing program is to conduct asset purchases at the scale of €60 billion a month. ECB president Mario Draghi's remarks highlighted downside risks in meeting the inflation target. He stated, "The information available indicates a continued though somewhat weaker economic recovery and a slower increase in inflation rates compared with earlier expectations."¹ **The downside risks to his inflation forecast were:**

- Continued drop in oil prices
- Recent exchange rate appreciation
- Notably sluggish growth in several emerging market economies seen as not easily reversible

While Draghi didn't announce additional asset purchases at the meeting, his remarks contained some very dovish messages, and there is speculation that additional asset purchases will be coming, especially if the above deflationary forces continue. **Draghi highlighted three ways the ECB might change its program:**

- Extend the duration of the asset purchase program beyond September 2016 if necessary
- Expand the size of the asset purchase program above €60 billion a month
- Expand the type of assets being purchased beyond the current instrument of bonds

There was one technical adjustment in terms of the bonds the ECB can buy – a "parameter" of its operations, as Draghi called it: Previously, the ECB could purchase up to 25% of any given bond; that limit is being expanded to 33%. One of the fallouts of the market volatility in late August was the trend for a weaker euro—and the euro shot up from \$1.10 to \$1.17 in mid-August.² A common explanation of this strong move was an unwinding of carry trades—the euro was used as a funding currency (people short the euro to buy other assets), and as risk sentiment turned negative, people covered their short positions, thereby sending the euro higher. With the settling of some volatility and the latest Draghi speech, the euro was heading back toward \$1.11. **Nominal and Trade-Weighted Euro Currency**



Source: Bloomberg, as of 9/3/2015. Past performance is not indicative of future results.

While everyone focuses on the euro versus U.S. dollar cross rate, on a trade-weighted basis the euro has not depreciated anywhere near as much over last year. While the euro is down approximately 20% from the start of 2014, on a trade-weighted basis that depreciation is just 11%.³ The markets reacted positively to Draghi's news: broad European indexes were up around 2%, while the euro fell 1%.⁴ This shows a developing negative correlation between the euro and the European equity markets, very much as has been the case for the Japanese equity markets over the past few years. At one stage earlier this year, both European and German equity markets were up almost 25% on the initial announcement of the QE program in January. These two markets actually dipped into negative territory for the year—taking into account the August volatility—and are only barely positive following the latest ECB announcement. To be fair, European markets are performing better than U.S. markets, which were down almost 4% year-to-date.

Volatility in European Equities



Source: Bloomberg, as of 9/3/2015. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of indexes in the chart, visit our [glossary](#). I believe the more dramatic sell-off in many of these European markets offers an opportunity. Valuations have come down, and there is no less of a commitment from the European Central Bank to support the economic environment. While there are risks from the emerging market economies and China in particular—which is a big market for such European exporters as Germany—I see a continued weakening of the euro that will help their competitive positioning. As Draghi made clear: There are no limits to the possibilities in the ECB's gearing up monetary policy if its objectives are not met. And while the Fed may actually hike interest rates next week, the ECB just emphasized the divergent policies that are impacting exchange rates. Valuation indicators such as European dividend yields versus bond yields are reading at levels that have rarely been hit in the last century, with rates of more than 200 basis points higher on European dividend yields than on bond yields. European equities—with a hedge to mitigate any currency volatility and weakness—should remain a focal point and over-weight for investors in global portfolios. 1Mario Draghi, ECB, Introductory statement to the press conference, 9/3/15. 2Source: Bloomberg, as of 9/3/15. 3Source: Bloomberg, as of 9/3/15. 4Source: Bloomberg, as of 9/3/15.

Important Risks Related to this Article

Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations.

Investments focused in Europe increase the impact of events and developments associated with the region, which can adversely affect performance.