The following Rapid Response Note on the announcement of a new bond buying programme by the ECB combines the analysis of Andrew Milligan, Head of Global Strategy, and Jack Kelly, Investment Director on the Fixed Income Team.

Capacity with conditionality
We have seen a powerful response to the latest ECB announcement. While Mario Draghi did not unearth anything dramatically new at the ECB meeting, he did deliver on much of what had been rumoured and leaked over the last few days. He outlined the Outright Monetary Transactions (OMT), a bond buying programme to address convertibility premia, purchasing up to 3-year maturities, in a sterilised manner. So, for once the ECB did not under deliver at the press conference, as it so often does.

However, there were some real causes for concern that so far have not preoccupied many commentators. Draghi’s mention of IMF involvement amid the continued mantra of conditionality is one example. We also saw no live demonstration of real bond purchases in, say, Portugal, and no true demonstration of waiving seniority in a future haircut on existing ECB Greek bond holdings. Overall, the ECB has bought time, essentially anchoring 0-3-year yields and allowing countries to continue funding themselves while progress on banking union and fiscal reforms takes place. The ball is firmly back in the politicians’ court.

What the ECB is outlining is the idea of a response that gives capacity alongside conditionality. Previous attempts at addressing the crisis had focused on the European Financial Stability Facility or European Stability Mechanism (ESM), with the ECB resistant to do the heavy lifting. The programmes have always been open to criticisms about their limited capacity. Although the ECB insists that any bond buying is contingent on the ESM also buying, the ESM purchasing can now be token in size. This will limit the capacity concerns.

What is different from last month’s ECB meeting?
Not a huge amount! The ECB did not backtrack but followed through on last month’s statements with some additional details. The true breakthrough was direct mention of purchasing up to 3-year bonds and liberal use of the term ‘unlimited’.

What happens now?
We essentially wait for a country to request aid for a programme. Given the discussion of IMF involvement, and the already impressive relief in bond yields, Spain may hold off further before asking for ECB support. Effectively the Spanish will see Draghi’s actions as an implicit guarantee on their debt, which gives them more reason to sit tight. There are risks around the German constitutional court decision on 12 September but on balance this should go through. The Dutch elections, with the Socialists doing less well in the televised debates, have become less of a concern.

Is this a game changer?
No, it is essential to emphasise that the major growth problems facing Europe are still there. The extra conditionality will ramp up austerity, even at the margin, not soften it, which will hit future growth. So while it does represent an appropriate response from the ECB, and could have a short-term impact on business and consumer confidence, its limitations are also exposed in attempting to address fiscally created problems with monetary policy. The crisis will almost certainly flare up again after a brief period of calm. The next trigger to monitor, therefore, is whether politicians can turn their attention from the ECB’s OMT towards a growth compact which could lift activity significantly into 2013. To repeat, the OMT is necessary but not sufficient to turn the Euro-zone around.
What can go wrong?
The Bundesbank is likely to be joined by other dissenters if no major reform progress is made. Some electorates are not going to be appeased by this bargain. Social unrest from onerous austerity could lead to government u-turns, reneging on promises, conditionality not being met, which then causes greater division at the ECB. Ratings downgrades are likely, as the agencies have already warned. It must be remembered that as we saw with the Securities Market Programme (SMP) to purchase bonds, which was also essentially unlimited (i.e. no caps on bond buying) and had less conditionality, the influence was temporary.

How are we positioning our funds?
The broad body of the ECB appears to be behind Draghi. Angela Merkel gave her open support for Draghi’s actions in direct opposition to the Bundesbank view. Hence, there is probably less immediate event risk here than previously. The ECB announcement is a timebuying exercise but we fear that the time will not be used constructively – previous ECB interventions have not been. Therefore, long-end peripheral spreads will be vulnerable to political risk, weaker growth or inflation shocks. However, over the next few months, the OMT could stabilise bond markets and be a risk positive driver. We have thus temporarily covered Light positions in Italy and Spain (now Neutral) but remain Light both in France (which will likely be vulnerable to a ratings downgrade with increasing liabilities) and the euro currency.