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Market Insights
Implications of ECB negative rates

June 2014

A positive move for European equities

The European Central Bank (ECB) has unveiled plans to introduce a raft of new monetary measures to stimulate the European economy, including negative interest rates on banks in respect of their deposits, and cheaper long-term loans to banks. In response to the news, European equities advanced on optimism that the new ECB stimulus measures will boost economic recovery. At Invesco, we believe that the ECB's actions are generally helpful, and earnings growth remains the key driver for the equity markets.

John Surplice, Fund Manager of European Equities at Invesco, said: "In my opinion, the return to earnings growth will be the dominant factor for European markets in the near term; in addition, further out, the gradual adjustment from super low interest rates and bond yields in the Western world will have a significant impact on the shape of the stock market recovery."

Unprecedented negative deposit rate and unconventional measures

On 5 June 2014, ECB President Mario Draghi announced an unprecedented string of measures to help record-low interest rates feed through to an economy threatened by deflation. The ECB said its deposit rates for banks will be cut from zero to -0.1%, effective 11 June 2014, to encourage banks to lend to businesses rather than hold on to money. This is the first major central bank to introduce negative interest rates. In addition, the ECB also cut its benchmark interest rate to 0.15% from 0.25%.

Draghi also announced some unconventional measures. Long-term loans are to be offered to commercial banks at cheap rates until 2018. These loans will be capped at 7% of the amount that the individual banks in question can lend to companies. Thus, the more banks lend to companies, the more money they can borrow cheaply from the ECB. The central bank is also doing preliminary work which could lead to buying bundles of loans that are made to small businesses in the form of bonds. This is being seen as a step towards providing companies with credit through the financial markets.

Draghi said the ECB's policymakers unanimously agreed to consider more unconventional measures to boost inflation if it stays too low. These measures are, in fact, well received by investment professionals. John Surplice said: "The ECB announced a broad range of measures to lower the cost and increase the availability of lending to support the recovery of the eurozone economy. We have been expecting a modest recovery of growth and inflation in the eurozone and anything that supports this is to be welcomed, though clearly it will take time before we know how effective the measures have been."

Investment implications

John remains upbeat on the outlook for European equities given the negative rate environment, and he expects investors to see earnings growth in the second half of 2014 and a further recovery into 2015. "Over the last two years, European markets have rerated from a price-earnings ratio (PER) of 10x to 15x in an environment of no earnings growth. For markets to progress meaningfully from here, we need to see a recovery of earnings growth and for that, we need European GDP growth (and particularly, nominal GDP growth). We expect earnings growth in the second half and a further recovery into 2015," John added.