

# CORE Comments

ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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## The European Central Bank Lays out its Plan

*The European Central Bank has announced its Quantitative Easing program, after many months of hints, speculation, and behind-the-scene negotiations with the Germans and others who have opposed the plan.*

*It is a massive program, under which €60 billion will be purchased each month for at least 18 months. Will it reverse deflationary expectations? Will it stimulate demand and rouse the eurozone economies from slumber? Time will tell.*

*It is quite likely that the ECB's QE program will cause stock and bond prices to rise and the value of the euro to fall.*

The new year has begun with financial markets and the global economy roiled by uncertainty and unexpected events. The European Central Bank has been the source of major uncertainties: firstly, what action it would take to attempt to revive growth in Europe, and, secondly, what effects will its actions have. The relentless decline in the price for crude oil has unsettled markets, economies, and geo-political calculations. The startling and utterly unforeseen action by Switzerland's central bank to end its 'peg' to the euro focused investors' fears that central banks had so manipulated normal prices for credit, currencies, and other assets as to render these prices and their underlying relationships unpredictable and vulnerable. This list could readily be lengthened.

These events, these uncertainties occur at a time of difficult economic conditions. Pervasive weakness in global economic demand has caused prices for goods and services in many countries to stagnate. Median inflation in developed economies is now below 1 percent. Deflation--i.e., falling prices--is at hand in many countries; the 50 percent decline in oil prices in six months pushes prices even lower. While the United States had reasonably strong growth in last nine months of 2014, Europe, Japan, and other developed economies have been barely positive. China's growth, still strong by standards of mature economies, has slowed considerably.

**The European Central Bank** settled one open question on Thursday with its announcement of its plan to buy a huge quantity of bonds issued by the various eurozone member governments. The scale of purchases is larger than expected; it is comparable in size (€60 billion per month) to the recently-ended Federal Reserve's asset purchase program; it is potentially open ended insofar as the ECB promises to continue the asset purchases until inflation returns toward the ECB's target level. The planned purchases are very great, €1.1 trillion or more, and the concessions to Germany's opposition are modest. Thus, at long last, the ECB begins its quantitative easing program (QE).

The ECB's announcement and the market's favorable initial reaction begs the question: Will it succeed? This is unknowable. QE programs initiated by the Federal Reserve and the Bank of England have been followed by higher economic growth in the United States and the United Kingdom, but those programs began several years ago. Has the ECB come too late to the party? Japan's central bank is in the midst of an enormous asset purchase program, but its was also begun rather late in the game. So far the result in Japan has been to weaken the yen and to bolster the stock and bond markets. These results were intended and expected, but the bigger targets, the revival of Japan's growth and the escape from deflation, have not been hit. It is simply impossible to know if the ECB

**By**

**Jack Mayberry**

can halt the deflationary spiral in Europe and stimulate economic demand. Europe, like much of the developed world, suffers from too little demand. As a result, it is awash with savings not put to productive use, while it has terribly high and very long-term unemployment, particularly afflicting younger people.

**Investment implications.** Three points to consider: First, European stocks will probably rise with the ECB's QE program, while the euro declines in value. Second, US stocks and the US dollar are the favored investments by most investors around the globe. Finally, volatility--wide and sharp swings in asset prices that have characterized the last six months--is likely to continue.

Whether the ECB's asset purchase scheme will raise inflation toward ECB's close-to-but-less-than 2% target is an open question, about which skepticism is well warranted. Whether the program will stimulate much-needed economic growth is similarly unknown. What seems quite likely, however, is that the ECB's program will stimulate the prices of investment assets in Europe and around the world, just as has been the result of the QE programs of the Fed, the Bank of England, and the Japan's central bank. Stock prices in eurozone countries will rise. Equally likely is that the euro will continue to decline against the US dollar. Since the middle of 2014, the euro has fallen from about \$1.40 to \$1.12 today. Although the euro may not continue its straight-line descent, over the next 18 months of the QE program, it is likely to fall further. Accordingly, we will continue our investments in European stocks and we will maintain our currency hedge, so that the decline in the euro does not offset the gains in the stock prices.

The US stocks dollar was as strong as new rope in 2014 and US stocks provided better returns than did most other equity markets. Surveys show that many investors expect similar results for 2015. This remains to be seen; rational expectations are often dashed by reality. We maintain a balanced approach and hold European, American, and Japanese stocks. The continuation of Japan's very large scale QE program and the initiation of the ECB's will support their stock markets and others around the world. The Fed promises to take great care in raising interest rates. The result is likely to be decent, if unspectacular, economic growth in the US, giving rise to improved corporate profits and supporting stocks valuations.

Finally, we have seen an increase in the frequency of sharp falls and rises in the prices of various assets and currencies. Expect this to continue. The unsettled nature of economies and the divergence in monetary policies between Japan and Europe on the one hand and the US on the other will probably disturb markets. The very sharp decline in oil in since last summer is also a cause of increased volatility, in part because of stresses it creates in Russia and the Middle East. (Witness the violent upsurge in fighting in recent days in eastern Ukraine, again at the apparent instance of Russia and with another large influx of Russian arms and personnel. This appears to be Mr. Putin's response to the economic distress in Russia caused by the collapse in the rouble and oil prices.) Geo-political concerns, also including ISIL, the Iranian nuclear threat, the Sunni-Shia violence throughout much of the Muslim world, and Ebola, are likely to unsettle markets more than once this year.

Core seeks to strike a balance between opportunities and risk, by maintaining a goodly set of investments that stand to gain in coming years, while taking measures to mitigate the risk of deep declines in portfolios. Increased volatility certainly heightens risk, but it also gives alert investors opportunity to buy at temporarily low prices. Onwards into 2015!

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CORE ASSET MANAGEMENT

PO Box 1629  
108 Caledonia Street  
Sausalito, California 94966  
(415) 332-2000 • (800) 451-2240  
fax (415) 332-2151  
[www.coreasset.com](http://www.coreasset.com)  
[info@coreasset.com](mailto:info@coreasset.com)