FINANCIAL TIMES
TUESDAY OCTOBER 28, 2014

Markets & Investing

Europe must act now to avoid 'lost decade'

None of the tools currently on the table will get the job done

Scott Minerd
INSIGHT

In recent conversations – whether with the US Federal Reserve, the European Central Bank, the US Treasury or the International Monetary Fund – one theme is playing large and loud: things in Europe are bad and policy makers appear already to have fallen behind the curve. Quantitative easing in Europe is coming, but too slowly to avert a severe slowdown and perhaps even a hard landing.

The depreciation of the euro, while welcome, will not be enough to lift the economy out of the doldrums and more must be done both in terms of monetary policy and fiscal reforms. The European Investment Bank stands ready to support infrastructure investment, but at a scale that currently appears too small to make much of a difference.

In the meantime, the ECB will work as quickly as it can to expand its balance sheet. The problem is simply that there may not be enough assets to buy. Mario Draghi, ECB president, has made it clear that the ECB must increase its balance sheet by at least €1tn – a tough mandate as the balance sheet will continue to shrink in the coming year as the earlier longer-term refinancing operation (LTRO) assets roll off. The reality is the ECB will need to purchase at least another €1.5tn in assets, and even that may not be enough.

The much heralded asset-backed securities purchase programme will only yield about €250bn-€450bn in assets over the next two years. More LTRO (or the newer targeted LTRO) will prove a challenge as sovereign bond yields in Europe are so low that a large balance sheet expansion through this means seems impractical. Perhaps there is another €500bn-€750bn to do over the next year or two. Outright purchases of sovereign debt would prove politically difficult, as many would interpret such purchases as violating the ECB's mandate and the matter would probably end up in the European courts.

The bottom line is that none of the tools currently on the table will get the job done. There are not enough assets to purchase or finance and the timetable to get anything done is too long. Policy makers do not have the luxury of a year or two to figure this out. The ECB balance sheet shrinks virtually daily and as it shrinks, the monetary base of Europe is contracting and putting downward pressure on prices. Europe is clearly in danger of falling into the liquidity trap, if it is not already there. The likelihood of a "lost decade" like that experienced in Japan is rapidly increasing. The ECB must act and act quickly.

How is this affecting the markets? The recent rally in US fixed income is materially different than when rates last approached 2 per cent. Previously, the Federal Reserve was actively managing the yield curve to reduce long-term borrowing costs in order to stimulate the economy. The current rally is caused by a massive deflationary wave unleashed upon the US by beggar-thy-neighbour policies in Europe and Asia.

The precipitous decline in energy and commodity prices and competitive pressures on prices for traded goods will probably push inflation, as measured by the Fed's favoured personal consumption expenditures index, back down toward 1 per cent. This raises the likelihood that any increase in the policy rate by the Fed will be pushed into 2016 or later.

With inflationary expectations falling and the relative attractiveness of US Treasury yields over German Bunds and Japanese government bonds, US long-term rates are likely to continue to be well supported with limited room to rise and a dynamic that could push them lower from here.

In the real economy, the decline in energy prices should offset the effect of reduced exports, which is supportive of US growth in the near term. This will help equities recover from the recent storm of volatility as we move deeper into the fourth quarter, which is a time of seasonal strength for the stock market. However, this may prove to be the rally to sell. Results from currency translations for large, multinational companies will weigh heavily on S&P 500 earnings in the first half of 2015.

It is too early to be making decisions for next year, but the events overseas provide ominous portents of things to come. If we do get a sign of a bear market in US equities, it could be that the events in Europe presage what lies ahead for the US. Is it too late to change these shadows of dark foreboding? It is hard to tell but time is not on our side.

Scott Minerd is global chief investment officer and chairman of investments at Guggenheim Partners