Threadneedle increases allocation to European equities following ECB announcement

- Tailwinds have emerged for European equities as QE provides a boost for markets (but is not a cure for all ills)
- The jury is out on whether QE will help the real economy in Europe
- The fly in the ointment is Greece and its imminent election

Mark Burgess, Chief Investment Officer at **Threadneedle Investments**, comments:

The ECB yesterday announced full-blown quantitative easing (QE), by confirming that it would inject up to €1 trillion into the eurozone economy through the purchase of eurozone government and corporate bonds. It has also improved the terms of its longer-term refinancing operations (cheap loans for banks), cutting the interest rate at which they are offered.

The market's reaction so far has not been significant, as the ECB's move had been anticipated widely. It is nonetheless pleasing that it exceeded expectations as government bond purchases alone are likely to amount to around €40-45bn a month or equivalent to around €750bn over an eighteen-month period (the market had expected sovereign bond purchases in the order of €500bn). There has been some discussion about the lack of 'mutualisation' or risk sharing of the government bond purchases, but we feel that the important issue is the commitment from the ECB to expand its balance sheet. Risk sharing was always likely to be a stumbling block, particularly given strong German opposition to the idea, but it should not reduce the effectiveness of the policy in terms of addressing short-term growth and deflation concerns. Importantly, German policymakers have not questioned the legality of the ECB's decision to implement sovereign QE, although it is clear that many Germans do not like it.

In terms of the market impact, the QE programme should mop up around two times the annual net issuance of eurozone government bonds. This means that the ECB will need to displace some of the current holders of eurozone sovereign debt. Given that 30-year Bunds yield just 1.25%, it should not be too difficult to find sellers of sovereign paper, particularly if growth does begin to pick up. For eurozone peripheral debt, yesterday's announcement is good news, although the current high level of positioning within that asset class means that there may be relatively little buying in the short term, particularly as the Greek election is scheduled for this weekend.

The bottom line is that the ECB has done everything that could have been reasonably expected and more. The tendency amongst investors will be to own more risk assets, particularly as the ECB's move will help to keep interest rates low globally. Inflation should not rise excessively and we could see growth rates well above the cost of borrowing in many countries. That is normally a good environment for risk assets such as equities.

For European equities specifically, four tailwinds have emerged in quick succession:

- A weakening currency
- A weaker oil price
- Sovereign QE
- Lower valuations versus other world markets

We have therefore decided to increase our weighting in European equities by 25 basis points for our multi-asset portfolios, funded from cash. We also feel that, in general, the ECB's move should reinforce demand for income-producing assets, and in that context higher-yielding equity markets such as the UK should remain attractive.

The jury is out on whether QE will help the real economy in Europe. The eurozone economy is very different to that of the US as it runs a current account surplus and is an exporter of capital. QE, in our view, is not likely to have a big impact on economic fundamentals and therefore it is unlikely that we will see an upturn in investment in the real economy. Naysayers will undoubtedly question how long the positive impact of the announcement can last, given that QE will not foster the structural reform that is still needed in much of Europe. However, the ramifications for investors could be more significant, particularly as bond yields will decline further. Domestic European investors are likely to look for income opportunities in markets that still offer positive yields (such as the US) and we could therefore see some flattening of yield curves. The question will be whether US growth will be strong enough to offset the ongoing search for yield. The rates impact of the ECB's decision is therefore unclear at the moment, but if the experience of the US and UK is anything to go by, QE will be positive for risk assets such as equities. The most obvious impact will be for the euro, which should weaken. This will give eurozone exporters a welcome boost.

The fly in the ointment, if there is one, is Greece. If the anti-austerity Syriza party triumphs in the election, as seems likely, Germany may hope that Syriza will soften its stance once it is in government. If Syriza does not cooperate, Germany may feel that it can ask Greece to leave the eurozone. Unfortunately a risk premium would need to be applied if this were to happen, even if other peripheral countries (such as Portugal) decided that they wanted to keep the single currency.

Overall, we are positive on the financial market impact of European QE, if it brings down risk premia (such as peripheral bond spreads). Moreover, the economic background in Europe does appear to be showing mixed as opposed to negative signals (see the recent ZEW survey of investor confidence, which has jumped to an 11-month high, for example). It is also important to remember that the European stock market is not the same thing as the European economy; Europe is home to many world leaders, and many of these companies have strong positions within their particular industry or sector.