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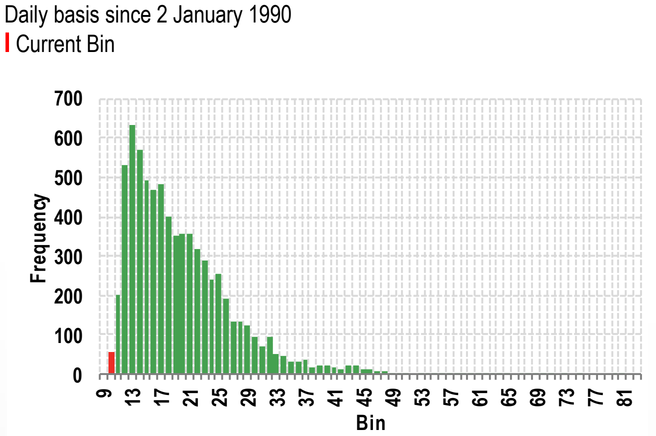
QE, Dr. Pangloss, Dr. Jekyll, Mr Hyde

■ The ECB's Financial Stability Review expresses concern about increased risk-taking behaviour in financial markets ■ Such behaviour increases the sensitivity of markets to unexpected developments in the economy ■ Accommodative monetary policy is a balancing act when growth is robust, inflation low and asset valuations rich

With robust growth, low inflation and rich valuations, running an accommodative monetary policy has become a balancing act. What better illustration is there than recent communication by the ECB? In a speech in Frankfurt on 17 November Mario Draghi gave a good description of how QE influences investor behaviour: "*By accumulating a portfolio of long-duration assets, the central bank can compress term premia by extracting duration risk from private investors. Via this "duration extraction" effect, the central bank frees up risk bearing capacity in markets, spurs a rebalancing of private portfolios toward the remaining securities, and thus lowers term premia and yields across a range of financial assets.*" He added "*as market conditions have normalised and the economic outlook has improved, risk perceptions have declined and the capacity to absorb risk in private portfolios has risen.*" To put it differently, the improved economic outlook boosts investor risk appetite. Are investors living in a Panglossian world? Not sure when one reads this: "*continued risk premia compression and signs of increased risk-taking behaviour in financial markets are sources of concern as they may sow the seeds for large asset price corrections in the future.*" The quote is from the ECB's Financial Stability Review (FSR) released earlier this week. Financial market participants will be relieved that the FSR comment didn't appear in the Governing Council meeting account because it would have been interpreted as very hawkish. Yet they may also be puzzled about the contrasting messages. To be fair, the FSR is far more concerned about Wall Street than about eurozone markets. Yet, the quote reflects a worry that at some point, justifiable optimism about the state of the world economy morphs into a view that risk has virtually disappeared from the equation. In this respect, the extremely low level of the VIX index, including from a historical perspective, deserves monitoring. More than ever monetary policy is a balancing act. After all, one wants to avoid that Mister Market turns from a Dr. Jekyll into a Mr. Hyde.

FREQUENCY DISTRIBUTION OF THE VIX INDEX



Source: Chicago Board Options Exchange

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