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ETF Securities Fixed Income Research:

Limited prospect for Eurozone bond gains amid political uncertainty

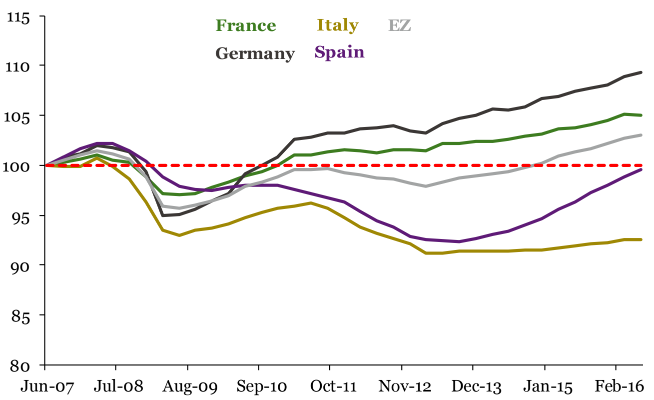
Summary

- The rise of populism in the Eurozone could weigh on the ECB's Staff forecasts and force the ECB to extend its asset purchase programme (APP) beyond March 2017 at its December meeting.
- Countries with the highest level of political uncertainty – France, Austria and Italy – have been hit the strongest by the global bond rout since September.
- We believe the ECB could ultimately opt for yield-targeting if political uncertainty markedly alters the financial conditions in the Eurozone.

Subdued economic recovery

Economic growth in the Eurozone was stable at 0.3%qoq (1.5%yoy) in the third quarter, marking the 14th consecutive quarter of positive growth. However, the differential between growth rates among the Eurozone countries has been rising. While the economic growth in Germany slowed (0.2%qoq) over the period, growth in France (0.2%qoq) and Italy (0.3%qoq) has been revived and Spain continued to outperform its peers (0.7%qoq). Overall, the Eurozone has surpassed its pre-crisis GDP level by 2% at the end of Q3, but the recovery remains reliant upon monetary accommodation, as evidenced by comments from ECB President Draghi at the European Banking Congress last Friday.

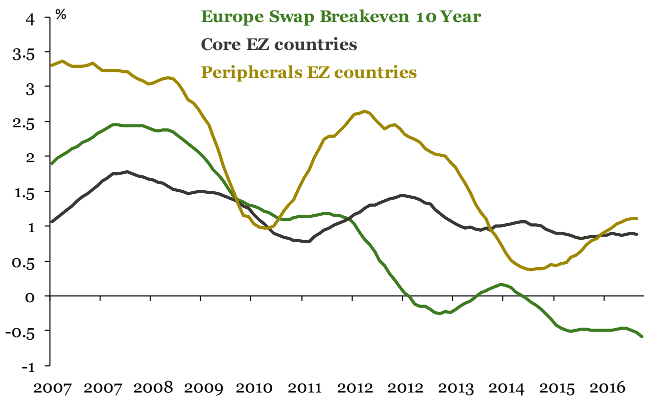
Eurozone GDP Indices (Q2 2007=100)



Source: Bloomberg, ETF Securities as of close 15 November 2016

Furthermore, headline inflation is slowly picking up, in particular for peripheral countries, reflecting base effects from the rebound in commodity prices. However, inflation expectations and core inflation (excluding food and energy) remain at multi-year lows. ECB VP Constancio stated that the fact that core inflation – which reflects domestic factors such as wage growth – is not recovering represents a cause of concern, stressing that it would ultimately weigh on headline inflation and thus affect monetary policy.

Core CPI Inflation and inflation expectation



Source: Bloomberg, ETF Securities as of close 15 November 2016

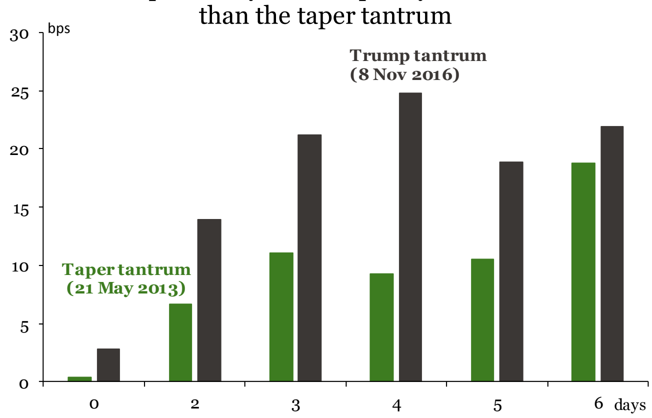
Besides, ECB Board member Coeuré emphasised that tightening would require a stronger economy, only achievable if governments carry out structural reforms. The European Commission recommended in a report published last week that Eurozone countries increase fiscal stimulus by 0.5% of Eurozone's GDP (i.e. €13.3bn).

In our opinion, fiscal policy will progressively assume a greater role than monetary policy in the effort to stimulate growth. However, the slow recovery and the prospect of larger fiscal deficits are likely to prevent the ECB unwinding its accommodative policy anytime soon.

Eurozone yields caught up in the Trump's tantrum

The global bond rout that followed Trump's victory on November 8 has been pushing yields across the Eurozone despite the support from the ECB's quantitative easing. While more Eurozone government bond yields now exceed the deposit facility rate (-0.4%) – minimum rate to be eligible to the ECB's asset purchase programme (APP[1]) – increasing the amount of bonds available for purchase, the ECB is unlikely to be complacent with the rise in yields for non-domestic reasons.

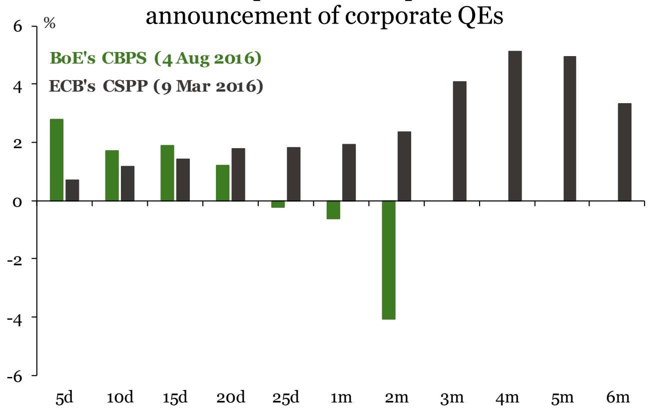
Trump's victory hit European yields harder than the taper tantrum



Source: Bloomberg, ETF Securities as of close 16 November 2016

In addition to sovereign bonds, the APP includes the corporate sector purchase programme (CSPP). Overall, the CSPP has pushed Eurozone corporate bond prices up by over 3% since it has been announced on March 9, which is significant in comparison with the BoE's corporate bond purchases scheme (CBPS) that has failed to achieve the same goal. However, the effect of the CSPP has been fading since the end of the summer and Eurozone corporate bond prices lost almost 1% in the five days following Trump's win.

EZ and UK corporate bonds perf. since the announcement of corporate QEs



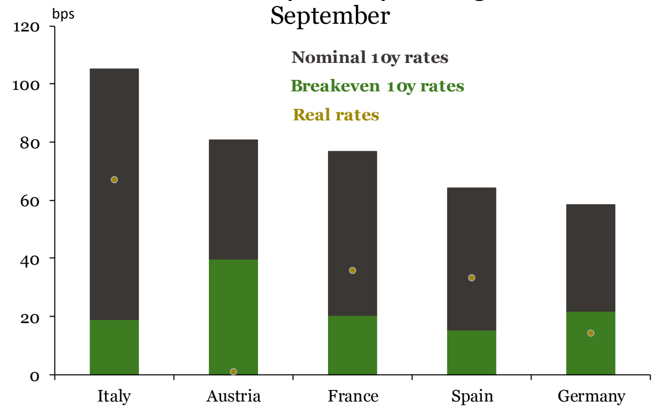
Source: Bloomberg, ETF Securities as of close 17 November 2016

Both external and internal factors are exerting pressures on the ECB to extend its APP beyond March 2017 at its next meeting on December 8. We expect the ECB to extend the APP by at least six months to October 2017 in order to boost consumer confidence while leaving its policy rate unchanged. However, we believe this adjustment will have a lower impact on Eurozone yields than when the APP was announced in March 2015, as most of the APP buying has already been priced into the market.

Trump's win spurred populism in Europe

Donald Trump's victory in the US presidential election has fostered populist movements across Europe. A parallel path is seen for Marine Le Pen (far-right National Front) who has surged in French opinion polls to 29%. In Italy, the latest polls reveal the "No [to the constitutional reform]" camp is ahead, increasing the risk that PM Matteo Renzi (Democrat) resigns after the results of the Referendum on December 4. At the same time, the Austrian Freedom Party could win the presidential election which will also take place on December 4, bringing the first far-right President since the end of WWII. As a result, countries with the highest level of political uncertainty – France, Austria and Italy – have been hit the strongest by the global bond rout since September. We expect these countries to continue to underperform their peers in the currency bloc.

Political uncertainty drives yields higher since September



Source: Bloomberg, ETF Securities as of close 17 November 2016

The ECB's Constancio warned that the world economy faces an "abnormal degree" of uncertainty, challenging long-term economic prospects. The December ECB staff forecasts will likely incorporate the ECB's views on the rise of populism and the risks it poses to the Eurozone economic outlook.

Ultimately, we believe the ECB could switch from quantity-targeting (APP) to yield-targeting (like the Bank of Japan (BOJ)) to avoid the yield curves to flatten excessively (hurting banks' profitability) or to steepen unpredictably in reaction the rise of political uncertainty (altering the financial conditions in the Eurozone). Such a change in strategy was suggested[2] by the ECB's Coeuré at the US Fed's Symposium at Jackson Hole in August. However, the execution would be significantly different from the BOJ as the ECB would probably need to fix yields for 19 different curves.

[1] Monthly purchases in public and private sector securities amount to €80bn on average since March 2016. From March 2015 until March 2016 this average monthly figure was €60bn.

[2] Coeuré noted that a target focused on short-term interest rates makes sense when this is the main policy variable, but if short-term rates are persistently pushed towards the lower bound, monetary policy has to focus on a wider constellation of rates across different maturities and asset classes.

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