January 19, 2018

Strong economy emboldens ECB hawks

Last week, markets were somewhat rattled by the release of the minutes of the ECB's December monetary policy meeting. The document conveyed a more hawkish tone than had been perceived at President Mario Draghi's press conference immediately after the meeting.

On December 14th the ECB upheld its ultra-easy policy stance, stating that rates would be kept low for an extended period and that, if necessary, more stimulus would be provided beyond September 2018 – the date that its €30-billion-per-month bond-buying program is scheduled to run until.

However, from the minutes, it was evident that there is a growing appetite amongst committee members for the bank to revise its policy message "early" in 2018, especially guidance that links the bank's asset purchase program to inflation. Against a backdrop of stellar growth, it is now

expected that the ECB will tweak its policy message between March and June in order to begin preparing markets for the day when the umbilical cord of central bank support is cut.

Currently, the ECB has left the door open on its asset purchase program, stating that it could persist beyond September 2018 if necessary and only after it was stopped, would rate hiking begin. Following the publication of the minutes, the conviction that the ECB will stop buying bonds in September rose. There was re-pricing across the money market curve as investors recalibrated expectations regarding rate hikes. Markets now expect the first ECB rate hike since 2011 to take place before March 2019 (by 15 basis points (bp)), followed by another 25bp hike by the second half of 2019, with a normalization of the deposit facility rate to 0% taking place before the end of 2019.

However, upon detecting a more hawkish disposition, currency traders drove the euro to a three-year high against the dollar. As we discussed in a previous article, a strong euro could be detrimental to Europe's recovery and may even scupper the ECB's plans to wean the economy off of its support in the medium term. A firmer currency tends to dampen inflation by making exports more expensive and imports cheaper. Data released on Wednesday confirmed that inflation in the euro-area remained subdued in December at 1.4% (annualized) – still quite far off the ECB's 2% target.

Speaking to the Italian newspaper, La Repubblica - with regards to the euro's appreciation - Vítor Constâncio, ECB vice-president said he was "concerned about sudden movements which don't reflect changes in fundamentals." The ECB's Ewald Nowotny also said that recent euro strength against the dollar is "not helpful".

Indeed, the euro is now roughly 4.5% above the level which was factored into the ECB's December forecast and the currency's rapid appreciation will need to be thoroughly assessed before further revisions are made to forward guidance.

Whilst a stronger euro may buy some time for bond markets, easy monetary policy must come to an end sooner or later. In the meantime, bond markets will continue to be highly sensitive to ECB commentary signaling an end to ultra-low interest rates and the asset purchase program which keeps yields suppressed (and prices artificially high) across the sovereign and corporate bond universes.

Our asset allocation is formulated to try and provide a degree of insulation against rising bond yields. Our tactical allocation holds only a nuanced selection of investment grade corporate bonds and maintains underweight positions in both European sovereign bonds and European high-yield bonds, giving preference to emerging market debt.

In terms of sovereign bonds, yields are already starting to head north - expectations are for the Bund to reach 0.80% by the end of the year. Yields are also set to rise in the corporate bond

market once the ECB ends its buying spree which has capped borrowing costs for companies but led to a scarcity in quality debt.

As discussed in a previous publication, scarcity and the hunt for yield has pushed investors towards the riskier end of the debt spectrum into the high-yield (junk) bond market. These instruments, though not directly purchased by the ECB, could be one of the hardest hit asset classes after the central bank's support is withdrawn, compelling investors to re-price risk and scurry back up the quality curve. For this reason, investors wishing to add an element of risk to portfolios would do well to consider European equities which are still taking sap from the continent's solid economic growth.

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