THE DRIVE YOU DEMAND

NAVIGATING QUANTITATIVE TIGHTENING IN THE EUROZONE

Spotlight

Global Investment Committee

UBP

Union Bancaire Privée

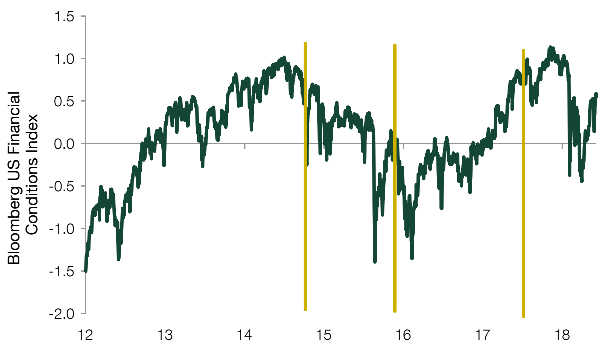
Key points

- *The European Central Bank (ECB) has announced the end to its Quantitative Easing (QE) programme and the start of a multi-year Quantitative Tightening (QT) programme by end-2018*
- *Given the more complex risk backdrop and lower starting yields than in the US, the ECB's QT may be more gradual than the Fed's*
- *Lower-rated government and corporate bonds should suffer more than their higher-rated peers*
- *Danish mortgage bonds are an attractive alternative to German bunds and high quality credit*
- *We prefer asset-backed securities, insurance-linked bonds, and event-driven alternative strategies for investors seeking alternatives to peripheral sovereigns and low-rated credit*

US Quantitative Tightening: A road map for the ECB

Since the 2008–09 global financial crisis, the Federal Reserve has set a trend among major central banks by cutting policy interest rates nearly to zero and implementing more aggressive bond-buying strategies, known as Quantitative Easing (QE), driving down longer-term interest rates to support its flagging economy. With US economic performance now on the mend, the exit begun by the US Federal Reserve (FED) in 2013 provides a good road map to understand both the trajectory and reaction function of the US central bank to changes in underlying economic conditions as a result of its policy shift.

US QT: Calibrating tightening to sustain economic growth



Source(s): Bloomberg Finance L.P. and UBP

With the US economy among the most advanced in its recovery cycle, the FED began its exit process in 2013 by slowing its asset purchases ("taper") before halting its QE programme in October 2014. As inflation was showing signs of accelerating and despite slowing growth momentum, the FED raised rates for the first time in December 2015. As the US economy began to slow sharply and inflation expectations started to fall noticeably in 2015-16, the Fed paused its rate hiking cycle, staying on the sidelines for 2016.

As growth rebounded in 2017, the US rate hiking cycle resumed and the FED took the next step in unwinding its QE strategy by beginning to shrink its balance sheet so putting an end to its reinvestment policy.

While this tightening bias of the US central bank was apparent throughout its exit process, the FED outlined its willingness, to moderate both the magnitude and speed of its exit depending on the development of growth, inflation and overall financial conditions (see chart). The aim was to ensure that the economic recovery trajectory would remain intact even in the face of slowdowns as seen in 2016.

So, with current growth strong and inflation within the FED's target, the US central bank will unwind its balance sheet to the tune of between USD 1-1.2 trillion of US Treasury securities and around USD 800 billion of US Mortgage Backed Securities according to our estimates. Should the US economy show signs of faltering once more, as it did in 2015–16, we expect that the Fed will again adjust the magnitude and pace of its rate-hiking cycle.

ECB: Navigating a more complex road

Beginning in 2017, the European Central Bank (ECB) began to scale down its asset purchase programme. In fact, the ECB has announced that it will not extend QE purchases (currently EUR 30 billion per month and EUR 15 billion after September 2018) beyond December 2018, approximately one year after beginning its tapering, as seen in the US.

While the ECB appears to be following a similar path as set by its US counterpart, the single currency area's central bank has to navigate a much more complex risk and political backdrop. A new government in Italy, progress towards the UK's exit from the European Union, as well as burgeoning trade pressures with the US, and rising geopolitical tensions all pose credible risks to the current growth trajectory.

Given lower starting levels of both short-term and long-term rates in the eurozone as well as lower potential economic growth rates, we expect that the ECB tightening process may be more gradual than what is taking place in the US, having to be responsive to the impact the policy changes are having on growth, inflation and overall financial conditions.

In spite of these risks, with growth in the eurozone currently above potential, the case for exiting their quantitative easing policy regime seems prudent. Indeed, should these risks prove short-lived, growth, inflation and financial conditions might allow the deposit facility rate to rise by mid-next year according to our estimates. The ECB balance sheet would only start to decrease in 2021.

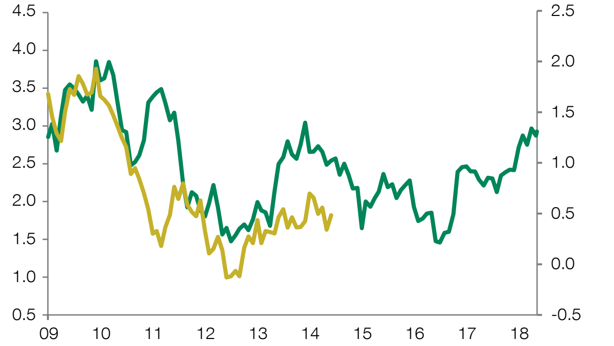
However, as with the US, should growth and/or inflation slow dramatically in light of the ECB policy shift or financial conditions unduly tighten, we expect the ECB to adjust the speed of travel along its policy trajectory.

Outlook for Eurozone Fixed Income Markets

As the ECB pivots its policy, eurozone fixed income markets should face a more challenging environment looking forward – shifting from a decidedly declining rate environment to one characterised by rising two-way volatility in interest rates.

Indeed, though many investors fear a sharp rise in yields as seen in the 2013 US 'Taper Tantrum', even with that US yields have moved broadly sideways, though admittedly in a much wider range.

Eurozone QT: Look for increased two-way volatility in bond markets



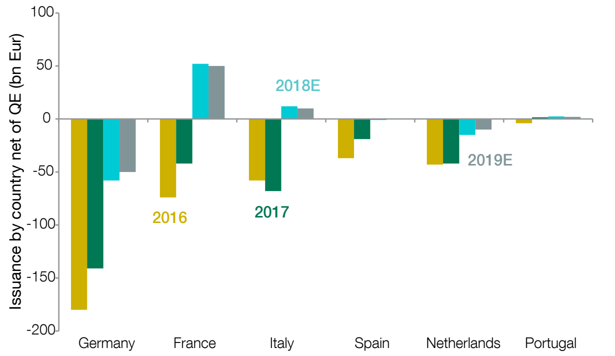
Source(s): Bloomberg Finance L.P. and UBP

Several factors, however suggest that the eurozone may see more upward risks to yields than the US experienced as the FED exited their QE programme.

From 2012-2015, as the FED began slowing its purchases of US government debt, the issuance of new debt declined as the US fiscal deficit narrowed from 8% of GDP in 2012 to as low as 2% of GDP in 2016. Similarly, during 2012, the Bank of Japan began its own version of quantitative easing (QQE) while the ECB joined in during 2015 pushing investors to buy US Treasuries in search of yields and potentially helping to cap the upside in yields in the US.

In the eurozone, the end of quantitative easing will see more limited buyers stepping into the shoes of the ECB. While the reinvestment of maturing bonds in the ECB portfolio will provide some additional demand, this reinvestment will fall short of new issuance in the eurozone as a whole.

France and Italy to place more significant pressure on yields



Source(s): Natixis and UBP

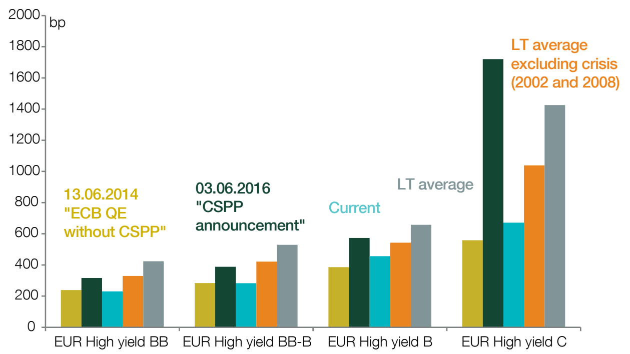
We expect the impact of QT to vary by country with German bunds well supported with still negative net issuance expected in 2018-19. Indeed, France which saw as much as EUR 40-70 billion in supply removed from the market in 2016 and 2017 should see net new supply of EUR 50-55 billion in 2018-19 (see chart), a swing of EUR 90-125 billion.

Furthermore, peripheral countries have benefitted the most from the ECB's bond purchasing programme. The 10 year yields in France, Italy and Spain have decreased by 100-200 basis points since June 2014 while German yields fell a more modest 85 basis points over the same period.

Undoubtedly, the biggest beneficiary of the ECB quantitative easing programme has been European credit via the Corporate Sector Purchase Programme (CSPP). Through the CSPP, the ECB bought 30 to 40% of net market issuance over the period. As a consequence, the cost of capital decreased sharply especially in France and Spain. European Investment grade and high yield spreads tightened by 62 and 300 bps respectively.

Even in that context, lower rated bonds were the biggest beneficiary. Even with the ECB reinvesting principal from maturing bonds, its net purchases are expected to decline from EUR 55 billion to EUR 18 billion in 2018-19.

Low quality credits benefitted most from ECB QE



Source(s): ICE and UBP

Thus, even starting with a baseline of sideways movement for risk-free yields in the eurozone, the likely lack of fiscal tightness limiting new issuance as seen in the US, a slowing of Japan's QQE programme combined with more substantial supply-demand imbalances for France and Italy among government issuers and lower rated credits among corporate issuers all merge to suggest the prospect for an upward bias to yields and thus a headwind for returns in the Euro-area fixed income as the ECB shifts its policies.

Seek refuge in bonds which have not benefitted from ECB QE

Fixed income investors in the eurozone are facing a very challenging environment with the ECB exiting as a major buyer in the market.

While German bunds and higher quality corporate credit should benefit in relative terms, their low absolute yields provide little in the way of return prospect should yields stay stable and only a limited cushion should yields even back up slowly in the months ahead.

We see AAA-rated, callable Danish mortgage bonds as a liquid, comparatively higher carry alternative for risk-averse EUR-referenced investors. Pegged to the Euro and backed by substantial reserves, investors are exposed to modest FX risk despite a higher carry.

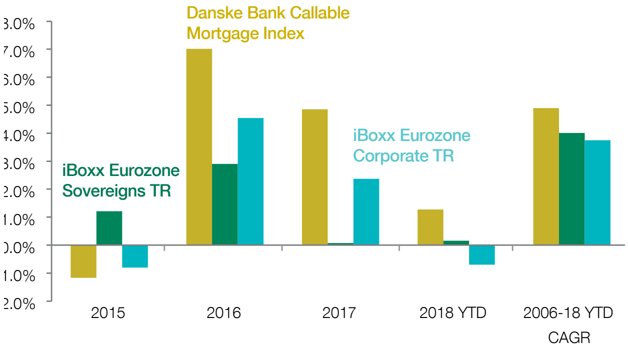
Similarly, should yields in Denmark and the broader Euro-area rise, the ability of Danish homeowners to effectively buy back their mortgage at a discount caps the potential losses in a rising yield environment.

In addition, held to maturity, (actively managed to mitigate credit risk) fixed maturity bond portfolios can provide some refuge for investors able and willing to look through interest rate volatility as seen in US government markets since 2013.

For investors who had sought refuge in peripheral eurozone government bonds or lower-rated corporate credit in search of higher yields, we view US dollar denominated asset backed securities, hedged back into Euros as a credible alternative way to secure yields while diversifying away from the prospect of a further widening in corporate credit spreads that began earlier this year.

Similarly, seeking to avoid high concentrations in corporate credit risk, insurance-linked, or 'catastrophe' bonds provides an additional, alternative source of attractive carry, uncorrelated to the economic cycle. Though it does expose investors to the risk of natural disasters (as seen in September, 2017), the high yields and floating rate structure protect against both rising bond yields and provide sufficient income to mitigate the negative impact of periodic natural disasters for long-term holders.

Danish Mortgage Bonds: A Credible Alternative for low-risk EUR investors



Source(s): iBoxx, Danske Bank and Bloomberg Finance L.P.

Authors

Michaël Lok
Group Chief Investment Officer (CIO)
and Co-CEO Asset Management

michael.lok@ubp.ch

Norman Villamin
Chief Investment Officer (CIO)
Private Banking and
Head of Asset Allocation

norman.villamin@ubp.ch

Yves Cortellini
Deputy Head of Asset Allocation

yves.cortellini@ubp.ch

Patrice Gautry
Chief Economist

patrice.gautry@ubp.ch

Disclaimer

June 2018

Union Bancaire Privée, UBP SA | Head Office
Rue du Rhône 96-98 | P.O. Box 1320 | 1211 Geneva 1 | Switzerland
ubp@ubp.com | www.ubp.com