Ahead of the curve

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The impact of ECB tapering on European markets

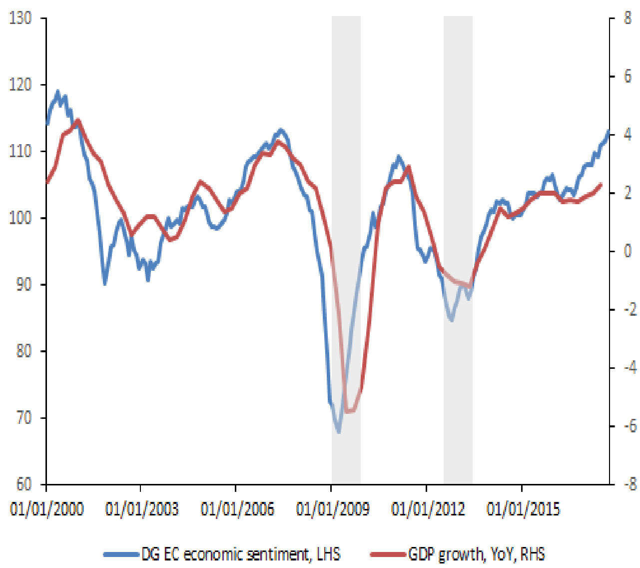
- **The ECB in 2018 will officially embark on QE tapering. Monthly purchases will be halved to €30bn over the first nine months of 2018. That could be the final stage of the so-called APP.**
- **The improved economic background provides a strong justification for ECB tapering. However, the approach will be cautious, given inflation is still undershooting the ECB's target.**
- **Tapering means the ECB will continue to provide stimulus, only at a slower pace. Hence, unless markets interpret it as paving the way to a more aggressive normalisation, the ECB stance will continue to exert a cap on bond yields, albeit with less intensity than before.**
- **A model for European long-term rates based on a set of economic and financial variables suggests that peripheral rates are more sensitive to bond purchasing than core rates. As purchases are reduced, the focus will shift back more onto fundamentals.**
- **The impact on euro-zone rates & yields (and European financial assets in general) from ECB tapering is likely to be relatively limited next year, which in consistent with our 'new normal' view of low-for-longer global rates...**

An improved economic outlook has set the stage for ECB tapering...

At its October meeting the ECB announced a reduction of the monthly pace of its QE purchasing starting from January next year, officially embarking on the so-called tapering process. The step-down of monthly purchases will be reduced to €30bn (half the current pace) over the first nine months of 2018. **While the ECB retained the flexibility to provide further extensions if needed, this move is likely to mark the closing stage of the ECB QE programme, the so-called APP (Asset Purchase Programme), launched in early 2015.**

Significant improvements in economic conditions in the euro-zone over the last year or so have given the ECB the opportunity to start to dial down its APP. Economic surveys (Markit PMIs, DG economic sentiment) are now running at post-recession highs, and, accordingly, GDP annual growth is tracking at 2.2% this year, a strong rate by recent standards ***(chart 1)***. Consumption has accelerated, underpinned by favourable lending conditions and by a significant improvement in the labour market. The unemployment rate has fallen sharply to 9.1%, most recently from a peak of 12.1% in early 2013. Business investment

Chart 1. A positive growth picture for the Euro-zone...
Economic surveys and GDP growth are back to pre-recession highs



Source: Eurostat, European Commission, CEPR

Chart 2. But core inflation is below where the ECB prefers it
Black dotted line is the ECB's medium-term target for headline CPI inflation

Source: Eurostat, CEPR

and exports have also been supported by easy lending conditions, while also enjoying the synchronised pick-up in global demand that became apparent at the turn of the year. Inflation is still the missing piece of the puzzle as it is still running below the ECB target of close to, but below 2%. However, as the ECB pointed out at its recent meetings, core inflation has shown some modest advance and, most importantly, deflation risks have now disappeared.

It is going to be a gradual, predictable and flexible process

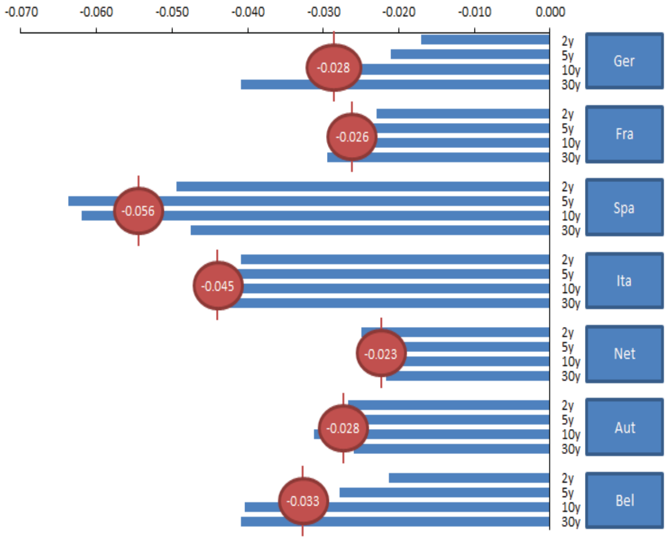
All that said, the ECB will adopt a cautious approach to tapering, as the process will be gradual, predictable and flexible. There are a few reasons for this. First and foremost, as already mentioned, the ECB is still missing on its inflation target, and the recent increase in core inflation has been only tentative ***(chart 2)***. The ECB October statement reiterated that *"measures of underlying inflation have ticked up moderately since early 2017, but have yet to show more convincing signs of a sustained upward trend"*. In general, the recovery following the double hit from the Great Recession and the Sovereign Debt Crisis has been slow by historical standards and still looks vulnerable.

It is no surprise that even at a time when downside risks look marginal and mainly external (related to geopolitical risk and FX appreciation), the ECB is extremely wary not to disrupt the apparent growth momentum. The memory of the so-called taper tantrum, *i.e.* the disorderly reaction of financial markets (rates, notably) to the Bernanke's testimony that hinted at Fed tapering back in May 2013, is still vivid. Central banks and financial markets alike have learnt the lesson; the former have adopted a cautious and predictable approach to the reduction of accommodation and the latter have accordingly adjusted their expectations.

Even with tapering the overall monetary policy setting will remain highly accommodative over the next year at least. First, the forward guidance stating that the key ECB rates would remain at their present levels "well past the horizon" of QE was confirmed. Reading between the lines, that probably means the first rate hike will take place around mid-2019 at the earliest.

Chart 4: Peripheral yields are more sensitive to QE than core

European yields' sensitivity (pp) to a 1% debt stock held by NCBs, different maturities



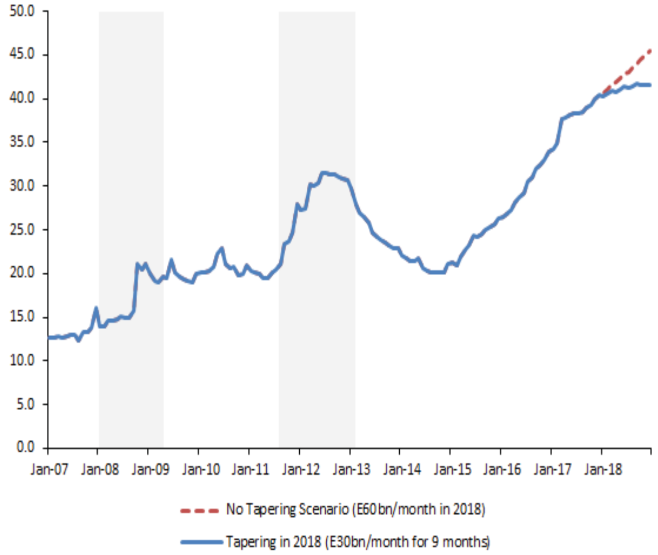
Source: Hermes Investment Management, based on Bloomberg, ECB, & Eurostat data

Importantly, tapering still implies that the ECB balance sheet will continue to grow, only at a slower pace. The announced tapering implies a boost to the ECB balance sheet of an additional €270bn over 2018. The ECB balance sheet currently stands at almost €4.4trn, or around 40% of Euro Zone GDP. With tapering it will increase to €4.8bn, or around 42% GDP by September 2018. For the sake of comparison, if the ECB were to continue buying at the current monthly pace of €60bn over the next year, its balance sheet would increase to €5.2trn, or 46% GDP by the end of 2018 ***(chart 3)***.

Beyond September 2018, the reinvestment policy of maturing bonds (which was confirmed for an "extended period" at the October meeting) will make sure that the ECB balance sheet will remain sizeable for

Chart 3. The ECB balance sheet will remain large in 2018

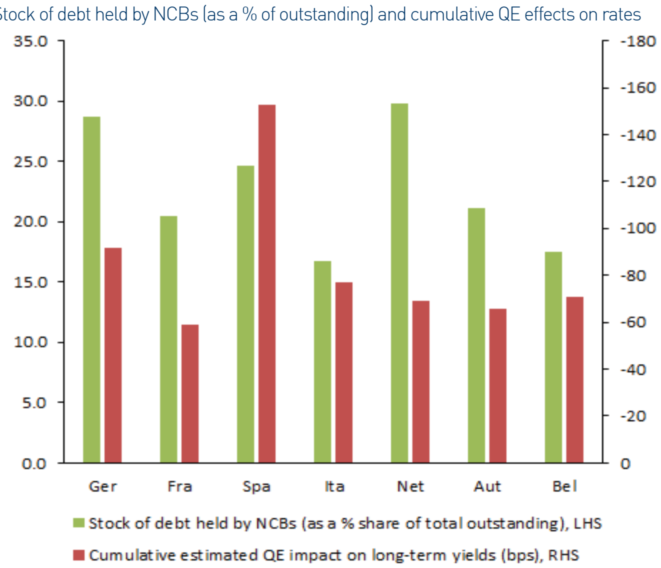
ECB balance sheet as % GDP (tapering vs no tapering scenarios)



Source: Hermes Investment Management, based on ECB, Eurostat, & CEPR data

Chart 5. NCBs hold larger shares of core debt, leading to a large cumulative impact of QE for most European yields

Stock of debt held by NCBs (as a % of outstanding) and cumulative QE effects on rates



Source: Hermes Investment Management, based on Bloomberg, ECB, & Eurostat data long, while the flexibility embedded in the APP means purchases can be stepped up should adverse circumstances materialise. If the Fed experience is anything to go by, the ECB will maintain its reinvestment policy for a considerable time; the Fed has fully reinvested maturing bonds in its portfolio for more than three years after the end of its last QE programme in October 2014.

Assessing the impact of ECB tapering on European rates; stock effects will continue to provide downward pressures

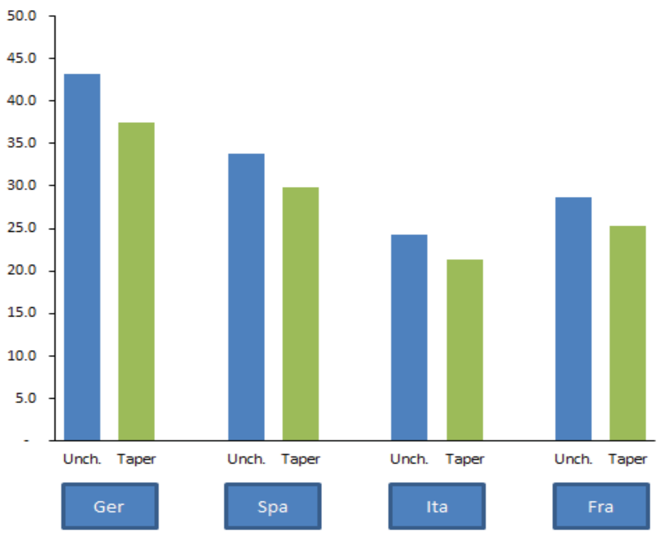
When thinking about how quantitative easing affects markets, analysts typically distinguish between stock effects (i.e. the impact from the announced full amount of purchases) and flow effects (i.e. the impact from each actual clip of purchases). In general, existing literature suggests that stock effects are the main channel through which QE affects financial markets and, in turn, the real economy. By contrast, flow effects are deemed as less relevant and more elusive to identify.

A model for government bond yields based on a set of macro and market variables suggests that **yields in core markets (in Germany, notably) are typically less sensitive to QE than yields in the large peripheral markets. An additional 1% debt stock held by national central banks shaves around 3bps off German yields (on average across different maturities) compared to 4.5bps for Italian yields and 5.5bps for Spanish yields (*chart 4*).**

The higher sensitivity of peripheral rates to national central banks' buying has been largely counterbalanced by the capital key rule, implying relatively larger purchases of core (German, notably) debt. Taking into account the sensitivities above and the stock of government debt (as a share of the total) national central banks have bought so far, **the cumulative negative impact from QE purchases on yields so far is largest for Spain (150bps), followed by Germany (around 90bps) and Italy (around 80bps) (*chart 5*).**

As already pointed out, tapering still implies the ECB will continue to provide stimulus, only at a slower pace. Hence, unless the market interprets tapering as paving the way to a more aggressive balance sheet normalisation or rate increases in short order (unlikely), the ECB

Chart 6: Effects of ECB tapering on % share of debt held by NCBs (vs a no-tapering scenario)



Source: Hermes Investment Management, based on ECB data

Chart 7. ECB tapering implies yields will be 10-20bps higher by the end of 2018 compared to a no-tapering scenario

	Germany	Spain	Italy	France
Effect of taper on share of debt held by NCBs (vs a no-tapering scenario), pp	-5.71	-3.97	-2.94	-3.27
Yield sensitivity (pp) to a 1% debt stock held by NCBs (QE)	-0.028	-0.056	-0.045	-0.026
Tapering impact on yields (compared to a no-tapering scenario), pp	0.16	0.22	0.13	0.09

Source: Hermes Investment Management, based on Bloomberg, ECB, & Eurostat data

monetary policy stance will continue to provide downward pressures on bond yields (and to support asset prices), only with a lower intensity compared to a scenario where purchases continue at an unchanged pace. The slower pace of purchasing announced by the ECB for the next year implies the share of debt held by national central banks will be lower compared to a hypothetical scenario where purchases were unchanged at a pace of €60bn per month (***chart 6***). Accordingly, **yields will be 10-20bps higher by the end of 2018 compared to a hypothetical scenario where purchases were unchanged at a pace of €60bn per month (*chart 7*).**

The high sensitivities of peripheral yields to QE mean that peripheral long-term rates might be more vulnerable to a phasing-out of the ECB purchasing programme. As the ECB tapers its APP purchases, markets are likely to shift their focus on fundamentals (growth differentials, sustainability of debt dynamics), potentially punishing structurally weaker countries.

It is also worth highlighting that ECB tapering is not an isolated normalisation effort, but, rather, part of an informally synchronised and gradual move towards a less accommodative monetary policy stance across central banks. Most notably, the Fed started a gradual process of normalisation of its balance sheet (the so-called Quantitative Tightening) in October.

This is a significant difference compared to the Fed's tapering experience, which took place in 2014, at a time when other major central banks (the ECB and the BOJ, in particular) were stepping up their easing efforts. In the current context spill-overs from QT in the US probably pose a more serious risks to low rates in Europe than ECB tapering itself.

As it turns out the impact from an increase in yields elsewhere has a sizeable impact on those in the euro-zone. Based on the same model considered above, **a 1% increase in US long-term rates typically translates into an increase of 20-50bps in European rates, with the largest effects taking place in core markets. However, the Fed's balance sheet normalisation process is likely to have only limited effects on US yields, at least initially.** This will be helped by the fact the process has been well telegraphed, and is going to be only gradual.

In summary, the impact on euro-zone yields (and on financial assets in general) from ECB tapering is likely to be limited next year. Purchases will continue, so a cap on long-term rates will persist, only at a lower intensity then before. Debt in peripheral countries could be more vulnerable, notably where fundamentals are relatively poorer. But in general, the cautious ECB tapering process next year fits into our new normal 'lower-for-long' view for global rates.

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