FIXED INCOME

Three Developments in Europe You May Have Missed over the Summer—and One You Didn’t

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The months of July and August are traditionally a little quieter for markets in Europe as participants take a summer break. But things don’t stop completely. As the wheels get back up to speed, David Zahn, Franklin Templeton’s Head of European Fixed Income, considers a few developments in Europe over the summer months that might have slipped under the radar.

“Flight to Quality” Pushes Core European Bond Yields to Unrealistic Levels

For a few days in the traditionally quiet mid-August period, concerns about a crisis in Turkey generated feverish headlines and created some volatility in emerging-market assets.

We felt the likely economic fallout was largely confined to Turkey and we regard the knock-on effect on the financial markets and economies of the European Union as very small.

One or two individual European banks had some exposure to the Turkish lira, but these were generally considered to have more than enough capital to deal with any problem. So, the risk of contagion to the European financial sector seems to us negligible.

Investors Adopt Risk-Off Approach

However, noise around the situation in Turkey did trigger a risk-off sentiment among some investors, prompting a so-called “flight to quality”.

Investors’ risk aversion has driven yields in core European bonds down over the past few months. Notably, the 10-year German bund tumbled to 0.30% in mid-August.

Ultra-low German bond yields don’t make sense to us, when you consider the macroeconomic background in the eurozone: core inflation is still near 1%, with headline inflation at around 2%.

The European Central Bank’s (ECB’s) asset-buying program looks set to wrap up at the end of the year, which we think should keep a cap on European bond yields. However, we’d expect to see the German 10-year yield up at around 0.70% to 0.80% at least, which would still reflect some risk premium built in.

Bank of Japan’s Stealth Taper

One of the potentially most interesting developments for European bond markets over the summer happened well away from Europe—in Japan.

While it appears the ECB will start wrapping up its quantitative easing (QE) program at the end of this year, the Bank of Japan (BOJ) will likely be the last major central bank still engaged in asset purchases.

But slowly and without fanfare, even the BOJ has been reducing its purchases over time in what we refer to as a "stealth taper."

BOJ's Asset Purchases Are Falling

The BOJ owns so much of the bond market, it really doesn't need to keep buying as much as it did in the past, but still, the amount of additional QE purchases has been falling.

At its monetary policy meeting in late July, the BOJ announced a small change to its approach. It widened its tolerance for fluctuations in the yield on the 10-year Japanese government bond to 0.20% above or below its 0% target. Previously, the central bank would have stepped in from 0.10% above or below the target.

Widening the range before it steps in means allowing for more volatility, which is something that's been absent from bond markets for some time, and as a consequence more normalization.

While yield curves globally have seen a flattening trend over the past year, given the coordinated central bank approach we anticipate going forward, we think yield curves could potentially begin to steepen.

Leadership Vacuum in Europe as Italy Prepares a Potentially EU-Baiting Budget

It's become apparent to us over the summer that there's a leadership vacuum at the head of Europe.

Neither French President Emmanuel Macron nor German Chancellor Angela Merkel currently appear strong enough to take a forceful lead of Europe on their own, and so they will need to work together.

Macron has not been able to build the power base that he'd expected. His opinion poll numbers in France are disappointing, and he's not been able to make all the changes domestically he said he wanted.

Merkel has also faced challenges within her ruling coalition in Germany which have left her weakened politically.

Italy's Populist Government to Outline Spending Plans

At the same time, we're gearing up for potential challenges to the European Union (EU) status quo from the newly formed populist coalition government in Italy.

The Italian government is preparing to unveil its budget for the forthcoming year in September or October. It has previously indicated a willingness to run deficits to spur economic growth, in contravention of EU guidance.

The question is whether Italy will propose a very populist budget that looks to spend lots of money and require deficit spending.

We think the Italian government will tread cautiously. It's seen what's happened to countries such as Turkey when financial markets are spooked. In our view, Italy's leaders will likely recall the volatility that greeted the election success of the two populist parties there.

We'd expect an Italian budget that proposes growing the budget deficit more than the EU would like, but still within what it can comfortably finance.

Brexit: "No Deal" Looks Increasingly Likely, But Would Represent a Failure for Both Sides

What's going on with Brexit? Unfortunately not a lot.

Based on the current state of negotiations, we think the United Kingdom is getting closer to crashing out of the EU without a deal. But significantly, we think the lack of a deal will increasingly become problematic for other EU member states as they see how much it likely to hurt them, not just the United Kingdom.

We also think a no-deal scenario would be seen as a failure for the EU's lead negotiator, Michel Barnier. His goal was not to eviscerate the United Kingdom, but to come up with a deal that all sides could work with.

If all Barnier does is punish the United Kingdom it's not a successful negotiation in our eyes. If that was the plan, the EU could just have walked away from negotiations.

So in the coming weeks, we think there will be more pressure on Barnier and his team of EU negotiators to come up with a viable deal.

We'd expect a lot of last minute gamesmanship not just between the negotiating parties in Europe but within the political parties in the UK. We're heading towards to party conference season, which could decide the future leadership and policy direction of the main political parties in the UK.

There are a lot of moving parts at a time when what's needed is stability.

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