A Strengthening Case for European Bonds

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The pace of the eurozone's economic recovery has been so slow that many people are now asking whether quantitative easing (QE) is inevitable to support a recovery and prevent deflation. But David Zahn, portfolio manager for Franklin Global Government Bond Fund, thinks recent European Central Bank (ECB) interventions in the European financial markets already amount to QE. More importantly, he thinks the extensive set of measures that the ECB has announced not only may support Europe's economic recovery, but bring a highly favorable backdrop for European fixed income investments generally. Here's why.

Although the pace of economic improvement in the eurozone is slow, there is at least some growth. We are optimistic about the prospects for fixed income investing in the region—perhaps more than many other areas of the world.[1]

I was very encouraged by the package of measures introduced by the ECB in June. Equally, I'm encouraged by what the central bank could be expected to do to encourage banks to lend where it is most needed.

There's been a lot of talk about whether the ECB should follow in the footsteps of the central banks of economies such as the United States and Japan and attempt to inject liquidity into the financial system by printing money to buy bank assets—a process known as quantitative easing (QE). I believe in time the ECB will most likely engage in that particular form of QE probably toward the end of this year or at the beginning of next year because it seems to me that it will not reach its target for inflation otherwise. In June the ECB lowered its forecast for inflation in the eurozone to just 1.4% in 2016, well below the official inflation target of just under 2%. But to achieve even that, the bank is using what I think are optimistic assumptions.

In the meantime, I think the way the ECB has begun to unwind the so-called "sterilizations" that began with the 2010–2012 Securities Markets Programme (SMP) amounts to QE in everything but name. I also think that, taken together with other liquidity-enhancing policy measures it adopted in June, this could potentially have a significant impact on Europe's economy.

ECB Boosts Money Supply

When the ECB began the SMP in May 2010, it purchased assets including the government bonds of Greece, Ireland, Portugal, Spain and Italy. It then borrowed back from the banks the money it used to purchase them, effectively keeping the money supply stable. Even though the last SMP purchases took place in February 2012 and the program was terminated in September 2012, the sterilizations continued until June's announcement.

However, in the week after the bank confirmed its intention to halt further sterilization purchases, it borrowed only about €100 billion rather than the roughly €160 billion[2] that would have been required to cover its purchases, thereby increasing the amount of money in the system and making additional liquidity available to the banks. This was effectively QE, with the difference being that rather than printing money to buy bonds, the ECB bought the bonds between 2010 and 2012 and then years later printed the money.

The important policy point is that the ECB has shown that it can do QE if need be and this potentially opens the door to the central bank doing it again in a more direct way. I think this was why bond markets, particularly in peripheral Europe, responded so positively. Over the two days that followed the ECB announcements, government bond yields in the five- to 10-year in both Italy and Spain declined about 50 basis points each.[3]

TLTRO Helps Focus Lending

Other measures that stand to have a real impact on Europe's economy include the Targeted Longer-Term Refinancing Operations (TLTRO). These are designed to help boost bank lending to Europe's non-financial private sector over the next two years by making about €400 billion of loans available at very low fixed rates.

That's a good start, I believe, in terms of bringing liquidity to bank balance sheets because these measures should encourage lending in those parts of Europe where it is needed most. Equally encouraging was the ECB's indication that it could continue to conduct these kinds of auctions on a regular basis. So it has set the stage to do TLTROs in the future—potentially as often as quarterly—thereby continuing to support bank balance sheets and thus, banks' ability to lend.

I'm also encouraged by the ECB's acceleration of plans to make outright purchases of certain asset-backed securities (ABS). While in other markets such as the United States, these kinds of financial securities backed by receivables from pooled assets are held by a broad range of investors, ABS in Europe are relatively insignificant outside of the banking system. So for the ECB to purchase ABS outright from banks is another way to increase liquidity on their balance sheets and therefore encourage lending.

Value in Peripheral Bonds

I wouldn't want to understate the daunting task of economic reform that many countries in Europe continue to face, and there will be bumps along the way as countries work through particular issues that come up.

Yet, I believe there is value to be found in European bonds. We think, for example, that peripheral eurozone countries such as Spain and Italy continue to offer value in the five- to 10-year part of the curve, particularly in relation to Europe's core markets in Germany and

France, because these have already seen yields decline quite significantly.[4] German 10-year Bunds are currently yielding 1.18%,[5] so we wonder whether buying bonds when yields are approaching 1% makes sense as an investment, so we are looking to other high-yielding government bonds right now.

But overall, when you look at all of the factors that are present in the region—very low growth with low to no inflation and a central bank that is implementing very accommodative monetary policies—I think European fixed income has the potential to perform well.

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Franklin Global Government Bond Fund

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1. As of 6/30/14, Franklin Global Government Bond Fund geographic breakdown: EMU 32.95%; North America 20.77%; Europe/Non-EMU 12.67%; Asia 11.82%; Latin America/Caribbean 7.75%; Australia/NZL 5.57%; Africa 1.60%. Holdings subject to change.

2. Source: European Central Bank, June 2014.

3. Source: Bloomberg LP, as of July 25, 2014.

4. Source: As of 6/30/14, Italian government bond holdings represent 15.23% and Spanish government bond holdings represent 4.49% of total net assets of Franklin Government Bond Fund. Holdings subject to change.

5. Source: Bloomberg LP, as of July 25, 2014.

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