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Why ECB Tapering Could Prompt a Change in Bond-Market Philosophy

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Speculation had been rife that the European Central Bank might have used its September Governing Council meeting to signal the start of tapering for its quantitative easing program. That confirmation didn't come, switching attention to the October 26 meeting. Here, Franklin Templeton Fixed Income Group's Head of European Fixed Income, David Zahn, explains how he thinks markets will react once the announcement is made and how it could lead to a change in bond-market philosophy.

Markets had been on tenterhooks ahead of the September meeting of the European Central Bank's (ECB) Governing Council. They were anxious to see whether ECB President Mario Draghi would confirm what most observers, including us, already expect: eurozone quantitative easing (QE) would begin tapering in 2018.

In the end there was no specific guidance on tapering, which leads us to believe that an announcement will be made at the October 26 meeting. After that date, there is only one more scheduled meeting before the QE program is scheduled to end, and the ECB has generally tended to flag its intentions well in advance.

In general we'd expect bond markets to be quite relaxed with this outcome.

We know tapering is eventually coming, but don't yet know the scale or timetable, so absent any details, we don't expect bonds to move that much in the aftermath of Thursday's meeting.

While we think it would be better to confirm sooner that tapering will begin in 2018 because markets are set up for it, in reality there's no rush for the ECB to announce its tapering plans.

Eurozone Growth Has Momentum

The eurozone economy is doing very well in our eyes. Economic growth is above 2%, the euro has come back to reasonable levels and there's momentum behind the eurozone which we think makes its trajectory sustainable.

Eurozone economic growth is mainly driven by domestic consumption, which is traditionally more durable than export growth. As a result, the eurozone is not overly dependent on the level of its currency to drive marginal export growth. That makes the recovery robust, in our view.

The shrinking number of bonds available to purchase is another important factor which we think should lead the ECB to pull the trigger on tapering, as the central bank is not permitted to own more than one third of any issue.

Inflation Target Remains Out of Reach

On the flip side, we have the ECB's lack of success in achieving its just-under 2% inflation target.

While some commentators may question whether the ECB should embark on tapering when it still doesn't see itself hitting its inflation target within its time horizon, I would say that's exactly what the central bank should do.

Its other plans are working. Tapering wouldn't mean it has to raise interest rates in the near future. Indeed, we don't think ECB President Mario Draghi will hike interest rates during his current tenure, which lasts until 2019.

However, we do think there is scope to scale back monetary policy from "extremely accommodative" to "very accommodative".

Modest Kneejerk Likely Response to an Announcement

When the ECB does announce its tapering intentions, we'd expect to see the knee-jerk reaction of a sell-off, particularly in the periphery where the ECB has been a big buyer.

On the other hand, we don't foresee a major cathartic sell-off, rather something more modest, coupled with the likely strengthening of the euro slightly.

Announcement Could Prompt a Change in Philosophy

Whenever the ECB confirmation comes, a more significant outcome could be a possible change to the bond market's current philosophy of buying on a sell-off.

Currently, when there's a sell-off in bond markets, and subsequent spike in yields, buyers flood in knowing the ECB is there with a mandate to buy €60 billion of bonds a month, and yields go down.

Once that big buyer isn't there, or once it's clear they're going, that may change.

Impact Could Be Felt More Widely

When it comes, the ECB tapering announcement could also have an impact outside the eurozone, as the ECB is a huge provider of liquidity for global markets at the moment.

And, it's one of the few central banks undertaking a big QE program. That could put pressure on some other areas of the world for bond yields to rise—notably the United States and United Kingdom—but again, not dramatically, in our view.

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