FIXED INCOME

Italian Election Outlook and Why We Don’t See an ECB Rate Hike Before 2020

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The upcoming Italian election is not attracting the same sort of attention among investors as votes last year in France and Germany. For that very reason, David Zahn, Franklin Templeton’s head of European Fixed Income, believes an unexpected result might provoke an outsized market reaction. And while investors seem more preoccupied with the trajectory of eurozone monetary policy, Zahn believes there are good reasons to think the European Central Bank will hold off until 2020 before pushing interest rates up.

Italian Political Uncertainty

Most polls suggest there will be no outright winner in the upcoming Italian general election, due to take place on March 4. We think the most likely outcome is either a technocrat government or a grand-coalition—neither of which we’d expect to have a dramatic impact on bond markets.

However, it could be a different story if one group were to win enough seats to form a government, particularly if that group was the coalition of center-right parties currently riding high in the polls.

The final opinion polls published ahead of the election suggest the coalition of center-right parties (that includes the Silvio Berlusconi-led Forza Italia) could win the most seats. In contrast to traditional center-right dogma, the Berlusconi coalition’s manifesto calls for increased spending and a larger Italian budget.

It currently looks unlikely to reach enough seats to win an absolute majority, but if it did creep over the line, that outcome could have negative repercussions on Italian debt. The country’s central bank would likely be issuing more government bonds (BTPs) at a time when one of the biggest buyers, the European Central Bank (ECB), is scaling back its purchases of government debt.

Modest Volatility and Rising Yields in Europe

Looking more widely, we’ve seen little evidence so far that contagion from the global equity pullback at the beginning of February has spread into fixed income markets.

In European corporate markets, there’s been some modest volatility (more at the index level) and we’ve seen some spread-widening, but nothing that’s overly concerning to us.

European sovereign bond yields are higher this year and have risen a little more quickly than we expected. We felt they would rise in time, but while economic growth has been strong in Europe, inflation remains quite low. However, there are some signs of higher inflation coming through in the data.

European Central Bank (ECB) President Mario Draghi has indicated that keeping eurozone inflation just below 2% is a long-term target. This implies the ECB could be comfortable with inflation rising above 2% for a short period of time.

So our feeling is the bank's governing council will want to see inflation rising higher before it considers less-accommodative monetary policy.

Our current assumption is that eurozone quantitative easing (QE) will continue into next year and that the ECB will likely aim for its first interest-rate hike in 2020.

However, markets are starting to price in hikes even sooner. That's probably partially because some investors have been expecting yields to increase for quite some time. Understandably, people want to make sure they don't miss out, but we think the market is getting a little bit carried away.

Positive Fundamentals

In general, we think the underlying fundamentals for both investment-grade and high-yield corporate credit in Europe remain positive.

European companies in general appear to have good balance sheets and borrowing rates are low. At the same time, there's some inflation coming back into the system in Europe, so companies are able to pass through price increases to customers. We see all of this as positive for corporate bonds in the region.

However, we think some valuations on the credit side have become slightly stretched. The widening spreads on the credit side may reflect a normalization to compensate for some of the risk investors are taking.

While we recognize that the uptick in equity-market volatility may have contributed to the stretched credit valuations, uncertainty over the ECB's monetary policy path seems to also be playing a role. In particular, investors are watching for clues as to the timing and size of the ECB's QE tapering.

The current QE program is due to expire in September of this year, and we think it's unlikely the ECB would end it abruptly then. So we think an extension, possibly featuring further tapering, is likely. That said, we don't expect the ECB to make an announcement about its tapering plans until at least the summer.

Draghi has indicated any decision on the future of QE would be driven by data. Waiting until the summer would give the central bank policymakers more data to consider. Meanwhile, our analysis suggests other considerations could affect the timing of interest-rate hikes.

The ECB has previously indicated that it wouldn't hike rates immediately after ending the QE asset purchase program. Assuming the ECB extends the program into early 2019, a moratorium of six to nine months would take us very close to the end of Draghi's tenure as ECB president.

We think it's likely the ECB would delay an interest-rate hike until the arrival of a new ECB president, which in practical terms pushes the first rate hike into early 2020.

We've been monitoring the ECB's buying habits since it cut the size of its asset-purchasing program from €60 billion a month to €30 billion a month starting in January 2018. Although the total monthly purchases have halved, the amount of non-government assets bought—including covered bonds or corporates—has dropped only slightly from €10 billion a month to around €8-9 billion a month.

So, government bonds have felt the bulk of the reduction in purchases. If QE continues into 2019 as we expect, it should likely remain focused on private assets.

Short Bouts of Volatility Likely

We reckon the low volatility in European fixed income markets we've seen over the last 12–18 months is probably behind us.

Although we don't think we're heading into a period of a high volatility, we think investors should accept there will likely be short bouts of it. We consider volatility an opportunity to invest if we see spreads widening on names that we think are solid.

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