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# ECB Preview: Will Recent Italian Developments Influence Europe's Tapering Timeline?

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The future of the European Central Bank's three-year-old quantitative easing program lies in the balance. Will the bank's governing council use its scheduled June meeting to extend the program or confirm that asset purchases will end in September? David Zahn, Franklin Templeton's head of European Fixed Income, believes recent European economic data and political developments in Italy point towards an extension. And he argues that means eurozone interest-rate hikes are unlikely before 2020.

The European Central Bank (ECB) started its quantitative easing (QE) program in March 2015, and later this month we finally expect some concrete details on a timeline for wrapping it up.

Officially, QE is due to end in September this year, but with eurozone growth data softer recently and inflation also relatively muted, we think it would be premature for the ECB to embark on a tightening cycle.

So our expectation is that current ECB President Mario Draghi will extend the asset-buying program at least to the end of this year and most likely into 2019.

With further tapering possible, we believe the purchase program will lean even more towards private assets, such as corporate bonds, as the ECB continues down the path of reducing government bond buying.

A continued focus on corporate bonds should also help maintain narrow credit spreads, while government purchases can continue to be reduced.

## Italian Situation Adds to Europe's Risk Premia

Meanwhile, political developments in Italy, in particular, have contributed to a general widening of risk premia in Europe.

Since the League and Five Star Movement have successfully formed a government, we expect a loosening of purse strings in Italy. The bond market has already reacted negatively to this possibility. But we don't think this is a systemic issue; rather, it's a case of assessing what risk premia should be added to Italy given its likely new fiscal focus.

The Italian bond market sold off quite considerably amid political turmoil in Italy at the end of May, but in our view the economic fundamentals remain unchanged. Despite concerns around what the government will look like, we believe the situation is very country specific. If this were an existential risk with a real chance of Italy leaving the European Union (EU), then we would likely see the euro under pressure, along with Spanish and French bonds.

In our view, a lot of the recent market anxiety has been driven by positioning, as investors have capitulated out of Italian bonds. Now, we are seeing a return to normality. This also means there will likely be a lot more volatility in Italian spreads, as well as European fixed income in general, because this situation opens up the question of whether there will be reforms in Europe. A risk premium will now be built in, which we view as positive.

The turmoil in Italy is another wake-up call for Brussels, in our view. First, the United Kingdom wanted to leave the EU, and now Italy has stated it wants adjustments made to the relationship. It's important to note that the Five Star and League parties were elected not for anti-euro reasons, but to push for reforms in Europe. So, it's likely we will see a change to Italy's relationship with Europe in the future.

We anticipate all these considerations will affect the ECB discussions at its meeting on June 14 and will likely encourage its decision to keep QE options open. With growth continuing to slow, inflation still low and now political risk in the eurozone, we believe it's unlikely the ECB will stop QE until there is some resolution.

Thus, the recent flare-up in Italy only reinforces our view that the ECB will extend the asset-buying program into 2019. And, we think the likelihood of rate hikes is now pushed out much further into the future.

It's much easier for the ECB to adapt (grow or reduce) an existing QE program than to restart an expired program.

So, we think ECB President Mario Draghi would rather keep the current QE program running at a low level, until there is more data on the impact of political developments in Italy.

However, we expect the ECB governing council to use the June meeting to be more explicit about its timeline for raising interest rates after the QE program ends.

As we've [explained before](#), if it pushes QE past the end of the year, as we expect, it's difficult to see interest rate hikes in the eurozone before 2020.

## Questions over Draghi's Successor

Draghi's stint as ECB president expires in November 2019, and we're already starting to see discussions about the possible candidates to replace him. We expect that speculation to intensify towards the end of the year.

The two leading candidates currently seem to be Bundesbank Chief Jens Weidmann and outgoing Bank of Finland Governor Erkki Liikanen. We'd expect both of them to lean towards a less loose monetary policy than there has been in the past.

But given the current environment, Draghi would probably not want to commit them to any rate-hiking cycle until they're in situ in the fourth quarter of next year.

## Italian Bonds: Are They Interesting Again?

Italian bonds are in the area where they're interesting again. They seem to be offering quite a bit of extra yield, albeit it for taking a bit of extra risk.

The market will need to see more details of the government—who the ministers are and what the fiscal plan is—before we can become too focused on exactly what level of premium should be put on Italian bonds.

We think whispering about avenues for removing Italy from the euro is just noise for domestic consumption at the moment and we don't expect that to develop into action in the short term.

However, recent developments indicate populism is still very much alive in Europe. While it has been pushed back in some countries, it has come back to the forefront in Italy and is an ongoing trend across Europe. What the euro area needs now, in our view, is a program of adjustment or reforms that could accommodate solutions to the concerns driving populist sentiment.

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