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# Why ECB Tapering Expectations May Be Premature

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Matthias Hoppe
Senior Vice President, Portfolio Manager
Franklin Templeton Multi-Asset Solutions

Recent upbeat comments from European Central Bank President Mario Draghi prompted an immediate reaction from global financial markets, which appeared to sense early signs of a change in approach from monetary policymakers. However, Matthias Hoppe, senior vice president and portfolio manager, Franklin Templeton Multi-Asset Solutions, warns of reading too much into Draghi's words and suggests investors should take a more nuanced approach.

Financial markets across Europe and beyond seem to have taken upbeat comments from European Central Bank (ECB) President Mario Draghi late last month as evidence that the end may be in sight for accommodative monetary policy in the region.

Our view is more nuanced, and we think some of the reaction to Draghi's comments may have been premature.

In particular, although the ECB may reduce the pace of its bond buying when it reviews the practice at the end of 2017, we do not expect an imminent change in interest rates, nor a formal "taper"—which implies a defined end point for the €60 billion per month bond-purchasing programme.

Draghi's comments, delivered on 27 June during an introductory speech at the ECB Forum on Central Banking in Sintra, Portugal, appeared to paint an optimistic view of the eurozone's economy.

Markets took his upbeat assessment literally and raised speculation that the ECB may be moving towards tapering, or scheduling an exit from its asset-purchase programme, by early 2018.

In the four days immediately after the speech, the euro appreciated more than 2% versus the US dollar. Eurozone bond yields moved up sharply, with French government bonds leading the correction, rising the most in almost seven months. In Germany, the two-year government bond yield climbed while the 10-year bond yield surged even more, resulting in a steeper yield curve.

In our view, the market's reaction to Draghi's comments may have overplayed the ECB president's optimism.

While we recognise that recent economic data have been mostly positive and political risks have dissipated after the French and Dutch elections, we think recent inflation prints have been disappointing in both the eurozone and the United States.

Furthermore, the market continued to dampen down inflation expectations, including by lowering medium-term inflation breakeven rates in recent weeks.

Thus we think any action the ECB takes will be gradual and cautious. And in fact, reading through the text of Draghi's speech, we think he sounded a lot less upbeat on inflation than some commentators have suggested.

Draghi noted that the transmission mechanism of strengthening demand to rising inflation has been more restrained than in past cycles. Three reasons for this were offered by Draghi: external shocks to prices, the size of the output gap and its impact on inflation, and the extent to which current inflation feeds into price and wage-setting.

According to Draghi, while the threat of deflation may have diminished, oil and commodity prices haven't fully recovered from the collapse in 2014 and 2015 and are still having a negative effect on inflation. There continues to be a lack of a clear upward price trend.

The second thing weighing on inflation is the unclear connection between the size of the output gap (the amount by which the actual output of an economy falls short of its potential output) and its impact on inflation. Increased labour force participation on one hand, and companies' absorption of input costs through lower margins on the other hand, could be part of the reason.

Finally, a persistent period of low inflation is feeding into the price- and wage-setting process in a more tenacious way, according to Draghi. He cites Italy as example of what he calls "backward-looking indexation of wages," which now covers around one-third of private sector employees there.

Against this background, Draghi insisted in his speech that the ECB "needs to be persistent" and needs to ensure that overall financing conditions continue to support the reflationary process until conditions are "more durable and self-sustaining." This message was consistent with the press briefing given by Draghi after the June meeting of the ECB's governing council.

Thus we think the market appears to have over-reacted. While we'd expect the euro should strengthen when interest-rate differentials start to narrow between US Treasuries and German Bunds, the recent move seems to us to have been too fast.

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