FIXED INCOME

ECB Meeting: Fresh Clarity, But Let's Not Get Ahead of Ourselves

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David Zahn, CFA, FRM
Head of European Fixed Income,
Senior Vice President,
Franklin Templeton Fixed Income Group

The European Central Bank's June meeting has offered some long-hoped-for clarity on the future direction of monetary policy in the eurozone. However, it hasn't provided all the answers, and much remains open to interpretation. David Zahn, Franklin Templeton's head of European Fixed Income, considers what might happen next and explains why he's still not expecting a eurozone interest-rate hike before 2020.

As we expected, the European Central Bank (ECB) has extended its quantitative easing (QE) programme—which was due to expire in September—until the end of 2018. But while the bank's post-meeting communique offers some fresh clarity, we think much remains open to interpretation.

In the short term, however, we see the extra clarity as positive. In the lead-up to the June meeting, European bond yields had risen sharply, apparently in expectation of an earlier end to QE and a resultant reduction in bond market liquidity.

When Will Interest Rates Start to Rise?

Ahead of the meeting, speculation had also intensified around the timing of potential interest-rate hikes in the eurozone.

Neither the official post-meeting communique nor ECB President Mario Draghi's press conference offered any explicit guidance on the exact timing.

However, the central bank did indicate it would expect a gap of at least two quarters between the end of the QE programme and the first eurozone interest-rate hike. That would suggest the summer of 2019 as the earliest time for a rate hike.

Although we now know that QE is scheduled to end under Draghi's watch, we think the ECB could wait a little longer before starting to raise interest rates.

With Draghi's term of office due to expire at the end of October 2019, we feel the ECB is unlikely to start increasing interest rates until the new ECB president is firmly in place.

If Draghi were to set the ECB on a tightening path, we think it would constrain whoever succeeded him. In our experience, central bankers in general don't like to prescribe what path their successors should follow.

No Need to Rush to Act, in Our View

We think there's no reason for the ECB to rush and bring its accommodative policy to a swift end.

Given that eurozone inflation remains very low, we believe the bank will want to remain accommodative.

If the ECB tightens quickly and the economy were to slow, that could exacerbate the slowing. Whereas if it proceeded more slowly, and the economy were to pick up, the bank can easily accelerate its rate hikes.

The ECB's target is to have inflation just below 2% over the long term. Under previous ECB President Jean-Claude Trichet, who served between 2003 and 2011, eurozone inflation went significantly above 2% in the short term, but it averaged out just below 2%.

Draghi's tenure has seen both deflation and a sustained period of low inflation, so we think the ECB would be comfortable with slightly higher inflation to bring the long-term average nearer its target.

There also continues to be political uncertainty across the region that we think will be factored into markets.

The ECB has insisted publicly that political events would not dictate its action, but we think it might have taken a different view if recent political turmoil in Italy or Spain had exacerbated, and yields on peripheral eurozone bonds had spiked.

Reinvestments of Maturities

The ECB intends to continue to reinvest maturing assets which should maintain liquidity in the market. That, in turn, should keep the longer end of the yield curve lower than one might expect for now.

And, we think that reinvestment process could continue for some time. If the bank follows the model of the United States, we'd expect it to start tightening before beginning to reduce the size of its balance sheet.

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