Our Take on 5 Key Things Happening in the Euro Area and UK

By Laura Sarlo, CFA, VP, Senior Sovereign Analyst

1) ECB meeting and QE taper

- The European Central Bank's (ECB's) October 26 announcement was consistent with recent signals: asset purchases will continue past the December 2017 expiration, and the **pace will be reduced from €60 billion to €30 billion per month until September 2018. We continue to expect nearly all of the reduction will be in sovereign bonds.**
- There was **not much change in the ECB's forward guidance, but it was emphasized and the market perceived guidance as dovish.** Rates appear set to stay low until well past the end of the quantitative easing (QE) program, and the ECB pledged to increase the size or duration of QE if there's insufficient progress on inflation or if financial conditions tighten too much.
- Beginning November 6, the ECB will publish more information about its portfolio. Given that the ECB has been vague relative to other central banks about its securities portfolio, this new information will help market participants analyze the potential supply/demand balance in euro area bond markets **as we edge from negative net bond supply to private bondholders to positive net bond supply.**
- **With ECB President Draghi seemingly on track to engineer a dovish taper, there should be less rate pressure in Europe.** Earlier this year, euro area rate expectations jumped along with Federal Reserve rate hike expectations, but they are now more solidly anchored by the ECB's firm commitment to low rates for longer, as shown in the chart below. Draghi reiterated that the US is well ahead of the euro area in its cycle, so policies should be quite different.

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EURO AREA RATE EXPECTATIONS MORE SOLIDLY ANCHORED

Source: *Bloomberg, data as of October 26, 2017.*

Yields on US 12x18 month forward rate agreements[i] (Left hand scale)

Yields on euro area 12x18 month forward rate agreements (Right hand scale)

2) Run up to UK BOE's MPC on November 2

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- **We believe the market has gone too far in pricing two rate hikes from the Bank of England (BOE) over the next year.** This hinges on the Monetary Policy Committee's (MPC's) assessment of the potential growth rate for the economy. If the MPC thinks growth is structurally lower, then the economy looks near full capacity, inflation pressures are building, and a hiking cycle seems warranted. If the MPC judges that potential growth is not too badly damaged, then the recent uptick in inflation should peak this quarter and modest economic slowing in coming quarters should require little policy change.
- **We are in the latter camp, and while we wouldn't favor a hike on November 2, we see scope for the BOE to reverse the post-Brexit "emergency" rate cut last summer and then move to the sidelines.**

3) Catalonia crisis

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- **Catalonia's parliament voted to declare independence on October 27.** Spain will implement Article 155 of its constitution for the first time, revoking all authority from the regional Catalonian government and centralizing powers in Madrid. While the Spanish government already pared next year's growth forecast from 2.9% to 2.6% due to Catalonia, 2018 forecasts are likely to see further downward revisions given the crisis.
- Before the vote, a negotiated settlement and a revised funding formula to change how tax revenues are distributed between the central and regional governments was the most logical resolution to the tensions between Catalonia and the Spanish government. But it's hard to see the path toward that now.
- **This crisis is the most serious test of Spanish civil institutions and the 1978 constitution, but capital markets are proving rather immune**. Spanish-German government bond spreads are well within recent ranges, and Catalonia June 2018 bonds are still trading above par. There's been somewhat more impact on Spanish stocks, which are down about 2% since early September while euro area stocks are up around 4%.

4) Italian electoral law

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- **Italian parliament has passed a new electoral law** that moves Italy from a fully proportional system to a mixed system: 2/3 proportional representation, 1/3 first-past-the-post representation. The new law was necessary after electoral reform failed via referendum under former Prime Minister Renzi. The law faced its staunchest opposition from the smallest parties, who are likely most hurt by the changes.
- **We still think the next election (due by May, might be held in March) will likely produce a weak coalition government with no mandate for meaningful reform.** This would keep the downward pressure on Italy's credit ratings, making us cautious on Italian government bonds. (Recall that the last Italian election, in February 2013, produced a hung parliament that took four months to resolve and widened the Italian-German 10-year spread by 100 basis points.)

- Polls show three blocs (including the Five Star party, a coalition of center-right parties, and the center-left Partito Democratico currently governing Italy) running pretty evenly.
- **The downside risk scenario, and potential for greatest market stress, would be an anti-euro coalition government** comprised of the Five Star party and parts of the center-right. Silvio Berlusconi may (again) prove the kingmaker in Italy.

5) Europe's mounting east-west stress

"The east-west schism is a building challenge for EU institutions."

- **The October election results from the Czech Republic and Austria are important developments**. The populist/nationalist politics seen across central Europe (Poland, Hungary, now the Czech Republic) will have a more sympathetic ear in the euro area in Austria's likely new prime minister, Sebastian Kurz. EU management of immigration is a key issue. The stress between staunchly pro-EU governments in Berlin and Paris and the leaders in central Europe will **get trickier under the new Austrian government**. The east-west schism is a building challenge for EU institutions.

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Endnotes

[i] *A 12x18 month forward rate agreement is an interest rate derivative that is effective 12 months from the issue date and terminates 18 months after the issue date.*

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