

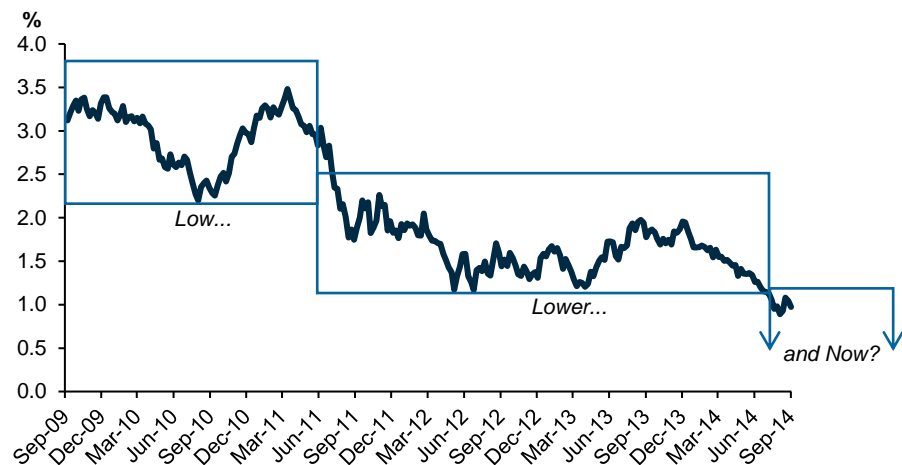


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Europe: Into the Void

Over the last 12 months, core European government bond yields tumbled from over 2% to below 1%, while European peripheral yields declined by even more, continuing their re-convergence with core country yields. This brief paper provides some perspective on these watershed shifts in valuation, their probable causes, as well as what's likely to come next.

Core European Bond Yields Fell Due to the Flagging Economic Outlook, Below Target Inflation & Aggressive ECB Policy



Source: 10-year German Bund Yields via Bloomberg as of September 2014

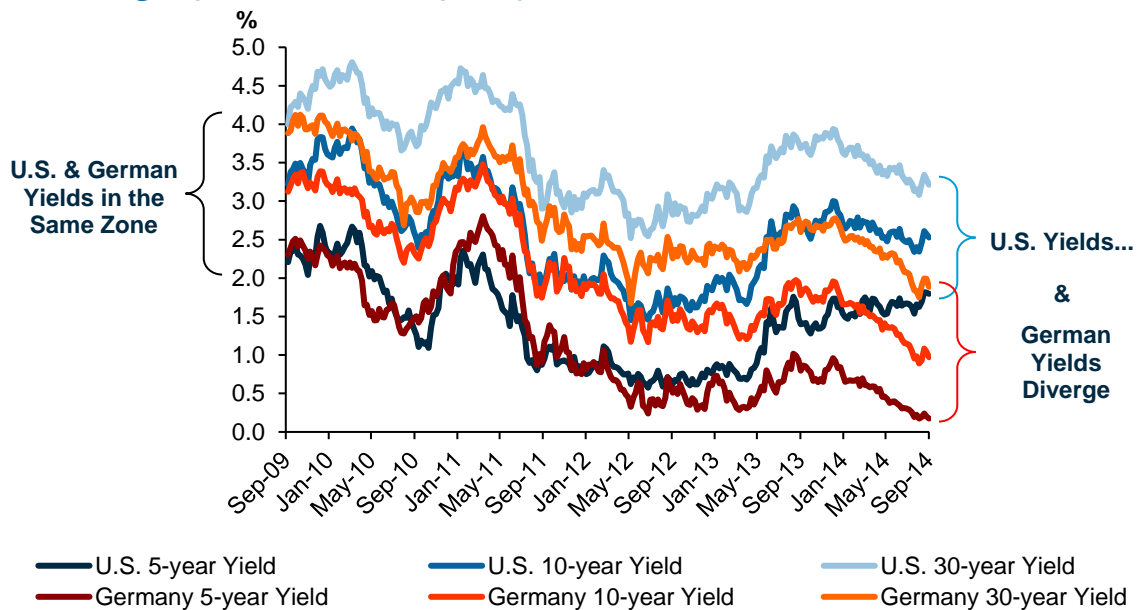
As the preceding chart shows, core European bond yields have dropped into a new realm—why? In contrast to expectations for eurozone growth to gain momentum this year, it has instead faltered. Furthermore, inflation in the eurozone has decelerated and, at less than 1%, is uncomfortably below target. Perhaps worse yet, some of the peripheral countries have not only seen growth disappoint, but have literally slid into mild deflation. And as for the prospects for improving European growth, the odds look long as geopolitical risks emanating from the Ukraine situation may very well dampen confidence and economic activity in the months ahead. Thus, geopolitics



complement the existing list of daunting headwinds that are led by fiscal consolidation and financial institution deleveraging.

Mario Draghi, President of the ECB, clearly depicted the gravity of the situation and the need for action in his recent Jackson Hole speech, which accelerated the nearly year-long rally in European bonds. Although yields rose a bit in the wake of the ECB's subsequent asset purchase plan and rate cut announcements, **ultimately, the slowing growth picture, combined with well below target inflation, is likely to keep core eurozone yields rangebound at very low levels—e.g., the 10-year bund closer to 1% than 2%—for the foreseeable future.**

G-3 Yields Regroup Part I: Core Europe Separates from the U.S.

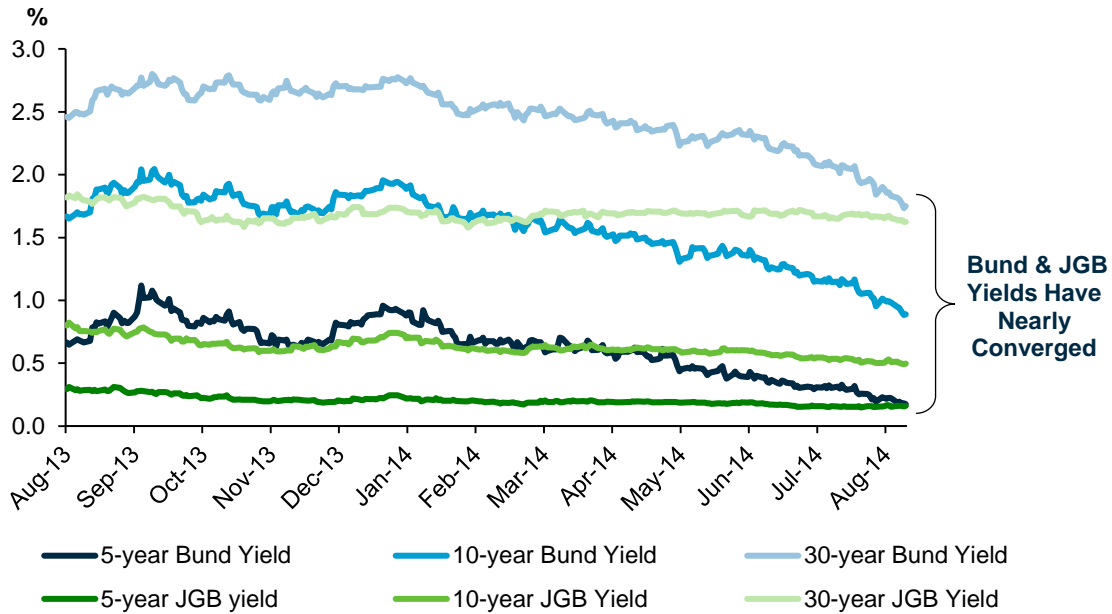


Source: Bloomberg as of September 2014

After sharing the same zip code for many years, core European government bond and U.S. Treasury yields have now diverged by over 100 bps across the curve. What's driving this divergence and will it persist?

With the rate of U.S. nominal growth looking set to continue at around 4% while Europe struggles to eke out 1% nominal growth, a wedge of roughly 3% has arisen between the two nominal growth rates. In the quarters ahead, the policies of the two central banks will head in diametrically opposed directions as the ECB moves towards a more aggressively accommodative policy, including asset purchases, term financing, and negative interest rates on excess reserves. In contrast, the Fed continues to wind down its asset purchases and clear the way to raise rates next year. **Between the differential in nominal growth rates and the divergence in monetary policy, a gap between European and U.S. rates of at least 50-150 bps across much of the yield curve seems likely to persist for some time.**

G-3 Yields Regroup Part II: The European Core Joins Japan

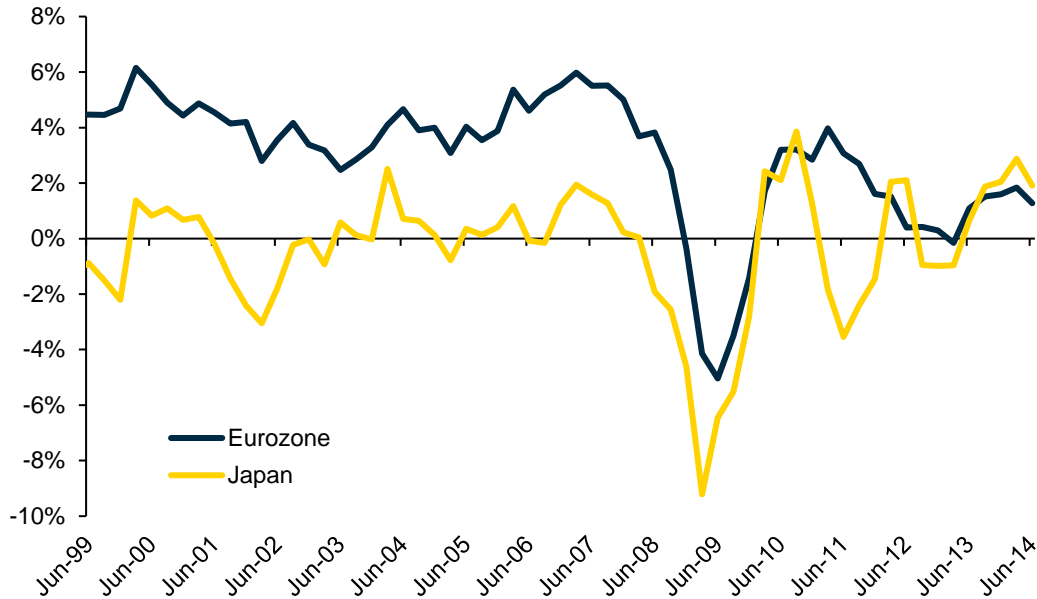


Source: Bloomberg as of September 2014.

While the situations in Europe and Japan have many differences, some subtle and some not, certain key common characteristics that are conducive to low yields are likely to be in place for a prolonged period. Perhaps the key difference is the current bounce in Japan's rate of nominal GDP. This is partly owed to the significant depreciation of the yen, resulting from a combination of aggressive quantitative easing and a stark deterioration in Japan's trade deficit in the wake of the Fukushima disaster. In addition to the recent consumption tax hike, these events have resulted in a largely temporary increase in the rate of inflation.

Meanwhile, growth has accelerated on optimism over Abenomics, fiscal stimulus, and demand that was pulled forward before the consumption tax hike. Given the demographic headwinds and the fiscal tightening scheduled to take place over the next decade, however, most of these recent gains in growth and inflation are, unfortunately, probably temporary. **And so in pricing JGBs, the market is largely looking through the current pop in nominal GDP and seeing an economic horizon similar to that in the eurozone, which begets ultra-low, long-term interest rates. Namely, an aggressively accommodative central bank policy that is characterized by a low central bank target rate and long-term asset purchases, coupled with an economic backdrop that is characterized by low nominal growth as a result of headwinds coming from fiscal tightening, ageing demographics, and the need for structural reforms.**

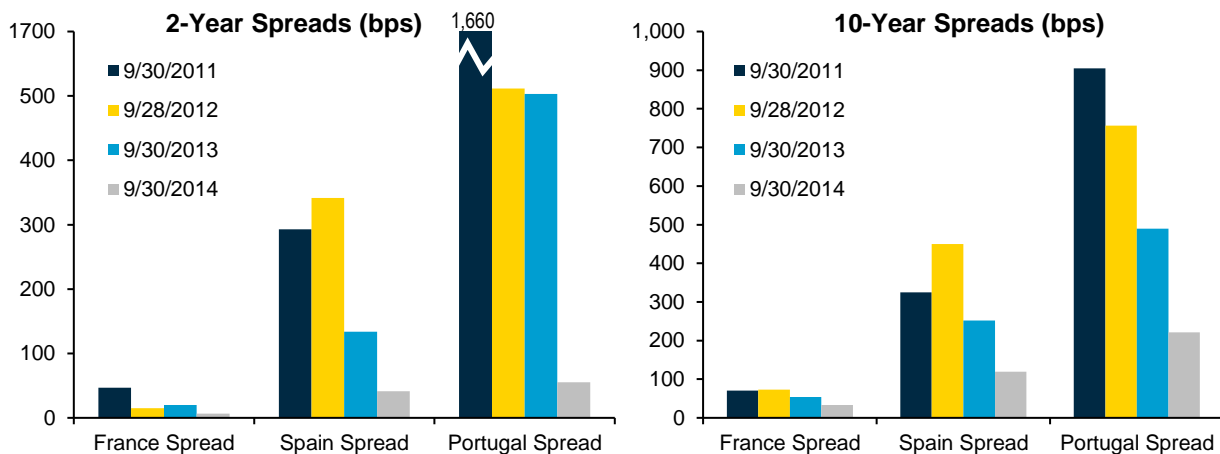
Similar Nominal GDP Pictures for Japan and the Eurozone (YoY)



Source: Bloomberg as of September 2014

European Peripheral Spreads Continue to Re-converge

Without a doubt, the periphery’s drop-off in growth and, in some cases, slide into mild deflation in recent months and quarters has been a significant fundamental setback. It has confounded their efforts to trim their budget deficits and stem the slide in their credit metrics, while also increasing the domestic political hurdles to implementing painful structural reforms. In the face of fundamental credit deterioration, however, spreads have continued to tighten. Why?



Source: Bloomberg as of September 2014

Kicked off by the assurances of the ECB in 2012, fiscal commitments, and various support mechanisms, the recent tightening of peripheral yield spreads is perhaps best seen as a continuation of the trend in place since mid-2012. Initially inspired in July 2012 by the famous

Draghi quote: “believe me, it will be enough,” the combination of fiscal commitments made by European governments and the subsequently announced support mechanisms, such as the OMT program, have triggered a fairly steady tightening trend in peripheral spreads.¹ Another factor that may have contributed to the trend on the margin is the eurozone's mid-2013 ratings agency reset, after which peripheral ratings have stabilized.²

So in short, with a strong perception of ECB support and stability on the ratings front, faced with falling yields on core European bonds and low cash rates, investors have been increasingly drawn to peripheral debt. They appear to have turned a blind eye to the challenged fundamentals, instead focusing on the prospects for incremental yield and possibly even capital appreciation from further spread contraction.

Does this Mean the Peripherals' Credit Problems are Behind Us?

While the market environment described above may keep peripheral spreads narrowing over the near to intermediate term, over the long term, fundamentals at some point will once again move to the fore. While lower interest rates may help reduce their financing costs and boost growth in the interim, low rates are not a substitute where structural reforms and long-term fiscal stabilization programs are needed. Although it varies country to country, ultimately, peripheral countries still have much work ahead to boost growth through structural reforms and to ensure their fiscal situations are on a sustainable path.

Conclusion

The past two years have been a watershed period for the eurozone government bond markets. Core European government bonds yields have left the realm of U.S. rates and instead have joined the ultra-low yield territory occupied by Japanese government bonds. Given the economic fundamental and monetary policy backdrop, this new configuration is likely to persist for quarters, if not years, to come.

Meanwhile, with negative cash rates and rock bottom yields on core European governments and the current stabilization of peripheral credit ratings, investors have seemingly pushed aside concerns about peripheral credit risk, fueling a massive compression in yield spreads. While fundamentals will eventually reassert themselves, over the interim, the search for yield is likely to further compress peripheral spreads, particularly while ECB policy remains aggressively accommodative.

¹ OMT refers to Outright Monetary Transactions.

² “Stricter Rules for Credit Rating Agencies to Enter into Force,” European Commission, June 18, 2013.

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