MARKET FLASH

A change in tone from the ECB : how will the latest moves impact fixed income markets ?

Mario Draghi provides himself with the means required

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The European Central Bank has changed its tone.

At its meeting on the 4th of September, the ECB clearly opted for a weaker euro in order to revive growth in the euro zone. Cutting the refi rate to 0.05% will cause the monetary rate curve to flatten-out and increase the bank's balance sheet to € 1,000bn, according to objectives defined by Mario Draghi, reducing the appeal of the euro, whilst boosting the competitiveness of the euro zone.

He has durably lowered expectations regarding monetary policy by warning that ECB rates will not be able to fall any further and stressing that they shall remain at this level for a very long time. This is an essential choice, bucking the trend which the Bank of England and the Fed may adopt during 2015. The ECB has deliberately aimed for the longer term, which marks it clearly apart from the other central banks.

The spectre of deflation

This monetary policy option reflects the incapacity of the euro zone to spontaneously revive more autonomous growth. At its press conferences over the past few months, the ECB president has explained that the risks threatening growth stem primarily from insufficient domestic demand. He wishes to create an external stimulus to reinvigorate it.

This change in strategy was all the more important as the ECB is now concerned by a new risk linked to the low level of inflation. Until now, the ECB president has indicated at his press conferences that inflationary expectations were firmly anchored and that consequently, there was a lower risk of seeing the inflation rate diverge durably from the 2% target defined by the ECB. If these expectations are no longer as firmly anchored as Mario Draghi has indicated, it would also suggest that convergence towards this target is no longer as certain.

A broad range of instruments prepared since June

The ECB therefore has to adopt unconventional means to remedy this perilous situation. As of June, at his monthly press conference on the 5th, Mario Draghi indicated a cut in ECB interest rates, to 0.15% for the refi rate, and the implementation of liquidity facility operations based on credit owned by the banks. This will exclusively be for loans granted to non-financial agents in the euro zone and will not concern housing financing. In the initial operations, this will represent 7% of the outstanding credit in question.

The objectives associated with these measures must be examined separately.

- The first aim was to reduce volatility in the euro zone monetary market. In addition to cutting interest rates, the ECB cancelled sterilisation measures within a portfolio of assets that it held (known as the SMP portfolio). The aim was to increase liquidity and therefore stabilise the monetary market. This was relatively successful.

- The second objective is to temporarily transfer the commercial banks' balance-sheet risk towards the ECB. These operations will be put in place on the 18th of September and the 11th of December 2014. They will have a final maturity date in December 2018. By reducing the banks' balance-sheet risk, the ECB aims to facilitate new corporate financing.

At **Jackson Hole**, in Wyoming, Mario Draghi's speech was notable in that he went a step further in his analysis than during the press conference on the 5th of June. It was here that he expressed his doubts regarding the anchoring of inflationary expectations and the necessity of acting collectively to restore more healthy growth momentum in the euro zone economy. In other words, he is concerned that he is unable, by the ECB's actions alone, to reduce the risk of deflation. For this reason, he called for a more accommodating budgetary policy, using all legal means (stability and growth pacts). As this is a question being asked at the level of the euro zone, he wished for a euro zone budgetary policy. In order to stimulate domestic demand, he also evoked the possibility of a public investment policy, echoing similar propositions made by Jean-Claude Juncker, the president of the European Commission. Beyond these short-term measures targeting companies, aiming to support demand, he also wished to modify business conditions over the medium term. The declared aim is to improve production conditions, adapt rules in an environment which has changed radically in order to revive a rate of growth which is more compatible with the need to create jobs.

The size of the ECB's balance sheet has been durably increased

Further to this indictment, and also out of necessity, Mario Draghi announced additional measures on the 4th of September based on the following rationale: the competitiveness of the euro zone must be enhanced in order to be able to benefit from increased production through external trade; once financing conditions have been improved, internal momentum can then take over and ultimately enable convergence towards a more robust growth trajectory. This is how the 0.1% increase to 1.9% in 2016 growth forecasts should be interpreted in my opinion.

These are original measures on two counts: firstly, clearly to render the euro less attractive by cutting interest rates (refi rate at 0.05%). This will reduce financial flows towards the euro zone and thus deflate the current account surplus. The other innovation is that the ECB now purchases and holds securities in order to durably expand its balance sheet. Operations implemented so far (various LTRO programmes) have been temporary, but this will no longer be the case for the ABS and covered bonds purchase operations which will be presented in detail at the ECB meeting on the 2nd of October. The creation of euros in counterparty for these asset purchases will also help drive the European currency lower. The Fed, the Bank of England and the Bank of Japan have durably increased the size of their balance sheets and the ECB now wishes to adopt the same strategy. One of the reasons is that the crisis is persisting and that temporary operations involve setting a timeframe at the outset, but without knowing whether the situation will be healthier at the end of these temporary operations. This criticism can be applied to the two operations launched in late 2011 and early 2012. Their duration was set at 3 years, establishing the hypothesis that, three years later, the crisis would be over. For part of its intervention, the ECB no longer wishes to be subject to these types of risk and constraints.

These broad-sweeping measures should reset the euro zone economy in a more favourable environment. Slow growth and very low inflation were not compatible with a high exchange rate. The ECB wished to remedy this imbalance. This must not prevent governments from taking an active role as defined at Jackson Hole by Mario Draghi in order to further support domestic demand.

In Wyoming, the ECB president also took a major step towards further federalism in order to instil a more coherent and better-coordinated dynamism within the euro zone. The issue at stake is to shift governmental decision-making centres towards a centralised body capable of implementing a unique budgetary policy. Beyond these technical factors, Mario Draghi is calling for a radical institutional change, which is necessary for the preservation of the euro zone.

What does ECB’s last week announcement imply for interest rate strategies ?

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Since the ECB announcement, the Euro reference curve has barely shifted. Although yields below 3 years are now clearly in negative territory, the market seemed more concerned in August when the 10-year German rate passed the 1% barrier and has stayed there. At that time, our central scenario incorporated lower yields, but not to the extent realized. Following this shift, Natixis AM reevaluated our year end 10-year Bund forecast, and we now consider it should evolve in a range from 1.25% to 2.00%, reflecting our view that current levels are overshooting and we should see a re-steepening in government yield curves between now and year end.

Since June, our interest rate strategies have maintained neutral to long duration posture, a view that has been rewarded since the start of the year. However, we remain more defensive than the consensus and prefer a neutral duration posture, because our reading of the BCE announcement still implies bearish risk for bonds as well. If the ECB strategy proves successful, growth and inflation expectations should improve, offering implicit support for subsequent rate increases. Moreover, we still think that rates could touch the higher end of this range toward the end of 2014 or later, as US yields should reflect anticipations for 2015 FOMC tightening by then.

Our sovereign strategies have benefited from long peripheral positioning over the year. Though current announcements only impact sovereign spreads indirectly, essentially, lower core rates imply more attractive carry in peripheral country spreads. This dynamic should contribute to further spread compression. For this reason, given the direction of peripheral spread tightening since the beginning of this year, we now expect Italian spreads to evolve between 1% and 2% compared to German rates. Spanish rates should remain within 0.9% to 2% above Germany. Our strategies thus remain overweight in peripherals.

Currency

The attractiveness of the Euro currency should decrease because of rate differentials with the US but also because of the BCE QE measures, equivalent to currency creation, at a moment where the US QE program is ending. A decline in the Euro currency vs. others should support economic activity lend support to export growth.

Inflation

Current market inflation expectations for Germany of 0.7% for five years and 1.26% for ten years, far below June levels, look even more attractive now in our view and justify a continued overweight or off-benchmark allocation to inflation-linked bonds in government and aggregate portfolios.

A reboot for credit

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The above measures, on top of the sharp decline in core and peripheral sovereign debt yields (German 5Y: 0.18%, Spain 5Y: 0.82%, as of 8/9/2014) should only amplify investors' search for yield in the coming months. As such, in relative terms, we still see credit as a favorable asset class. Investment grade credit currently yields about 1.19%[1], with a duration around 4. Granted, this is a historically low yield, but it corresponds to an attractive spread component of about 90bp vs. German government bonds.

Indeed, in the future, we expect that banks will further refinance through the TLTRO program, which implies lower bank debt issuance and an improvement in profitability. A more favorable environment for ABS should re-open the door to securitization as issuing ABS will allow banks to free up additional liquidity with the goal of increasing lending or other financing activities. Given this context, we overweight financials in the investment grade credit space for their compelling risk-return profile.

In particular, the ABS asset class stands to especially benefit from the ECB's announced ABS purchases. Issuers can capitalize on the current strong credit fundamentals and low default rates for European ABS, in particular for "plain vanilla" ABS which are highly granular. Securitization of the assets underlying these ABS, which include auto loans and mortgage loans, is intrinsically directed at stimulating the economy by lowering the cost of funding which in turn lowers the cost of credit. This asset class exhibits strong ratings (AAA) with relatively short maturities, which is of particular interest for insurers in the Solvency II framework. Moreover, the ECB has recently mentioned that European ABS' low default rates should justify a regulatory easing. With a supportive structure provided by the ECB, less punitive treatment for ABS compared to covered bonds or other credit asset classes would indeed further encourage a rebound in issuance for this asset class.

The High Yield asset class currently offers a yield of 4.3%[2] for a 3.40 year duration. Despite recent spread tightening, this asset class remains attractive for investors looking for yield. Moreover, company fundamentals are still robust; our expectation for average one-year default rates is still low at 2%.

Finally, convertible bonds also display a compelling risk-return profile, with both credit and equity components.

For credit in general, we remain constructive in the near term for technical and valuation reasons. Even though credit currently offers less compelling yields, we maintain a bias toward spread tightening while noting that the market may be prone to periodic corrections linked to systemic risk (central bank actions, geopolitical risks). In short, we expect the credit market to continue to perform going forward as it offers spread value and technical factors are supportive.

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[1] *Barclays Euro Aggregate Corporate index (as of September, 5 2014).*

[2] *BofA Merrill Lynch Euro High Yield index (as of September, 5 2014).*

Conclusion

For now, the market has incorporated this new information which is globally supportive of low rates and of further convergence of Euro area rates to the German benchmark. At this point it is still premature to separate the announcement effect from the actual impact of the programs the ECB has announced, beyond the clearly positive effect they are expected to have on peripheral country spreads and credit spreads in the near term.