THE ECB: MOVING THE GOALPOSTS OR REAL TAPERING?

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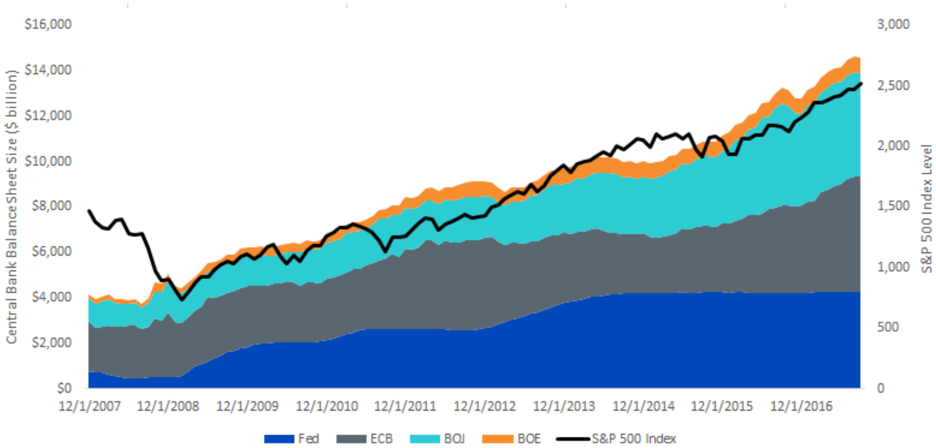
Is the "normalizing monetary policy musical chairs" trend now moving in the European Central Bank's (ECB) direction? The Federal Reserve (Fed) started the process in December 2015 by beginning to remove their zero interest rate policy and, more recently, took the next step in the process: paring down their balance sheet starting in October. The Bank of Canada joined the rate-hike party in July, while the Bank of England is widely expected to follow suit at one of their remaining two policy meetings in 2017. All eyes within the global financial markets are now on the ECB, and the question becomes: Is the result of the ECB's recent meeting the beginning of their normalizing process (tapering) or just an adjustment to their existing bond buying program (moving the goalposts)?

Heading into the most recent ECB convocation, comparisons were being made to the Fed's Ben Bernanke-induced taper tantrum here in the U.S. However, there are certainly a host of differences that stand out as the markets reacted to this announcement—namely, the level of the respective 10-Year yields. The U.S. Treasury 10-Year yield pre-taper tantrum in 2013 was 1.93%, while the German bund yield prior to the ECB's latest meeting was .47%. Perhaps the biggest difference between these two episodes is that when former Fed Chair, Bernanke first spoke of possible tapering in May 2013, it was widely unexpected (thus the negative reaction), while the ECB's decision was very much expected and became more a matter of what their tapering plan would look like, not *whether* it would scale back asset purchases.

Global Central Bank Balance Sheets



Source: Bloomberg, as of 9/30/17. The Bank of England stopped reporting full details of its balance sheet in 2014.
Past performance is not indicative of future results.

Prior to the October 26 meeting, the markets essentially were operating under three different possible scenarios (the current pace of buying is €60 billion/month through December 2017):

1. Pace reduced to €40 billion/month through December 2018.
2. Pace reduced to €30 billion/month through September 2018.
3. Pace reduced to €20 billion/month through June 2018.

Scenario #1 was expected to be viewed as a dovish outcome, with the 10-year bund yield either remaining unchanged or falling; Scenario #2 was viewed as more of a neutral event, with the 10-year bund being little changed; Scenario #3 was expected to be a hawkish development and the 10-year bund would sell off. In our opinion, the bottom line message is that despite this ECB decision, global central bank balance sheets (Fed included) are going to remain bloated for the foreseeable future, and in the case of the eurozone, this trend will continue to expand into next year.

In the end, the ECB decided on Scenario #2. Interestingly, the global bond markets went into the meeting expecting a bit more of a hawkish outcome. As a result, there was some knee-jerk buying in the German bund, but that was more of a relief rally. In addition, much like the Fed prior to its reinvestment pay-down plan, the ECB stated it will reinvest maturing debt for an extended period after quantitative easing (QE).

Thus, in aggregate, global balance sheets in the developed world for the four major central banks are still expanding, an important factor driving the appreciation of global equity markets. The quantitative tightening by the Fed continues to be more than offset by an expansion in the monetary base in Europe and Japan. Although the euro lost value in the immediate reaction versus the dollar and the yen, it will be interesting to see if the euro's impressive appreciation in 2017 versus the yen continues into 2018. European yields could begin to inch back up as U.S. rates creep higher. Given that the Bank of Japan (BOJ) is still pursuing its policy to suppress yields on Japanese government bonds, foreign bond purchases may become increasingly attractive to Japanese institutional investors. If the dollar and the euro appreciate relative to the yen, that could create advantages for Japanese exporters selling into Europe and for U.S. investors who invest in Japanese stocks.

Conclusion

The initial reaction for the U.S. dollar was to strengthen a bit versus the euro, as the worst fears were not realized. With respect to the yen, continued euro strengthening relative to the yen could be an additional catalyst for the bull market in Japanese stocks.

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DEFINITIONS

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Taper tantrum : a period in which global interest rates rose dramatically in 2013 as a response to a shift in monetary policy by the Federal Reserve.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

German bunds : A debt security issued by Germany's federal government, which is the German equivalent of a U.S. Treasury bond.

Dovish : Description used when stimulation of economic growth is the primary concern in setting monetary policy decisions.

German 10-year bund : a debt instrument issued by the German government with an original maturity of 10 years.

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

Eurozone (EZ) : Consists of the following 18 countries that have adopted the euro as their currency: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain (source: European Central Bank, 2014).

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Bullish : a position that benefits when asset prices rise.