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# Eurozone Debt: Can the rally continue?

At the beginning of the year, markets had taken the view that 2014 was going to be a difficult year for bonds. The US economy had established a clear recovery path and had grown in excess of 3% in the final quarter of 2013. The Fed had begun to taper its bond purchases, sending 10-year Treasury yields above 3% from a 2.5% low in October. European yields were expected to decouple gradually, but follow the broader trend up, especially those of benchmark German bunds.

Here we are, seven months on, and yields did exactly the opposite of what the consensus of analysts and investors had envisaged. In fact, the first half of 2014 saw a bond market rally in virtually all western sovereign debt markets.

| | **10yr government bond yield** | | | **Spread over Bunds (basis points)** | | |
|---|---|---|---|---|---|---|
| | 7/18/14 | 12/31/13 | chg. ytd. | 7/18/14 | 12/31/13 | chg. ytd. |
| | % | % | Bp | % | % | Bp |
| US | 2,48 | 3,00 | -52 | -- | -- | -- |
| Germany | 1,15 | 1,90 | -75 | -- | -- | -- |
| France | 1,47 | 2,42 | -95 | 32 | 52 | -20 |
| Italy | 2,80 | 4,09 | -129 | 165 | 219 | -54 |
| Spain | 2,72 | 4,14 | -142 | 157 | 224 | -67 |
| Netherlands | 1,36 | 2,23 | -87 | 21 | 33 | -12 |
| Portugal | 3,66 | 6,13 | -247 | 251 | 423 | -172 |
| Ireland | 2,27 | 3,43 | -116 | 112 | 153 | -41 |
| Greece | 6,23 | 8,42 | -219 | 508 | 652 | -144 |
| Source: Macrobond, Meriten Investment Management | | | | | | |

So, can this rally continue? We believe not, because the forces behind the surprising evolution of debt markets in the first half have evaporated. The economic performance of the United States was significantly weakened by winter storms in Q1 2014. Concerns about potential lasting effects of these aberrations on the business cycle, the inflation trajectory and Fed policy pushed yields lower. Meanwhile, economic data have returned to their favourable trend before the winter storms, unemployment has even dropped faster than anticipated, annual US CPI inflation has risen, and, more importantly, inflation expectations have settled above 2%. This pattern is fully consistent with the gradual normalisation of Fed policy that Janet Yellen proposed.

In Europe, there was never a region-wide cyclical recovery in the first place. Growth hopes were always concentrated on Germany and the UK. Hence also the dependence on the US cycle when it comes to growth expectations and the high correlation of bond markets with US Treasuries. In addition, there were, and still are elevated deflation fears in the eurozone which pushed yields lower. But in our view, they partly reflect a misinterpretation of structural wage and price adjustments in the EMU crisis countries which are also capping inflation in the healthier core countries of the monetary union.

The adjustments in the peripheral countries will probably continue in the quarters ahead. However, the harshest reforms, especially of labour markets in the south of the EMU, should lie behind us. Future efforts are likely to be less drastic, not least for political reasons, and will therefore have less dramatic impacts on wages and prices. In addition, virtually all EMU countries have emerged from the recession and there are growing signs that countries like Spain and Portugal are beginning to recover more meaningfully, leading improvements elsewhere.

Finally, we probably got as much assurance from the ECB as we can expect – and significantly more than we would have expected at the start of the year. Mr Draghi's announcements on 5 June of additional stimulus measures to be implemented in the months ahead (TLTROs, ABS purchases, etc.) made a significant contribution to the decline in government bond yields.

Can this rally continue? We find this is hard to imagine as none of the factors listed above will have the same force as in the last six months or so. Some may even begin to have adverse effects on bond markets in the absence of an unexpected growth disappointment, an unexpected escalation of deflation fears, or an unanticipated broadening of geopolitical tensions that also boosted core bond markets via safe haven flows.

Prudent investors should therefore consider further normalisation of economic conditions in the euro area a realistic possibility, and a continuation of the economic recovery in the US, on the back of unprecedented and still present monetary stimulus. The Fed is likely to finalise its QE taper as expected in October, and once we are there, markets will weigh its next steps. Even if Fed guidance will continue to try to defuse rate hike expectations on the grounds of slack in the US economy, markets are likely to look ahead and begin to price higher rates beyond the short-term horizon. A return of US Treasury yields to the 3% level and above before year-end is likely in this set-up.

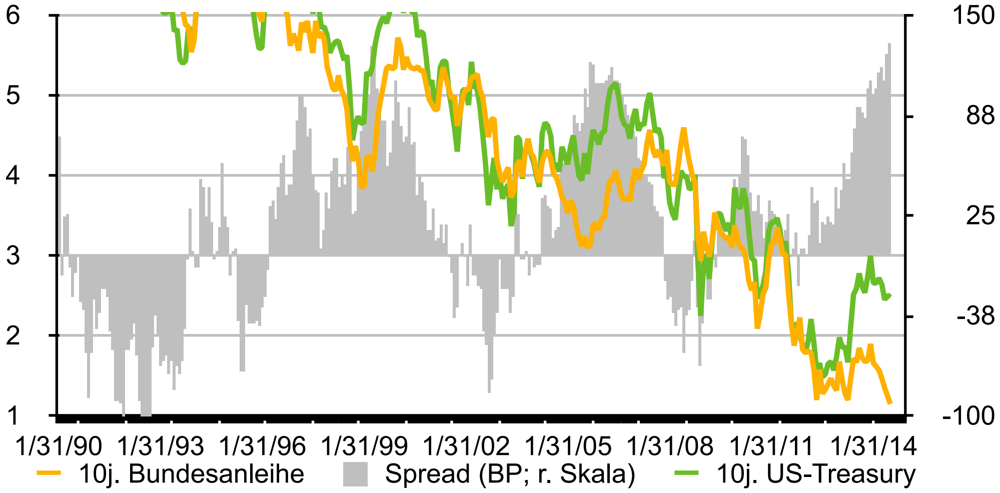


Chart: German bunds vs. US Treasuries – further decoupling?

Given the persistent problems in the European economy, the ECB will most likely stand firm and process its pre-announced additional stimulus measures in order to support the recovery in the crisis countries. This is going to take several quarters to fully filter through to markets. The ECB will also try to keep up expectations of even more easing. Consequently, bund yields have some potential for further decoupling from US Treasury yields. However, history suggests that there are limits. Consequently, barring nasty economic or geopolitical surprises, we see hardly any potential for the H1 2014 rally in benchmark bonds to be extended until year-end.

If the economic recovery of the EMU crisis countries continues as expected, and ECB stimulus proves to be effective, peripheral European debt has a fair chance to continue to outperform the core markets. Whether this implies a continuation of the rally in peripheral, or merely a continuation of spread compression in a higher rate environment, depends also on the pace of yield rises in the core. At the very least, the pace of the rally is likely to be significantly slower in the second half of the year.