

# Global Macro Strategy

## ECB's Taper Tantrum or Just Another False Alert?

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Global

#### The correction of a mis-pricing? Maybe. A regime change? Unlikely.

Yields in major bond markets have moved up by about 10bps in less than a week on the back of two main developments. First, US data has picked up from a very weak August set, a recovery our [Big Data framework](#) signalled early on and one which is likely to persist through September's prints. Second, following news reports that the ECB may be discussing ways to taper their asset purchases, European bonds have come under selling pressure. Neither development signals a regime shift towards structurally higher government bond yields. Yet, the EUR bond market sell-off should not be dismissed either. It is driven by a substantial market mispricing we have highlighted.

#### EUR yields are too low anyway you cut it

The macro environment of [low inflation](#) and [low trend growth](#) justifies subdued long-term yields. In the case of the Euro-area, low yields are exacerbated by a wide output gap and a large-scale compression in term premia due to the ECB's bond purchases. But even if we account for all this in a rigorous fashion, [Euro-area yields appear to be 70bps too low](#). This mis-pricing is likely driven by a combination of three factors: a) expectations of additional significant easing, b) residual risk-aversion among Euro-area investors and c) scarcity issues resulting from the modalities of the ECB purchase programme. Therefore, in the near term, ECB communication will be a key catalyst on whether this mis-pricing persists or unwinds.

#### ECB U-turn is unlikely. Still, the risk-reward for EUR bonds can be asymmetric.

Our economists do not expect a U-turn from the ECB; [economic conditions require the extension of policy accommodation](#). Having said that, one has to keep in mind the starting point and the asymmetries it creates. At this low level of European yields, the ECB needs to do a lot more to keep the curve this flat. Inversely, even if the ECB delivers less accommodation than anticipated (and market expectations are high), the curve can steepen further. We intend to discuss the ECB's options in upcoming notes.

#### A return to fair EUR yields would see a 20bps spillover into the US

[In our estimates](#), a full back-up of core EUR yields towards fair value, would push 10y US yields up by a total of 20bps approximately. In all fairness, we would think that a full swing back to fair value is probably at the high end of likely outcomes for EUR yields. That said, it is fair to say that, amid recovering US growth and inflation data, a "less-dovish than expected" ECB could give global bond markets a further shake.

#### Equity market impact to set the ceiling for bond yields.

As discussed in [Big Macro 04](#), low yields have been the predominant driver of high equity valuations amid slow earnings growth. For now, the bond shock has been better digested than the one from early September. This is because it has been in part driven by better growth data (and lower fears for a US recession), a Fed hike for December that is [as priced as it could be given current macro uncertainties](#), and higher external yields (which, in turn, has prevented a broad dollar rally). In that sense, deep equity damage, in response to the higher yields will also signal the end of the bond sell-off. The next big signpost will be the upcoming payrolls report and after that, potential statements from ECB officials during the IMF weekend meetings.

#### Where are Markets Likely to Settle?

By end-of-year we expect bund yields to equilibrate at around 0.15%. UST yields are unlikely to end up much higher from current levels. A narrower US/EA rate gap will likely support the EUR towards 1.16. We would view dips in dividend-rich equity sectors as a buying opportunity. Lastly the rush into EM assets is likely to moderate significantly [following a shift in European yields into positive levels](#).

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