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European Macroeconomic Strategy

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The European Central Bank (ECB) reported in their Account of the monetary policy meeting on December 13-14, 2017 that their language pertaining to forward guidance could be adjusted "early in the coming year", which we took to mean any of the Q1 Governing Council meetings (January 25 or March 08). However, quickly thereafter and following a sharp market reaction to the Account – higher rates, flatter curve, and appreciating euro – the ECB then made no changes to forward guidance at the January meeting.

Put together, the ECB's rhetoric indicates that the Governing Council will inch its way out of a highly accommodative, emergency, policy stance amid a robust economic upswing but with a penchant for stability in rates.

In this piece we map out our basic macro strategy for Bunds, which forms our core view on the direction of yields and the curve.

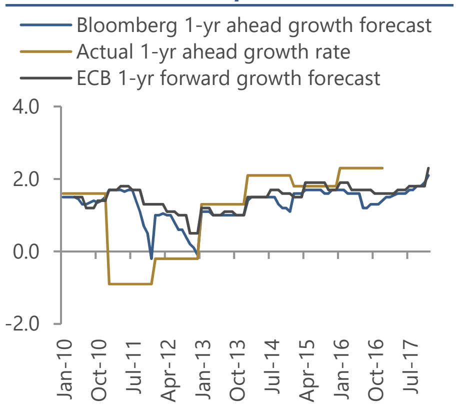
Macro strategy: Rates will move higher in line with the business cycle but the ECB will try to steady the uptrend. The output gap is closing, though, where macro data is likely to drive the ECB into a more hawkish framework sooner rather than later. Timing is highly uncertain, though.

Macro Strategy, Europe

The growth forecasting error has been substantial.

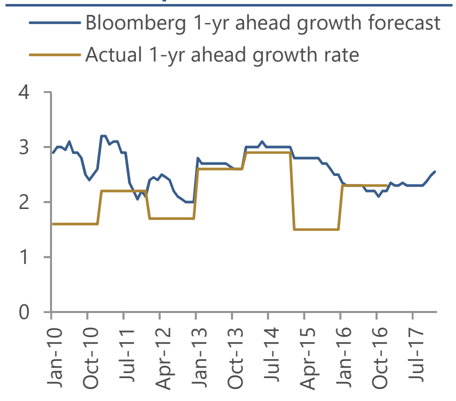
Market participants' and the ECB's 1-yr ahead growth forecasts undershot the ex-post outcome by an average of +0.5% and +0.3%, respectively, since the end of Europe's double-dip recession (2013). This differs from the US, for example, where forecasts have either met or undershot the associated 1-yr-ahead outcome.

Eurozone Growth Expectations (%Y/Y)



Source: Bloomberg, BNYM AMNA as of December 29, 2017

US Growth Expectations (%Y/Y)



Source: Bloomberg, BNYM AMNA as of December 29, 2017

In contrast, despite the strong momentum in the real economic data, European inflation has been stubbornly low. Since 2013, market and ECB forecasts have either met but mostly undershot year-ahead expectations.

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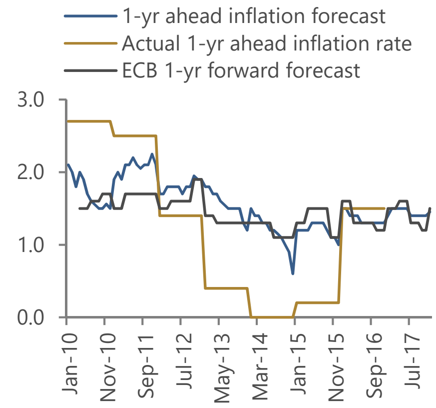
Eurozone Inflation



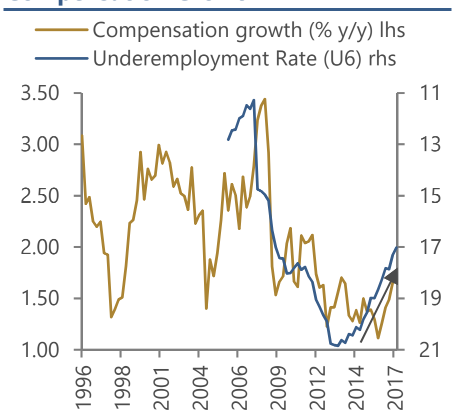
Source: Bloomberg, BNYM AMNA as of December 29, 2017

Will inflation be low forever? We are comfortable with a benign inflation forecast but the output gap is closing quickly.

The important factor is position in the economic cycle and the associated theory that a positive output gap leads the inflationary process. The Eurozone output gap will close to zero in 2018 and then post of surplus of 0.6% in 2019[1]. At that point, demand-driven inflationary pressures will evolve – the so-called Phillips Curve.

On the labor side, we do expect for wages to rise a bit more quickly this year based on this simple relationship, albeit at a relatively slow pace compared to history. According to the labor markets, the output gap is already closing as even underemployment of labor improves.

Underemployment in Europe vs. Compensation Growth



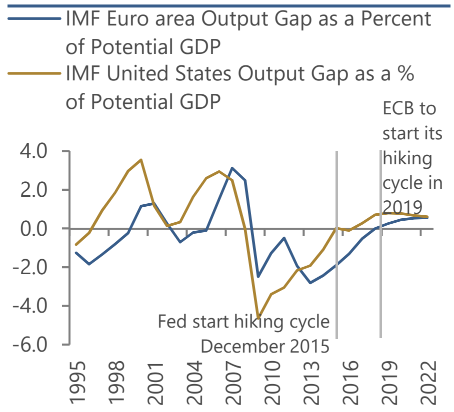
Source: Macrobond as of October 1, 2017

[1]See Table A8 of the October 2017 World Economic Outlook

But slow and steady inflation doesn't necessarily mean slow and steady policy! Risks around output gap closure are for soon or sooner.

The Federal Reserve hiked its policy rate for the first time about when the output gap had closed, according to the IMF. Market pricing for the ECB is to hike around a similar time in Europe's economic cycle, which is in the middle of 2019.

The Eurozone Output Gap Is Closing Soon Or Sooner

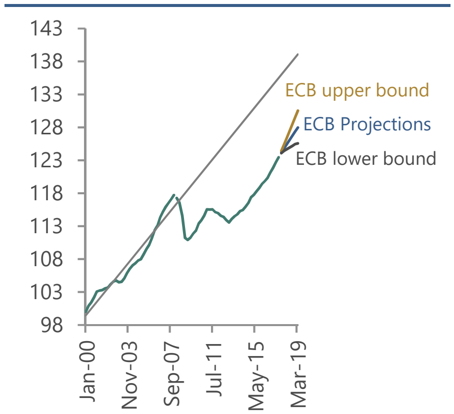


Source: Bloomberg as of January 16, 2018

Therefore, any material upside surprise on growth is likely to push a bit more volatility and steepen the uptrend in rates as the market perceives the ECB to be behind the curve.

Current survey data, such as the Markit composite PMI, point to a growth forecast more in line with the ECB's upper, rather than central forecast scenario. If the upper bound of the growth forecast becomes more evident, then GDP may push toward its pre- not structurally lower post- GFC trend!

Eurozone GDP



Source: Macrobond; ECB Staff Projections; BNYM AMNA calculations as of February 6, 2018

Survey reports, such as the Markit purchasing manager surveys, point to a robust growth pattern moving into the start of the year. This poses upside risk to both the ECB's and the market's consensus forecast. The survey data, however, have consistently overestimated the quarterly growth pattern in the euro area. We are therefore comfortable with our forecast that euro area growth maintains a steady but slower pace into 2018 with the first ECB rate hike coming by the middle of 2019.

Looking forward, if the macro data continue to point to an output gap that is closing more quickly than expected, yields in the belly of the Bund curve could rise more than forwards are currently pricing, as the the ECB is perceived to be behind the curve.

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