WHAT'S NEXT FOR THE ECB?

VIGILANTLY WATCHING RISING INTEREST RATES

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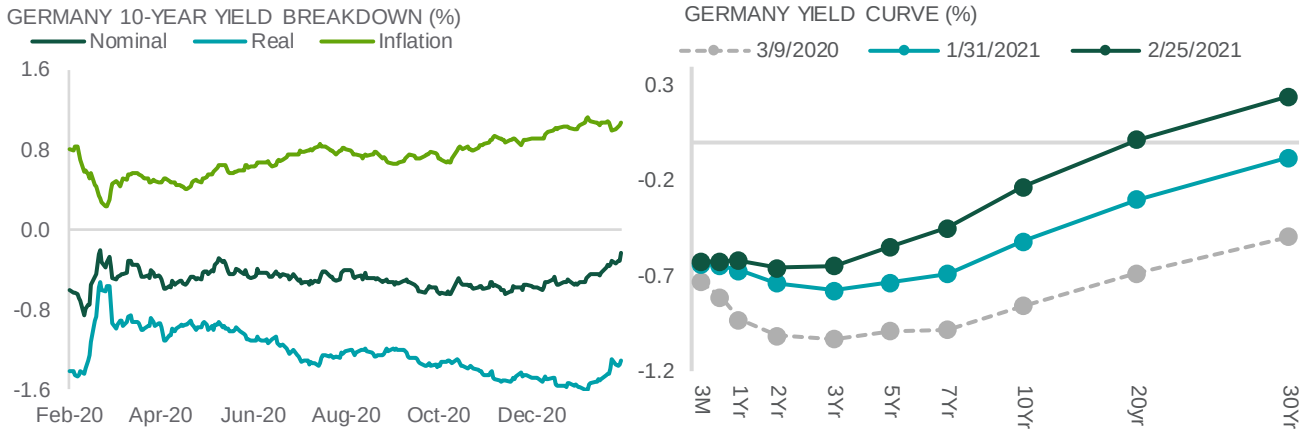
The recent rise in eurozone government bond yields — notably the bellwether German bund — has put the European Central Bank (ECB) on alert. In the short term, the ECB will closely monitor the extent to which financing conditions are adversely affected (if at all). Higher inflation expectations are welcome, but higher real yields are viewed with higher scrutiny. Longer term, the ECB must balance continued monetary accommodation with manageable inflation.

Higher government bond yields reflect changing expectations. A change in the nominal bond yield should always be reviewed in light of the underlying changes in the real yield and (breakeven) inflation expectations. For a central bank like the ECB that has been struggling to fulfill a 2% inflation mandate, a rise in inflation expectations is a positive sign. It's a vote of confidence from the market that it's on the right track; and, all else equal, pushes the real yield down. That matters, because the real yield is an important driver of investment and consumption. Lower real yields provide more support and incentive to invest, while higher inflation levels place greater urgency on consumption (today, vs. "tomorrow" when prices will be higher).

Looking at the 0.6% rise in the German 10-year yield from its March 2020 low through that lens provides some comfort. The whole rise is explained by higher inflation expectations. However, if we zoom in on the 0.3% rise in the last month we can see it's almost completely due to a rise in the real yield. That means the real yield, which was trending down for much of the last year, has now snapped back to its March 2020 level.

EXHIBIT 1: NOT SO FAST

Higher German government bond yields are putting the European Central Bank on alert.



Source: Northern Trust Asset Management, Bloomberg. Left: Data from 2/28/2020 – 2/25/2021. Inflation measured by Germany 10-yr breakeven rate.

This has grabbed the ECB's attention. At a time when the economy needs all the support it can get, it wants to keep the real yield low. Further, the quick rise has set off alarm bells regarding the eurozone's financing conditions. The ECB puts paramount importance on maintaining easy financing conditions to support the economic recovery. Already, it has announced it will utilize its Pandemic Emergency Purchase Program (PEPP) to buy more bonds to stabilize the market. It will also closely watch what happens with interbank lending rates and Overnight Index Swap (OIS) rates to gauge if stress is creeping into the financial system. So far, those rates have behaved well and only the OIS rates have moved up by a few basis points (one basis point is one hundredth of one percent). Should that change and/or rising government yields pick up pace, the ECB will likely become very vocal about its commitment to easy financing conditions and all that that entails in terms of its actions (more bond purchases and more support for the banking system).

What the ECB will target in the long run. Although the recovery from the COVID-19 recession is currently front and center at the ECB, it's important to note that the impact of all the crisis fighting on countries' debt ratios has further cemented the ECB's long-term goals. Because when it comes to that debt, it is clear that countries won't be able to pay it all back, nor will they be able to grow their way out of it. Instead, they will have to use the only remaining route which is to slowly inflate the debt away. To do that, the ECB needs to ensure nominal government bond yields are below nominal growth rates over a prolonged period of time. That will keep debt servicing cost contained and lowers debt ratios over time. It also means that one way or another, financial repression in the eurozone is here to stay. This is bad for savers in government bonds, but may be a key tailwind for investors in European equities (and risk assets more broadly).

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