Market Bulletin

12 June 2015

European assets: Volatility strikes back

What has happened?

Rather than abating, as many had expected, the sell-off in European markets that began in late April has continued into June. Exhibit 1 below shows the surge in eurozone government bond yields. This week, the German 10-year Bund yield broke through the 1% barrier to reach the highest level since September 2014; as recently as 20 April, it was at a low of just 0.05%. As the chart shows, yields elsewhere in the eurozone have largely followed suit. The moves in equity markets have been less extreme, but still painful: since hitting its record high in April, the Stoxx has lost 7% of its value.

What has been driving this?

There are a number of factors being touted as the primary driver of recent market movements, including:

- Changing inflation expectations relative to the start of 2015
- Unwinding of speculative positioning
- Liquidity concerns in key markets
- A mild softening of economic data
- Worries over Greece
- Worries over a rising euro

EXHIBIT 1: EUROZONE 10 YEAR BOND YIELDS

Sources: FactSet, J.P. Morgan Asset Management. Data as of 11 June 2015. The graph above and the graphs presented herein, are for illustrative purposes only.
Those looking for prime causes of the equity sell-off will probably find the answer is “any or all of the above”. But it’s the sovereign bond markets that have been at the centre of the storm. In our view, the sell-off there has been driven primarily by the first three factors on the list: changing expectations for inflation and, partly as a consequence, a sharp unwinding of speculative positions, with the impact amplified by reduced market liquidity.

In the first months of the year, short- and long-term inflation expectations were tumbling and investors were absorbing the potentially dramatic effect that European Central Bank (ECB) sovereign bond purchases might have on the net supply of European sovereign debt. This was an environment for bond prices to soar and for yields, correspondingly, to hit new lows. That is exactly what happened. But prices ultimately moved beyond what could be justified by even these extreme conditions.

The market for long-term German sovereign debt was especially affected, since traders were all too aware that the ECB would be buying a lot more than the German government would be issuing. Adding to the pressure was the ECB’s insistence that it would not buy debt with a yield lower than -0.2%. The further Bund yields fell, the larger the proportion of German sovereign debt that violated this condition and the smaller the amount that was available for the ECB to buy. This led to a self-perpetuating spiral, as the price of German sovereign debt that still commanded a positive yield was bid ever upwards by speculative investors convinced that the ECB had made these assets a one-way bet.

All of this shows up very clearly in Exhibit 2, which shows just how dramatic the movement in the 30-year Bund yield has been. At one point in late April, the yield on even nine-year German debt Briefly turned negative. Taken at face value, this would have suggested that investors were expecting barely any growth or inflation in Europe’s largest economy for the best part of a decade.

The further downward move in yields, even after the ECB began purchasing sovereign debt in March, seemed excessive—even by the distorted standards of the past few years. It was also at odds with the experience of quantitative easing (QE) in the US and the UK, where yields fell mostly in the lead-up to the start of bond purchases, not after they had formally begun. As Exhibit 3 shows, the further collapse in yields also ignored the pickup in medium- and long-term inflation expectations in the early spring, as oil prices rebounded and the global deflation panic started to subside.

So the market was ripe for a correction and that is exactly what has now taken place, with the self-perpetuating spiral now acting in reverse as hedge funds and momentum investors have rushed to cover their positions. But with German 10-year yields now back to where they were in September 2014, we have to ask whether the market has now overshot in the other direction.
Do we think this will last?

It is good news to see bond yields rising, if that increase comes as a result of reduced fears of deflation and/or increased hopes of economic recovery. This is partly what we have seen since April in the US and, to some extent, also in Europe. So it could well be that core European sovereign bond prices are now past their peak. But as we have discussed, economic fundamentals were not the only factors driving yields to those record lows. Speculation and lack of liquidity also played an important part, and these factors have probably now also helped yields to overshoot.

For example, markets are currently pricing in a 40% chance of the ECB raising interest rates by October 2016. While Europe’s recovery has begun, it is not set in stone and it will take some time for the economy to build up enough speed to justify any tightening by the ECB. It is true that eurozone inflation has surprised on the upside recently, coming in at 0.3% in May. However, the latest sharp rise—which was accompanied by a sharp jump in long-term inflation expectations in the week it was announced—was driven partly by short-term factors, which could easily be reversed in June and July. Europe may have put the threat of prolonged deflation behind it, but inflation is likely to remain below the ECB's target for a considerable period, fully justifying the continuation of bond purchases.

That brings us to the final reason to expect yields to slip back somewhat from here: the ECB. The speculative frenzy may have gone, but the gap between what European governments are issuing and what the ECB is buying remains, with central bank purchases accounting for nearly 200% of net issuance of eurozone sovereign debt between March 2015 and October 2016.

The dearth of liquidity in fixed income markets in the US is a recipe for continued volatility, which is addressed in greater detail in a new paper from Market Insights1. But in the context of continued ECB purchases, that lack of liquidity in European sovereign debt markets is also a recipe for continued downward pressure on yields.

ECB president Mario Draghi may have contributed to recent market moves by suggesting that the central bank was "comfortable" with this kind of bond market volatility. The ECB does not want to see markets rise to the kind of extremes we saw in April. But it will not be comfortable with a major tightening in financial conditions via bond markets that undermines the effectiveness of QE. Nor will it want to see the euro strengthen significantly from here. Though it has fallen back recently, the euro is now 7.2% above its March low against the dollar and 4.8% higher on a trade-weighted basis than it was in April.

Both the Greek crisis and the strong possibility of a US rate rise provide ample further reason to expect a bumpy ride in European markets in the months ahead. No one can know exactly how this will play out. What we can say is that Europe is at a much earlier stage of its recovery than the US, and Mario Draghi will want to do what he can to keep real interest rates at levels which reflect that different economic reality for some time to come.

1 Living in a less liquid world: The dos and don’ts for bond investors, June 2015
Investment implications

The lessons for fixed income investors are nuanced. Ultimately, we would expect both nominal and real yields to rise—and bond prices to fall—as European inflation and growth pick up and ECB support for the market is gradually reined back. But we are a long way from that today and German Bund yields, in particular, now look inappropriately high at 1%. That’s why we believe eurozone bond markets are likely to recover some ground in the coming months, as the impact of ECB purchases reasserts itself.

However, the recent volatility should serve as an important lesson that bond prices can go down as well as up—and fears of illiquidity in markets are not merely theoretical concerns. The days of the bond market “sure thing” may be over.

This underscores the case for a flexible approach to fixed income investing. Though European government bonds have delivered a negative 2% return year to date, investors in the Barclays pan-European high yield index have still seen a positive total return in the region of 2.5%. The asset class has shown some resilience during this period of market turbulence. Despite dramatic movements in government bonds, yields in European high yield have not budged and remain around 4.2%.

The strong performance of higher yielding credit in recent weeks points to a broader lesson, that a moderate overweight to risk assets still makes sense, both in Europe and the US.

With Greece and other uncertainties buffeting markets, equity investors should be prepared for further bouts of volatility in 2015. But we do not believe the recent downward move in European equity prices is justified by the fundamentals, which show European corporate earnings picking up and the recovery continuing. Even with the recent volatility, European equities have delivered a 14% total return in local currency so far in 2015.

The recent equity sell-off has helped to stabilise valuations, which reached 15-year highs in March as prices ran ahead of earnings growth. This could therefore be an attractive entry point for investors who missed out on the rally in European assets earlier in the year.

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