Beware the Ides of March

October 2016

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Famously dramatized by Shakespeare, Julius Caesar dismisses the soothsayer warning to 'beware the Ides of March', the day of his assassination in the Roman Senate. Markets will be hoping that March 2017 will not prove as fateful as they face a possible triple-whammy of risk events: the ECB potentially 'tapering' it's current €80 billion per month bond buying programme; the UK activating Article 50 and formally beginning its exit from the EU; and the US debt limit coming back into force. All three events highlight the increasing importance of politics and policy for investors.

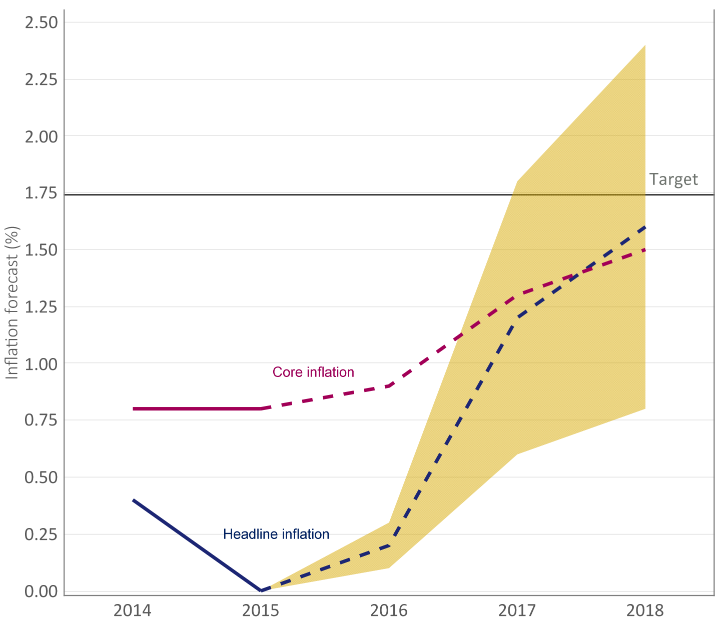
ECB mini-taper tantrum

A report by Bloomberg that there is an 'informal consensus' in the ECB that bond purchases will be 'tapered' down before the conclusion of the ECB's quantitative easing (QE) programme sent bond yields and the euro higher. The skittish reaction of markets reflects the failure of the ECB to offer clarity on whether and how it will extend QE beyond March next year and the surprise that at least some officials are focused on the 'exit strategy' at the same time that ECB taskforces are supposed to be working on how to extend QE.

The current ECB policy is that "..the monthly asset purchases of €80 billion are intended to run until the end of March 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim". The ECB's latest forecasts show headline and core (excluding food & energy) inflation remaining below its target of 'below but near 2%' into 2018. With still high unemployment and slack in the economy, there is very little domestic inflation pressure and in our opinion it would be premature for the ECB to taper just twelve months after QE was increased to €80bn ('QE2'). Monetary and financial conditions could tighten dramatically in response to tapering, especially in the 'periphery', with higher bond yields, credit spreads and euro.

We currently expect that the ECB will announce that it is extending QE at its meeting on December 8 when it will also release updated macroeconomic forecasts confirming that inflation will remain below target for the foreseeable future. ECB has so far bought €30 billion of bonds under its corporate sector purchase programme (CSPP) and we think can continue broadly at the current monthly pace of more than €7bn per month. However, the ECB will have to relax some of the self-imposed constraints on its sovereign bond buying

Fig 1: ECB September 2016 inflation forecasts (annual % change)



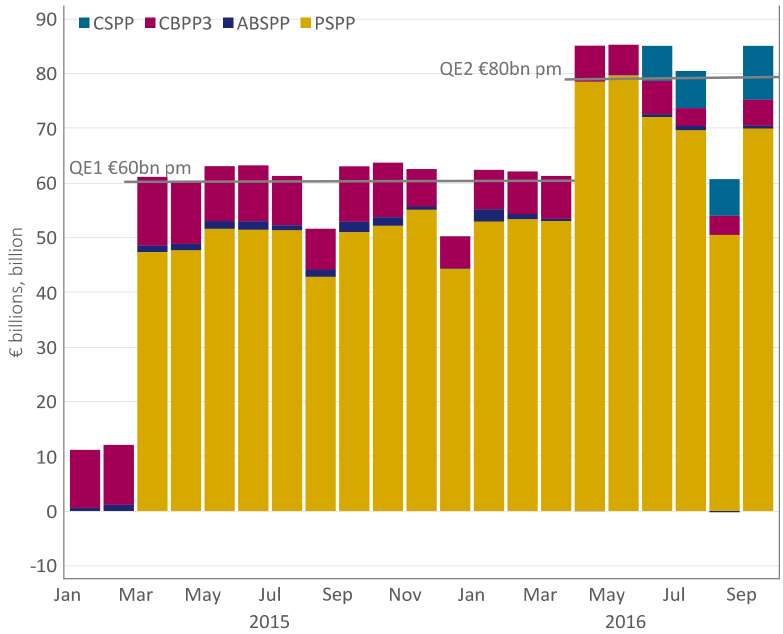
Source: Macrobond; ECB Staff projections, September 2016

(PSPP) that accounts for the lion's share of its asset purchase programme if it is to maintain the current pace of €80bn per month. But until there is clarity on whether and how the ECB will extend QE, we will likely see more episodes of volatility in European financial markets.

Brexit draws closer

British Prime Minster Theresa May has said the UK government will formally start the two-year withdrawal process from the EU under Article 50 by the end of March 2017. Mrs May also said Britain will not accept the free movement of EU citizens into the UK and the jurisdiction of the European Court of Justice, effectively signalling the UK will leave the single European market. The prospect of a so-called 'hard Brexit' prompted a further decline in the value of the British pound. As the UK 'takes back control', it may encourage anti-euro/EU movements when both France and Germany have general elections.

Fig 2: ECB monthly asset purchases, € billions per month



Note: PSPP = Public Sector Purchase Programme; CSPP = Corporate Sector Purchase Programme; ABSPP = Asset-backed Securities Purchase Programme; CBPP = Covered Bond Purchase Programme.
Source: Macrobond; lastest monthly data at September 2016

US debt limit a test for new President and Congress

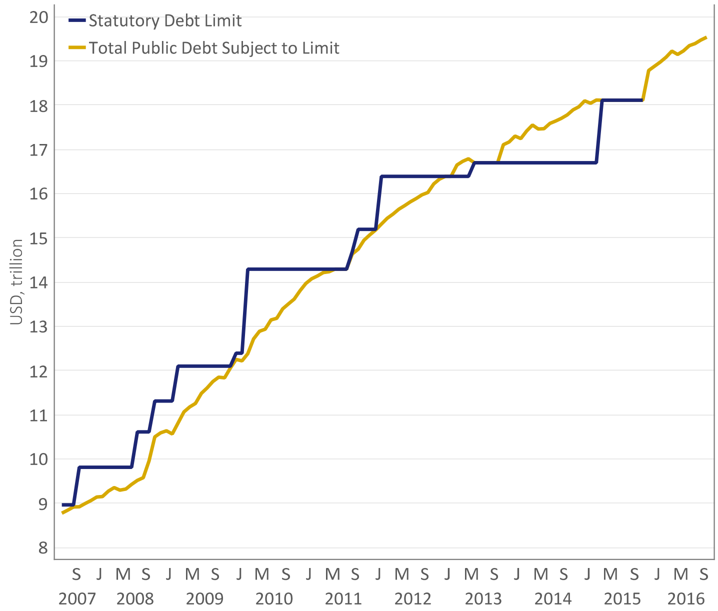
In November of last year, the US Congress voted to suspend the debt limit ceiling through to March 15, 2017. On the expiry of the suspension, the debt limit will be re-established at the prevailing level of the relevant Treasury debt and the Treasury Secretary will invoke extraordinary measures in order to continue to fund the government and avoid debt default. Although the US lost its 'AAA' rating from Standard & Poor's in August 2011, markets have become increasingly indifferent to subsequent episodes and largely ignored the theatrics in Washington.

Fig 3: Britsh pound falling in value

Source: Macrobond; data at 06/10/2016, 07/10/2016

More growth-friendly fiscal policy, including infrastructure investment and tax reform, will require collaboration and agreement between the new President and Congress. The debt limit will be an early test of that relationship and the likelihood that the US will take the lead in adopting a more expansive fiscal stance. Failure to promptly raise the debt limit will dash the hopes of those hoping that fiscal stimulus will take over from monetary policy.

Fig 4: US Treasury debt and the debt limit



Source: Macrobond; latest monthly data at 09/2016, 10/2015