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The limits of "no limits"

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The European Central Bank (ECB) is running into self-imposed limits on its asset purchases. An improving growth outlook and the fading of deflationary fears are also fueling market expectations for an ECB policy adjustment. The ECB's next policy meeting in October will come just as the Federal Reserve begins a well-telegraphed plan to start an outright slimming down of its balance sheet. See Crossing the river by feeling the stones for details. This month we shine a spotlight on the ECB, its expected policy shift and the potential market implications.

Highlights

- An improving growth backdrop should eventually lead to a sustainable move higher in eurozone inflation, justifying a removal of monetary accommodation. But we see inflation moving sideways in the near term – well below the ECB's target. This is why we expect any reduction in ECB asset purchases to be modest and gradual.
- The ECB is running out of bonds to buy under its asset-purchase program. Its ownership share of German bunds threatens to breach a self-imposed limit in the first half of 2018. This suggests the central bank may need to tweak its quantitative easing program soon, while keeping policy accommodative overall.
- We are maintaining a defensive stance on European debt, given risks that appear skewed toward higher rates. We see euro corporate spreads as fairly priced versus global alternatives, but low yields leave little margin of safety.

Yields bottom out

Treasury yields have bounced higher again in September after a two-month slide. The overall tone this year remains risk-on, with emerging market debt and credit leading year-to-date performance in the fixed income world, as seen in the table below.

Bond market summary

Sector	View	YTD return	Yield
U.S. aggregate	—	3.24%	2.53%
U.S. government bonds	▼	2.55%	1.91%
Short (1-5 years)	—	1.15%	1.58%
Intermediate (5-10)	—	2.92%	2.08%
Long (10+)	▼	7.09%	2.72%
U.S. inflation protected	▲	2.13%	2.34%
Agency mortgages	—	2.32%	2.79%
Non-U.S. developed	▼	9.98%	0.81%

Sector	View	YTD return	Yield
U.S. municipal bonds	—	5.00%	2.15%
U.S. investment grade	▲	5.11%	3.16%
U.S. high yield	—	6.69%	5.50%
Bank loans	—	2.89%	5.19%
Securitized assets	▲	2.98%	2.67%
Euro credit	▼	1.73%	0.79%
Emerging markets	—	9.09%	5.17%
Asia fixed income	—	5.51%	3.75%

▲ Overweight — Neutral ▼ Underweight ↑ Upgrade ↓ Downgrade

Source: Bloomberg, as of September 22, 2017. Notes: Performance and yields are represented by the S&P Leveraged Loan Index (bank loans); J.P Morgan EMBI Global Diversified Index (EM hard-currency debt), J.P. Morgan Asia Credit Index (Asia fixed income), and the respective Barclays Bloomberg indexes for the remaining sectors. Yields are yield to maturity, except U.S. high yield and municipal bonds (yield to worst). Performance is measured in total returns and in U.S. dollars, except for Euro credit (euros). Our TIPS view reflects relative performance vs. nominal U.S. Treasuries. Indexes are unmanaged and used for illustrative purposes only. They are not intended to be indicative of any fund or strategy's performance. It is not possible to invest directly in an index. Past performance is no guarantee of future results.

An evolving outlook

The prospects of both the U.S. winding down its balance sheet and the ECB contemplating the next iteration of its monetary accommodation put central banks in the spotlight – less bond buying by the ECB and outright balance sheet reduction plus further rate rises ahead from the Fed.

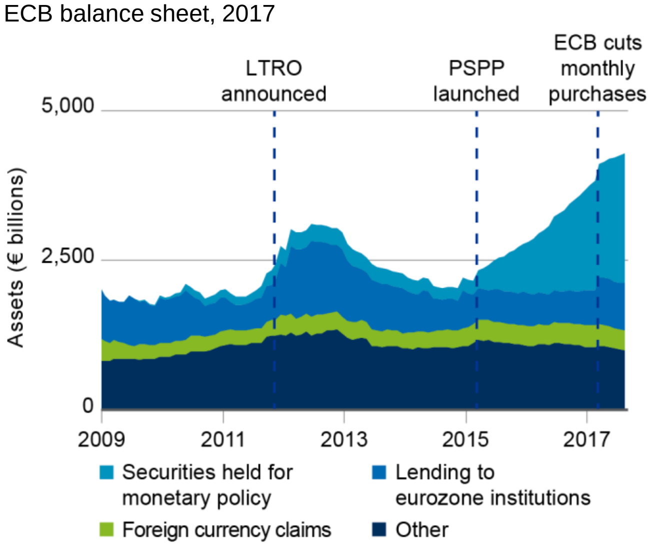
This heralds the end of crisis-era monetary policies that kept financial conditions loose and buoyed risk assets. The reversal has implications for global bond markets and financial markets more broadly. Rising rates could, over time, help restore the attractiveness of lower-risk government and shorter-duration debt – at the expense of more richly valued credit sectors that have benefited from the hunt for yield in recent years. See Float like a butterfly of August 2017 for details.

A recovery in eurozone growth – and a rise in inflation that is tentative, but has for now at least quashed deflation fears – have been part of the story fueling market expectations for a near-term ECB policy adjustment. The main driver, however, is a perception that the central bank is running up against self-imposed limits in its asset-purchase program. See the following page for details.

The central bank's balance sheet has more than doubled in size since the launch of its public sector purchase program (PSPP) in 2015. See the *Before the fall* chart below. The central bank added corporate bond purchases in 2016 – before scaling back its total asset purchases to €60 billion per month in April.

Before the fall

ECB balance sheet, 2017



Source: BlackRock Investment Institute, with data from Thomson Reuters, July 2017. Notes: The colored areas represent different categories of assets on the ECB balance sheet. "Other" includes gold and gold receivables, general government debt denominated in euro, claims on non-euro area residents in euro, marketable securities that are not related to the monetary policy operations of the Eurosystem and other assets (securities, equity instruments, fixed-term deposits and current accounts, participating interests and/or investments in subsidiaries). "Foreign currency claims" include claims on eurozone residents in foreign currency and claims on non-euro area residents in foreign currency. LTRO refers to long-term refinancing operation. The Eurosystem started to buy public sector securities under the public sector purchase program (PSPP) on March 9, 2015.

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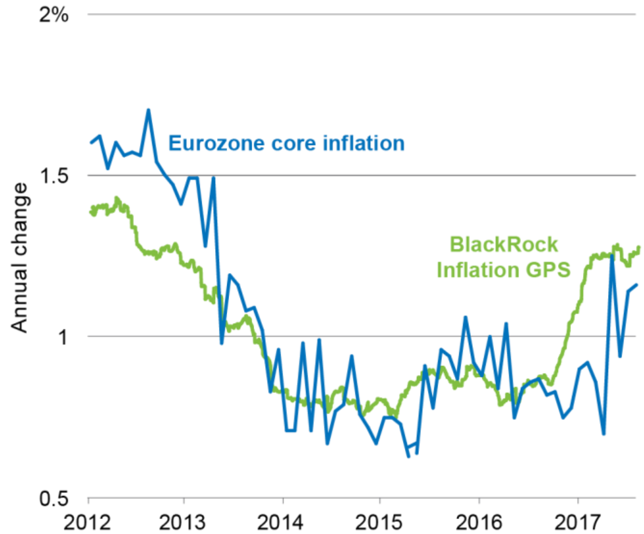
Room for catch-up

Eurozone Inflation GPS vs. core inflation, 2012-2017



Source: BlackRock Investment Institute, with data from Thomson Reuters and Eurostat, September 2017. Notes: This chart shows eurozone core inflation (the Harmonised Index of Consumer Prices excluding food, tobacco and alcohol) and the BlackRock Eurozone Inflation GPS. The GPS shows where core inflation may stand in six months' time.

Pushing the limits

Inflation is the fly in the ointment. Our recently launched Inflation GPS, which incorporates big data on price trends and daily updates of traditional inflation-related statistics, suggests official data may be modestly understating true inflation in the eurozone. See the *Room for catch-up* chart above. Nonetheless, the gauge remains well below the ECB's target given significant remaining slack in the eurozone economy. This suggests any ECB policy change could be more modest and more gradual than what markets are anticipating. See my colleagues' recent piece Getting to inflation's core for details.

ECB head Mario Draghi has laid out several conditions necessary to reach the central bank's medium-term price stability target. The rise in inflation must be durable (rather than transient), self-sustained (stable even without monetary policy support) and broad (across the whole of the eurozone). The durable and self-sustaining aspects are the most uncertain. The central bank revised down its inflation projection in September based on the appreciation of the euro, which has risen 6.5% on a trade-weighted basis this year as of mid-September. Any further gains in the euro would complicate the ECB's task.

Strong growth momentum, faith in a further tightening of the labor market and dissipating fears of deflation support a somewhat less accommodative monetary policy in the eurozone. Yet there are other factors affecting the central bank's policy stance. The market is increasingly focused on the natural limits to large-scale QE – despite Draghi in 2015 professing no limits to "how far we are willing to deploy our instruments." But the instruments have their limits: Eurozone central bankers are simply running out of bonds to buy. We discuss these limitations on the following page, as well as how the central bank may go about addressing them.

Running on empty

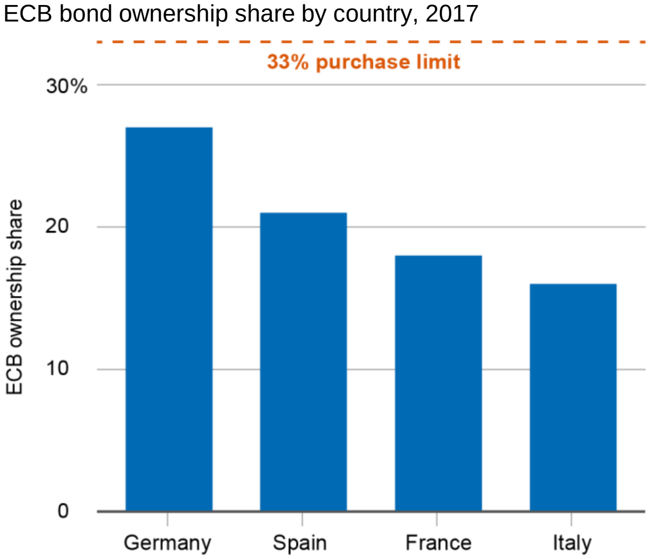
Unlike the central banks of the U.S. and Japan, the ECB faces the critical question of which countries' debt to purchase. The central bank aims to reduce ambiguity by purchasing bonds in line with the "capital key" – the percentage of ECB bank capital that each member state contributes based on its GDP and population share in the European Union. Yet there are complications: The amount of debt available for purchase depends on the fiscal stance of each country. For example, France and Italy run relatively high debt levels and deficits, leaving ample debt for purchase. By contrast, lower debt levels in fiscally conservative Germany mean there is a scarcity of debt available relative to the ECB's target.

The ECB imposes additional limits to mitigate the risk of becoming the dominant creditor of a eurozone government. The current limit prevents it from holding more than one-third of the outstanding paper of any issuer or individual bond. Germany is closest to this limit, as seen in the *Nearing limits* chart below. Our calculations suggest the ECB could breach the limit for Germany as soon as February. Estimates vary depending on the assumptions, but it is clear the current pace of buying German bonds is unsustainable without a change in ECB rules. A key point: These constraints imply a need for the ECB to tweak its QE program *regardless* of its underlying monetary policy stance.

What options does the central bank have? 1) Buy more supranational debt and credit; 2) buy maturities of less than one year; 3) break the capital key (either officially or unofficially); and 4) increase the ECB's issuer and individual bond (ISIN) limits to as high as 50%. But the simplest way for the ECB to alleviate scarcity issues would be to slow its pace of purchases. This would be made easier if monetary policy goals were in alignment: namely, the central bank expected to meet its inflation objectives over the medium term with less monetary accommodation.

Nearing limits

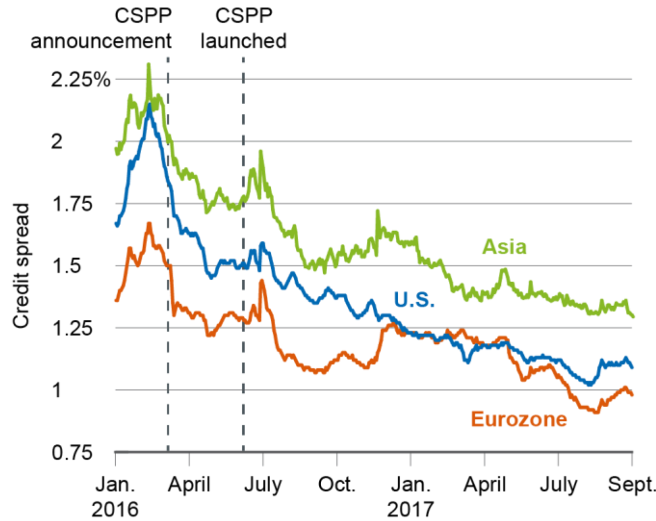
ECB bond ownership share by country, 2017



Source: BlackRock Investment Institute, with data from the European Central Bank, Deutsche Bundesbank, Banca D'Italia, Agence France Tresor and Banco de España, June 2017. Note: The chart shows the ECB's share of ownership under its PSPP program. The purchase limit refers to a 33% limit the ECB has on the maximum share it can own in an individual bond or the securities from one issuer.

Little premium

European corporate credit spread, 2016-2017



Source: BlackRock Investment Institute, with data from Bloomberg, July 2017. Notes: The spread is based on the Bloomberg Barclays Euro AGG Corporate Index (ex-financials). The ECB's corporate sector purchase program (CSPP) was announced on March 10, 2016, and launched in June 2016.

Exit costs

Markets are expecting the ECB in October to signal a step-down from the current €60 billion per month in purchases. The key questions: How will the central bank communicate its policy shift, what will the pace of its step-down be, and what is the endpoint of the ECB's policy? There is much uncertainty about the mix: A stepdown in purchases could be twinned with an extension of the program's length, for example.

The looming policy shift has global implications. Low or negative rates have pushed investors out the risk spectrum, narrowing spreads on credit across global markets. And direct purchases of corporate bonds have provided a further support for European credit markets. See the *Little premium* chart. Tightening financial conditions could also undermine future efforts at fiscal consolidation in the eurozone – and limit the scope of fiscal policy. The compression in sovereign bond yields has helped improve fiscal balances in recent years. But outside of countries participating in bailout programs (think Greece or Portugal), few have made progress on reducing their structural budget deficits – and now face a rise in debt-servicing costs as rates rise.

Bottom line: We maintain a defensive stance on European debt. Tight credit spreads and low sovereign yields highlight limited absolute value in credit, we believe. The still small, but growing, spillover risks to Sweden and Eastern Europe keep our positions defensive in those regions as well. One exception to our defensive stance is eurozone subordinated financial debt, where banking reforms and capital improvements bolster the investment case, in our view. For core European bonds, we see the risks as tilted toward higher rates. Yet we highlight the potential for negative surprises to risk assets, which argues for keeping some core allocation for diversification.

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