No excitement in bonds

A survey suggests euro-zone obligations ought to give ground just a little bit

By Vincenzo Sciarretta

Major banks in continental Europe would be surprised if any wild swings materialized in the euro-zone bond market over the next six months. As regards the 10-year German bond, they expect yields to fluctuate within a narrow trading range between 3.75% and 4.3%. Eight out of the ten banks surveyed this week by *TheEuropeanSide* lean towards a very mild bear market, while two bet on a modest decline in interest rates.

Eight banks also bet on two more hikes by the European Central Bank (ECB), while two consider a single hike more likely.

On average, rather than speak of a bear market, most analysts would describe the next months as a period of normalization in interest rates.

An easy money posture by the key central banks and the assimilation of the newly industrialized nations into the world economy was what depressed yields, according to **Thomas Mayer** of Deutsche Bank: "With the integration of the developing countries," he explains, "the policy of easy money was able to raise economic growth without unleashing an acceleration of consumer price inflation. What happened instead, as everybody knows, the ample supply of liquidity boosted asset prices. Now, the same central banks have embarked upon a gradual withdrawal of the monetary policy stimulus and we ought to witness a normalization of yields."

Analysts forecast a mild bear market for euro-zone bonds

Bank	Year-end targets	
	refi rate	10-year bonds
UBS	3,25%	4,30%
Unicredit	3%	4,40%
BNP Paribas	3,25%	3,75%
Credit Suisse	3,25%	4,2%
Société Générale	3,25%	3,75%
ABN AMRO	3%	4,25%
Crédit Agricole	3,25%	4,15%
Fortis	3,25%	4,30%
Banco Bilbao	3,25%	4%
Deutsche Bank	3,25%	4,30%

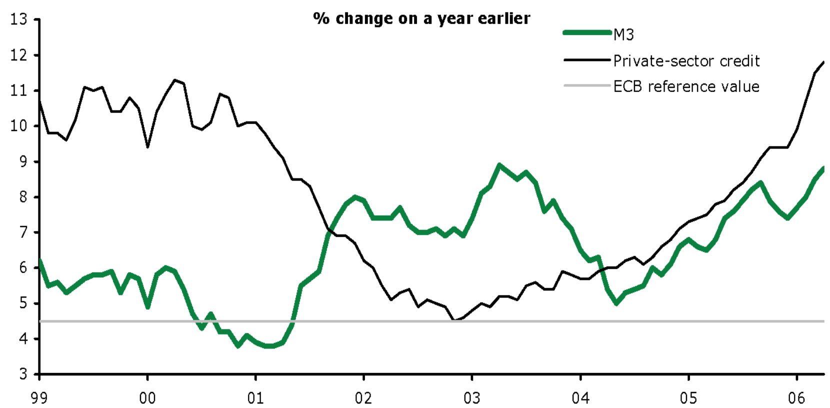
Source: TheEuropeanSide

Current values: refi rate= 2.75%; German 10-year bond = 3.95%

Mr. Mayer indicates three reasons why yields should trend higher, although marginally. "First, because the European Central Bank (ECB) is sticking with its measured approach to remove monetary accommodation; second, because the cost of borrowing is increasing on the other side of the Atlantic as well; and third, because government securities should respond to an improving economy which is expected to develop at 2.1% this year, to slow down a little bit in 2007 at 1.5-1.7%."

The single most important reason why the ECB ought to tighten its grip on monetary policy is the excess liquidity that has accumulated in the system and the fact that credit is booming. On the other hand, Mr. Tichet must approach the markets cautiously to avoid an abrupt reaction of the euro, breaking up on the upside on accounts of a decreasing interest rate differential with the dollar. It is a subtle alchemy. "International rate differentials," says Mr. Mayer, "need to be large enough to avoid a currency collapse in the current account deficit countries, but not so high as to

Euro-area excess liquidity

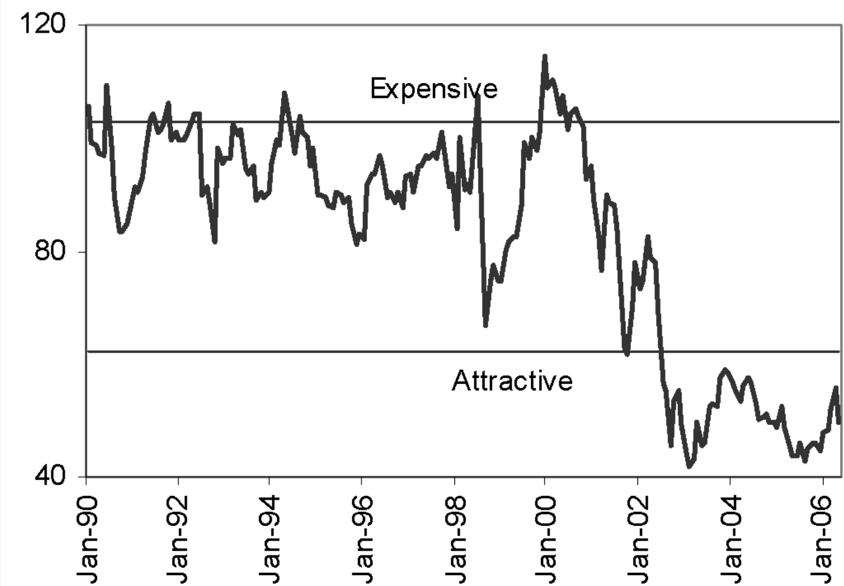


Source: ECB

Too much easy money around. The European Central Bank wants to remove monetary accommodation.

That drag on consumption called VAT

*"I fear" says **Conrad Mattern** of CONQUEST Investment Advisory AG "that German people are beginning to anticipate the VAT hike scheduled for January 2007. I mean that they are probably spending now in response to the rise in VAT in 2007. The Bundesbank is monitoring the phenomenon and mentioned it in its last monthly report." If Conrad Mattern is right, we cannot attribute any great importance to the signals of a rebound in consumer spending. "It is my suspicion" continues Mattern "that current purchases may turn into a retreat next year." The worry is shared by other experts as well. "The rise in VAT" writes **Dario Perkins** of ABN AMRO "could reduce household real incomes by around 1.5 percentage points in 2007. This would be a major drag on consumption, forcing households to reduce their savings significantly just to maintain previous levels of spending. We believe the German VAT hike could stall the consumer recovery in 2007." Mr. Perkins' words are somewhat echoed by **Stephan Deo** of UBS, who writes: "the euro-zone will have to swallow a sizeable fiscal tightening. Although we are not convinced the 3% VAT hike will be fully implemented in Germany, some fiscal tightening will happen." According to **Timo Klein** of Global Insight the squeeze may approach 1% of GDP. He also thinks the German economy is likely to survive, suffering only a slow down: "the economy is developing its own momentum", he says. "Taxes are larger than expected and exports remain impressive. There should be a 0.25% non-recurring dampening effect and a 0.5% general effect. I can envision the possibility that the German economy slows down toward 1.1-1.2% GDP growth in 2007, after reaching 2% in 2006. Not too bad, given the recent track-record.*



The chart shows how undervalued European Stock Exchanges are, according to the so-called Fed Model. It measures the attractiveness of stocks compared to bonds. From this point of view, euro-zone equities are among the most depressed in the world.

prevent orderly depreciation especially of the US dollar."

Analysts agree that an additional move at the July meeting does not appear to be an option. "The word *vigilance,*" explains **Elena Nieto** of Banco Bilbao, "that traditionally announces a rate hike the following month was absent from the ECB statement, which chose to use the expression *carefully monitoring*. This means that next rate hike decision should take place the 31st of August."

As we mentioned, the survey shows two analysts prepared for a mild bull market in bonds instead of a bear market. One is **Ciaran O'Hagan** of Société Générale. He has a simple explanation for his view. "The main central banks are tightening, and this behaviour will hurt growth. The US yield curve is in the process of inverting in the expectation of excessive tightening on the side of the Federal Reserve. Moreover, the European Central Bank is acting to dry up liquidity and not to counterbalance an an overheating of economic activity. Therefore, higher interest rates will slow down GDP and push interest rates mildly lower ." Yet, if analysts are right, don't bet on any big story for the next few months.

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