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# COUNTDOWN TO ECB “TAPER TANTRUM”: TAKING A “STEP-DOWN” IS BEARISH SAFE HAVENS—CONSIDER HEDGING GERMAN BUNDS

Wisdomtree EU  
26 Oct 2017

Forget “reflation”—when Mario Draghi articulates the ECB’s exit-plan from the QE programme on 26 October, it will be the clearest signal to come from officials who are judging the Eurozone economic recovery as increasingly self-sustained. That may cut short sentiment in bond markets well ahead of when inflationary pressures—if at all major—materialise. Absent inflationary risks in the near term, the event is potentially very bearish for bond markets.

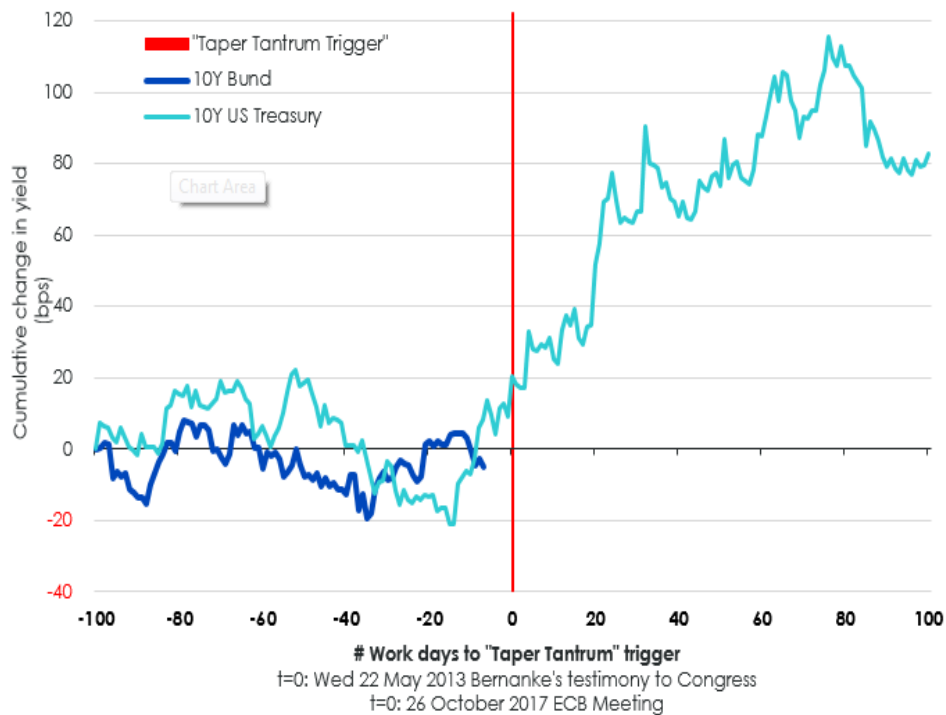
## QE taper talk extends bond market bearishness beyond October

Mario Draghi merely hinting at tapering QE further down the road may be enough to negatively reverberate bond markets well beyond the announcement. It does not require the ECB to quantify how much of the stimulus is withdrawn. Consider former Fed Chairman Ben Bernanke’s testimony to Congress on 22 May 2013 when he suggested the Fed would potentially ‘take a step down’ in the pace of bond purchases subject to economic conditions improving. The damage done to bond markets occurred well before the US\$10 billion per month cuts to government debt purchases was announced in December 2013, that same year.

The “taper tantrum” is a fitting frame of reference for how—following the ECB’s meeting on 26 October—sentiment in Eurozone’s safe havens may sour.

How bad could it get?

**"ECB QE Taper Tantrum" Countdown  
100 workdays pre- and post the announcement**



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Source: WisdomTree, Bloomberg.

As shown in the chart, 10Y US Treasury yields surged following Bernanke's Congress testimony on 22 May 2013 and over the course of three months rose over 100 bps to peak at close to 3%, before yields settled around 20 bps lower.

An "ECB taper tantrum" could set a precedent for the Eurozone's safe haven sovereigns to succumb to the kind of pressures as US Treasuries suffered during the Fed's taper tantrum in 2013. At risk are most notably German government bonds as, aside from accounting for almost a quarter of the EUR 1.8 trillion of QE amassed to Schaezle, Bobls and Bunds, they remain, even at this stage of solidifying Eurozone's macro fundamentals, extraordinarily expensive. Given 10Y US Treasuries yielded close to 2% just before the Bernanke's speech instigated the taper talk, the around 40 bps in yields of 10Y German Bunds today may suggest a prelude to an even sharper price correction.

10Y German Bunds have been volatile and sideways trending this year so far, with the choppy yield suggesting that the realisation of a finite life to ECB's QE programme has in Europe's undoubtedly most crowded market yet to sink in. For instance, it was only in October 2016 that the yield on 10Y German Bund broke out of negative territory, and, having fluctuated around lows of 30 to 40 bps this year, investors appear despondent.

### Solidifying demand fundamentals underpins the real inflationary risks

Post a QE exit, consumer prices are expected to anchor to a structurally-led strengthening domestic demand picture, spurred on by France's pro-growth reform agenda that is broadening out Eurozone's jobs market recovery beyond Germany for the next couple of years. That - as opposed to the sporadic, cyclical shocks of Euro weakness and elevated oil price volatility instigating import cost pressures and short-lived base effect surges to CPI - poses the real risk to Europe's bond markets longer term. The QE taper is a prelude to it. The steady uptick in German and Eurozone inflation readings

already markedly overshooting long dated high-grade bond yields suggest recent trading activity there is increasingly speculative, with investors banking on prices appreciation or spreads narrowing. They, unlike strategic investors seeking real positive income, may be the first to throw in the towel in the event of the ECB signaling tapering. Judging by the erratic path of German bond yields this year, the speculative trade into Bunds appears to have intensified.

### Implications for bond investors and hedging strategies

Allocations to Europe high-grade fixed income since the launch of QE in March 2015 now look particularly exposed and vulnerable to such a rising rates event risk.

Consider investors who, having assumed significant term risk to bid for meagrely low coupons rates with positive redemption yield in Eurozone's safe havens, risk high convexity and high duration inflict major capital losses to their portfolios.

As the veil of artificial support for Eurozone's high-grade sovereign and corporate bonds is removed through ECB's QE exit plan, prices in bond markets will revert to clearing around hard, that is, stronger economic fundamentals. Hedging fixed income portfolios benchmarked around European high-grade exposure may be warranted.

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Using leveraged short ETPs tracking Bunds may be considered as hedging instruments.

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