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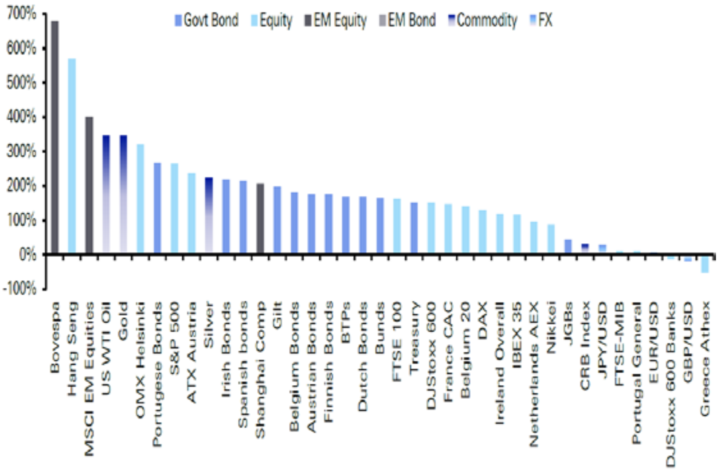
HAPPY BIRTHDAY ECB

Global Outlook

The European Central Bank (ECB) recently celebrated its 20-year anniversary and instead of a birthday cake, DB research released a compelling chart about how different asset classes have performed over this time period. Surprisingly strong was the performance of government bonds of peripheral countries. In fact, Portuguese government bonds outperformed even the S&P 500. Additionally, Spain, Italy and Ireland were at least able to beat German Bunds. Also the EUR can't be described as a weak or instable currency, given its performance over the last 20 years. Performance was on par with the USD and outperformed the GBP.

Figure 1: Total return performance of major global financial assets over the last 20 years (local currency)



Source: Deutsche Bank, Bloomberg Finance LP GED. Please note: bond total returns are 10y maturities

The chart above has been produced at just the right point, as the political situation in Italy is starting to get a lot of attention. The research community and the press have spent a lot of time on researching/speculating about which country might want to leave the EUR, EU or even the planet, as they are getting paid to get interesting stories out. Hedge funds and other fast-money players like to jump on these stories and short the market. But given the performance numbers above it can be assumed they lost more money by trying to short peripheral governments than any real money investors lost by investing in these bonds (even when the haircuts on Greek government bonds were very painful).

Sometimes it's hard for an outsider to understand the European experiment. And sometimes it takes people like current ECB President Mario "whatever it takes" Draghi in 2012 to fly to London and explain it. But then the damage to the short position is already done.

Of course, the EU as well as the EUR is a work in progress. Nevertheless, it is a stable framework where money can be made in government bonds as well as corporate bonds. We will always find movements who try to challenge the established framework, such as Greece or Brexit. But so far neither of them have been able to secure bespoke deals for their countries. We have recently seen the populist movement in Italy emerging, but the comment "politics are a rendezvous with reality" from Germany's former Finance Minister Wolfgang Schaeuble to his Greek colleague a couple of years ago remains valid. How are you going to spend money you don't have? It seems unlikely that this money will come from more relaxed EU budget funding rules.

Buying Time

All of the above gives comfort that the noises that were driving markets in the last few weeks and led to speculation that Italy wants to leave the EUR (and/or the EU) will go away. We don't want to advocate complacence, as recent election wins in Germany and France of pro-European parties have only bought the establishment a bit more time to kick-start necessary reforms to please the electorate and drive them away from the populist threat.

However, over the last few weeks German Chancellor Angela Merkel finally responded to French President Emmanuel Macron's reform proposals with her typical low-key style. She used a newspaper interview to announce that Germany will support the launch of the EMF, a Eurozone budget (albeit a small, "lower double-digit" figure) and raise its contribution to the 2021-2027 EU budget. In essence, Germany will pick up part of the funding gap resulting from Brexit. The money won't come for free, as tight conditions will be attached to the pay outs. Still, the decision underpins Germany's full commitment to the EU as well as the Eurozone, even beyond pure economic interest. Further integration is still driven by the idea of creating prosperity and maintaining peace in Europe.

The willingness of wealthy countries to push the European idea forward, even when this means increasing its financial contribution, makes us hopeful that Europe will continue to be a good place for investment and increase investor willingness to look past the current noise.

If we look back to the chart mentioned earlier, the performance data could raise the argument that numbers for peripheral government bonds were only good because of the involvement of the ECB. However, the ECB was not the only central bank that bought bonds. The Fed, BOE and BOJ went down the same road and, therefore, the increase in global liquidity supported assets worldwide--not just in Europe. In addition, the ECB only started buying bonds in 2015. This was done not to save countries from bankruptcy, but rather to stop the deflationary spiral in the Eurozone.

Gradual Changes Ahead

All in all, the ECB has good reason to celebrate its birthday, as the central bank helped to manage the Eurozone through the very difficult crisis years. Mario Draghi will leave at the end of October 2019, but even then the ECB will remain the anchor for stability in the Eurozone. However, the ultra-low yield policy of the Draghi-era will likely come to an end as Europe's biggest economy, Germany, is pushing for a change in this strategy. But even the German hawk Jens Weidmann, president of the Bundesbank, who is one of the potential successors to Draghi, will only able to change the direction of the ECB gradually and only if the economic situation allows it.

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