Drumroll to the ECB meeting

Louis-Vincent Gave | GaveKal| 29 May 2014

Yesterday, the yield on 10-year US treasury bonds broke downward through 2.5%, its floor ever since last summer's 'taper tantrum'. There were two main catalysts for the move. First, there was renewed weakness in the renminbi, as the offshore CNH set a new low for the year with US$-CNH rising to 6.27. Second, there was poor data from Germany and, especially, France, where the ranks of the unemployed continued to expand. Looking at the evolution of bond prices through the day, it seems it was the second point that really moved the market. Following the bad French and German job numbers, which themselves came close on the heels of poor leading indicators and weak money growth figures, markets are now pricing in expectations that the ECB will have to be very aggressive indeed next week if it is to turn back the tide of European deceleration.

Curiously, the situation is reminiscent of October 1987. Back then, the US dollar was falling against the deutschemark, contrary to the developed countries' promises of currency stability in the Louvre Accord the previous year. With the Fed baulking at aggressive interest rate increases to defend the US dollar, the market convinced itself that the Bundesbank would step in with rate cuts to weaken the deutschemark. To the market's (and US Treasury Secretary Jim Baker's very vocal) disappointment, this did not happen. Markets gapped downward. Computerised trading in the form of portfolio insurance programs took over, and the Dow Jones Industrial Average suffered its worst one-day performance in history.

We are not saying that a 1987-style crash is imminent—just pointing out that when everyone is sunbathing on the same side of the boat, an unforeseen wave can easily capsize the vessel. Today, recent market action (year-to-date highs for bonds, new highs for many equity markets, a long-term low for the Vix...) leads us to believe that the market's expectations for ECB action have reached sky-high levels. Of course, these expectations may well be met - but, given resistance from the Bundesbank and the ECB's track record of acting aggressively only when a crisis is already upon it, this is hardly a certainty.

If the ECB does act decisively next week - say by buying asset-backed securities in a bid to get money supply growth going again - the response from European bonds and global equities should be positive, while the euro will head lower. In this scenario, the spread between German bunds and peripheral bonds will most likely continue to narrow. But, if the ECB disappoints, then what? Logically, peripheral bonds would sell off, bunds would rally, and the euro might well strengthen (though this is not a certainty as disappointment with the ECB could lead to capital flight).

With that in mind, approaching next week's meeting with some protection makes sense. There are many different ways to build circuit-breakers into your portfolio. We particularly like the trades below:

- Long 10-year US treasuries, short 10-year French OATs - The idea is simple. If the ECB acts forcefully, the euro is likely to fall, which would deliver currency gains. At the same time, 'risk-free' sovereign yields would probably creep back up, especially in France, which continues to lose influence in Brussels (a trend amplified by the electoral obliteration of the French Socialist Party and bitter infighting on the right). On the other hand, if the ECB fails to intervene, then deflationary pressures will mount across Europe and the world, raising big questions about the French government's ability to meet its budget plans. (It was revealed yesterday that Francois Hollande's 2012 tax increases did not raise the planned €30bn last year, but just €15.6bn - the Laffer Curve in action?)
- Long Vix - Despite a combination of Ukrainian risks, questions about tapering and soft economic figures, in the last few days, the Vix has fallen to its lowest levels since March 2013. This indicates that investors, tired of paying a premium every month against a correction that does not materialise, have given up protecting their portfolios. In other words, bearish, or just prudent, investors have now capitulated.
- Long US dollar - Both valuations and momentum now seem to argue in the US dollar's favor. Plus, if the ECB delivers, the US dollar should rally... and, if the ECB fails to deliver, triggering a violent market rotation from one side of the ship to the other, the US dollar may well be perceived as the most sheltered haven from the storm.

In short, if we are right that the markets are heavily positioned for a move in one direction, then the trading sessions that follow the ECB meeting could turn out to be very 'interesting'. This may yet turn out to be a typical case of 'buy the rumor, sell the fact'.

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