

Euro area financial integration

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ECB – Bond Market Contact Group

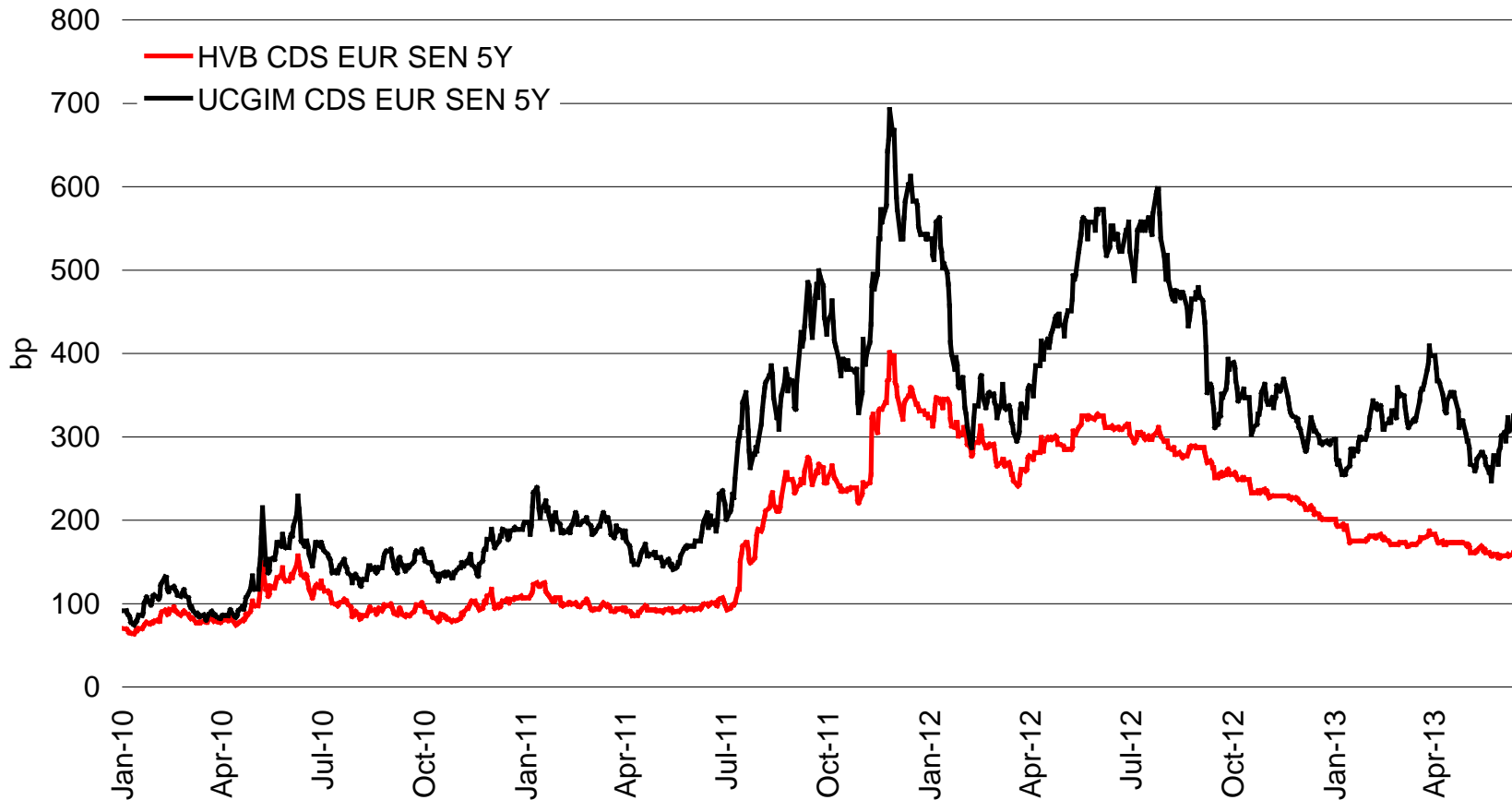
I. The Funding Perspective

General Assessment

- Dislocated money market
- No unsecured interbank market, even o/n market limited
- Repo with "periphery banks" in "periphery collateral" difficult or not possible
- Higher haircut e.g. GC pooling, LCH
- Strong ECB dependence
- Diverged funding levels e.g. 12m MM UC S.P.A Euribor +23bp

I. The Funding Perspective

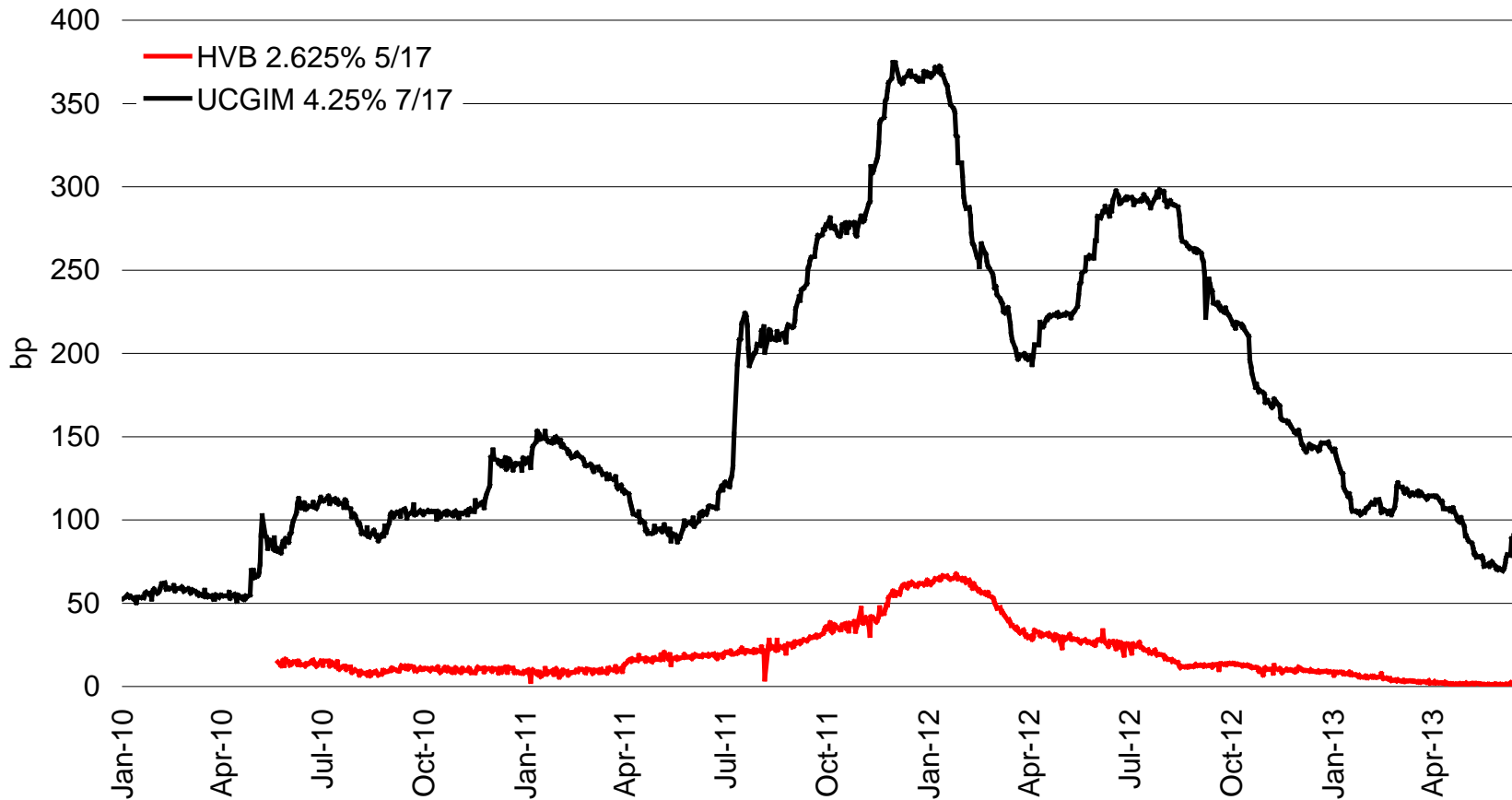
5Y CDS HVB and UCGIM



Source: UniCredit Research

I. The Funding Perspective

HVB Pfandbrief and UCGIM OBG



Source: UniCredit Research

II. The Investor Perspective

Executive Summary

- 3 Phases of European Area Financial Integration
 - Phase 1 - Convergence (1999 – 2007): Switch from local to European benchmarks
 - Phase 2 – Divergence (2008 – mid 2012): Refocusing on local benchmarks
 - Phase 3 – Readjustment (Mid 2012 – today): Still focus on local benchmarks with strong focus on ratings and liquidity
- „Target2“ still shows fragmentation despite some stabilisation
- Commercial Banks reallocate to domestic debt
- Duration positioning: close to benchmark with bias to short duration
- Country weights: still long exposure to peripherals vs. core countries despite spread widening

II. The Investor Perspective

	2013 Performance in % (2012)					
	Total	1 - 3 Years	3 - 5 Years	5 – 7 Years	7 - 10 Years	10+ Years
Euroland	0,11 (11,16)	0,00 (1,67)	0,13 (8,17)	0,40 (11,81)	0,21 (14,47)	-0,63 (17,76)
Germany	-1,55 (4,52)	-0,23 (0,46)	-0,85 (2,65)	-1,14 (4,83)	-1,38 (6,85)	-3,62 (8,60)
France	-1,41 (10,19)	-0,27 (2,35)	-1,09 (7,30)	-1,25 (11,32)	-1,11 (14,01)	-3,16 (16,43)
Italy	2,05 (21,01)	1,37 (9,65)	1,37 (17,12)	1,78 (21,22)	2,15 (25,14)	3,20 (32,07)
Spain	5,32 (6,04)	2,75 (5,61)	3,89 (6,40)	5,48 (7,38)	6,80 (5,19)	9,21 (7,80)
Netherlands	-2,03 (5,94)	-0,21 (1,17)	-1,18 (4,66)	-1,58 (7,08)	-2,31 (8,69)	-4,72 (8,70)
Belgium	-2,14 (16,67)	-0,38 (5,65)	-1,21 (12,67)	-1,83 (17,45)	-1,99 (21,76)	-4,28 (25,60)
Austria	-1,20 (10,78)	-0,10 (2,20)	-0,72 (7,00)	-0,98 (11,77)	-1,01 (13,93)	-0,73 (8,50)
Finland	-1,88 (7,30)	-0,36 (1,15)	-1,32 (4,55)	-1,96 (8,25)	-2,42 (10,02)	
Ireland	5,53 (29,31)	1,14 (14,99)	2,86 (24,73)	5,25 (32,84)	6,63 (34,20)	8,96 (36,42)
Portugal	4,34 (58,14)	2,10 (35,87)	2,57 (53,90)	5,76 (79,30)	6,62 (75,71)	8,10 (68,58)

Segment	2013 Performance in % (2012)
Euro Corporates All (IG)	0,12 (13,60)
Euro Collateralized	1,32 (11,39)
Euro Sub Sovereigns	-0,19 (8,75)
Euro High Yield	2,05 (27,19)
Emerging Markets (EMBI+; USD)	-9,36 (18,04)

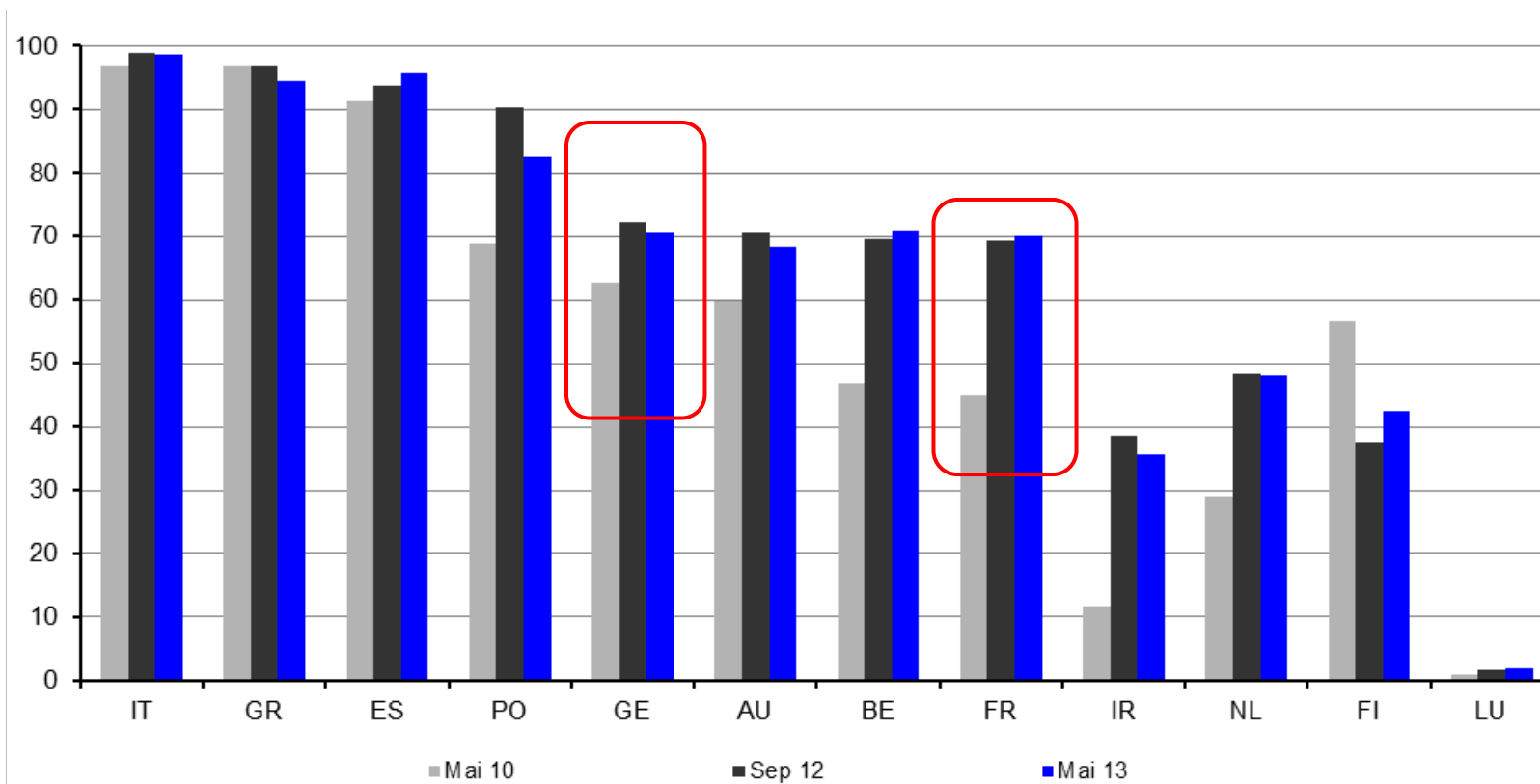
II. The Investor Perspective

1999 - 2007	2008 – mid-2012	Mid-2012 - today
<p>Convergence</p> <p><i>Euro-Euphoria/Enthusiasm</i></p>	<p>Divergence</p> <p><i>Euro-Hysteria/Scepticism</i></p>	<p>Readjustment</p> <p><i>Euro-Realism/Disillusion</i></p>
<p>Switch from local to European benchmarks</p> <p>Equities: EuroSTOXX, STOXX Bonds: JPM EMU, iboxx Eurozone Derivatives: EUROSTOXX-Future, Bund-Future</p>	<p>Refocusing on local benchmarks</p> <p>Equities: DAX, CAC40, IBEX .. Bonds: iboxx/JPM Germany, Italy, Spain ... Derivatives: CDS, BTP-Future, OAT Future</p>	<p>Still a tendency to local benchmarks with strong focus on ratings and liquidity.</p> <p>Equities: DAX, CAC 40, IBEX... Bonds: iboxx/JPM Germany, Italy, Spain ... Derivatives: CDS, BTP-Future, OAT Future</p> <p>Financial Transaction Taxes</p>

II. The Investor Perspective

Reallocation to Domestic Debt – My Home is My Castle

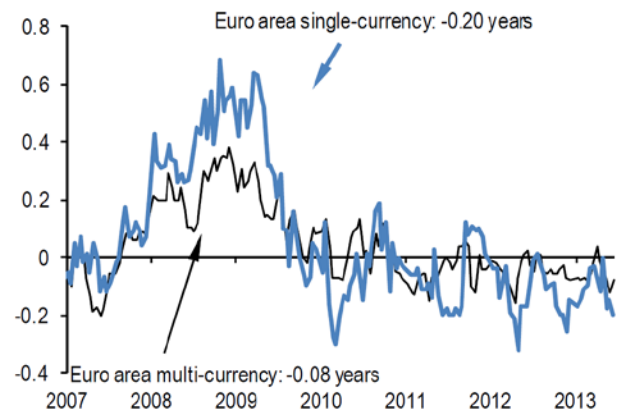
Proportion (in %) of Domestic Government Bonds to all Government Bonds held by Commercial Banks



II. The Investor Perspective

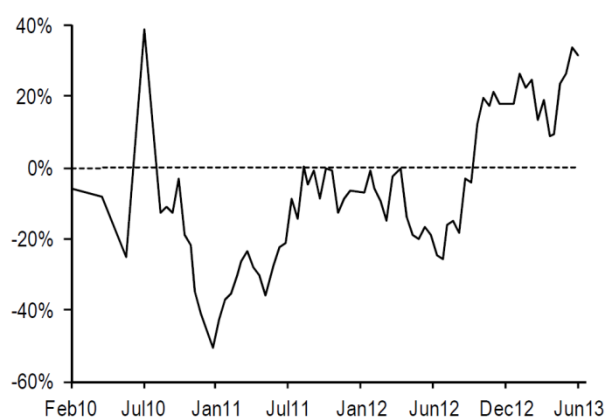
Investor positions have barely changed from the last survey

Duration deviation from the benchmark in years



Investors kept their long exposure to peripherals vs. core countries over the past two weeks broadly unchanged

Net exposure of Euro area investors to peripherals vs. core; %



European duration survey results

Duration deviation from the benchmark in years

	Signif. long		Small long		Neutral		Small short		Signif. short		Wtd mean (years)	
Multi-currency investors												
Europe	0	0	21	11	37	(8)	39	(3)	3	0	-0.08	0.04
US	0	0	16	0	36	(4)	44	0	4	4	-0.12	(0.04)
Japan	0	0	0	(5)	77	(1)	23	6	0	0	-0.07	(0.03)
Global aggregate	0	0	11	1	48	3	41	(4)	0	0	-0.15	0.02
Single-currency investors												
Euro area	0	0	11	(6)	37	1	52	5	0	0	-0.20	(0.05)
UK	0	0	10	0	50	10	35	(10)	5	0	-0.19	0.05
Peripherals vs. core												
Average	6	0	40	1	42	(3)	14	3	0	0	32	(2)

Duration:

Close to benchmark with short duration bias.

Country weights:

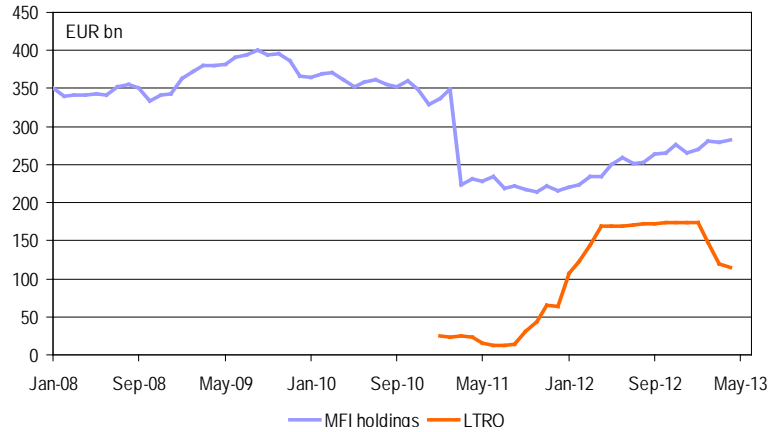
Still long exposure to peripherals vs. core countries despite spread widening.

III. The Dealer Perspective

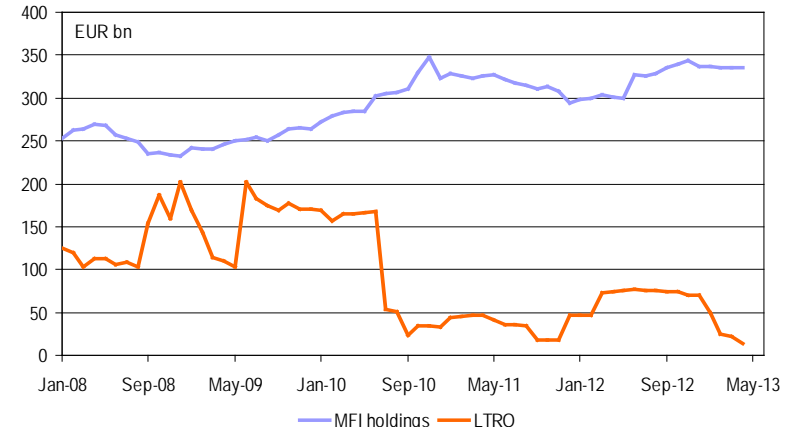
The Role of Banks in Fragmenting the EGB Market

Heavy LTRO usage in periphery → Fragmentation of the domestic demand patterns

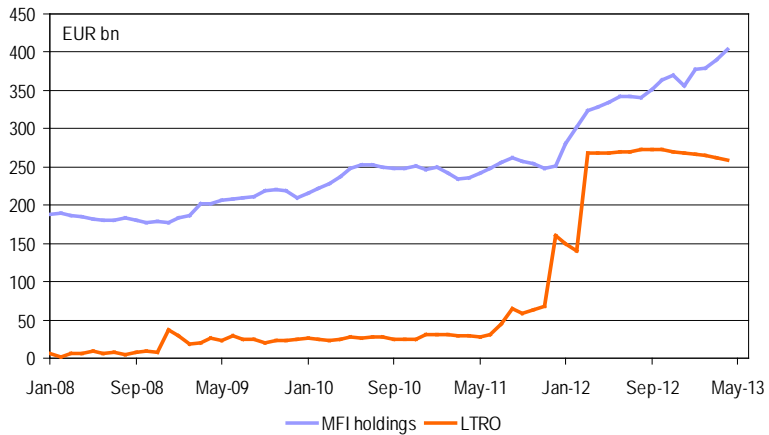
Banque de France



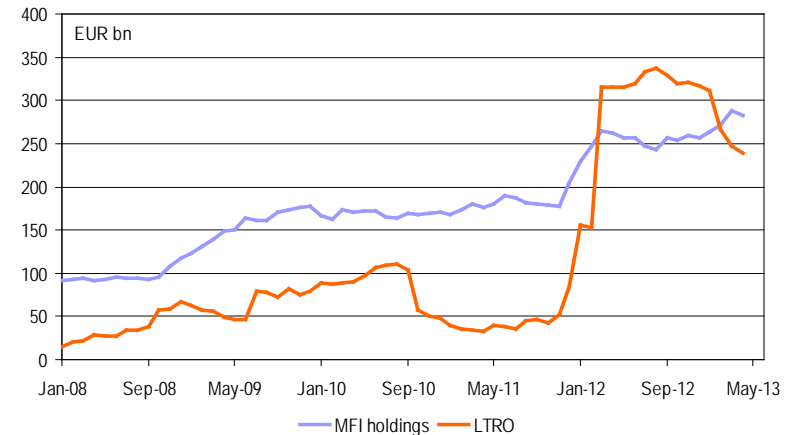
Bundesbank



Banca d'Italia



Banco de Espana

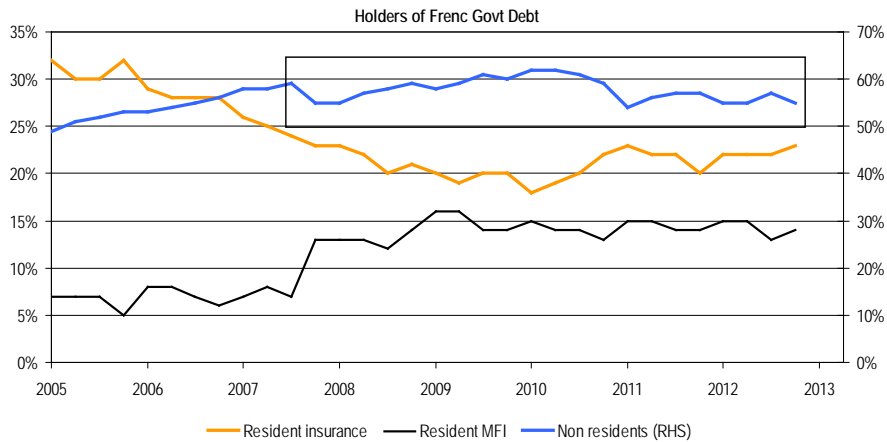


Source: ECB, Citi Research

III. The Dealer Perspective

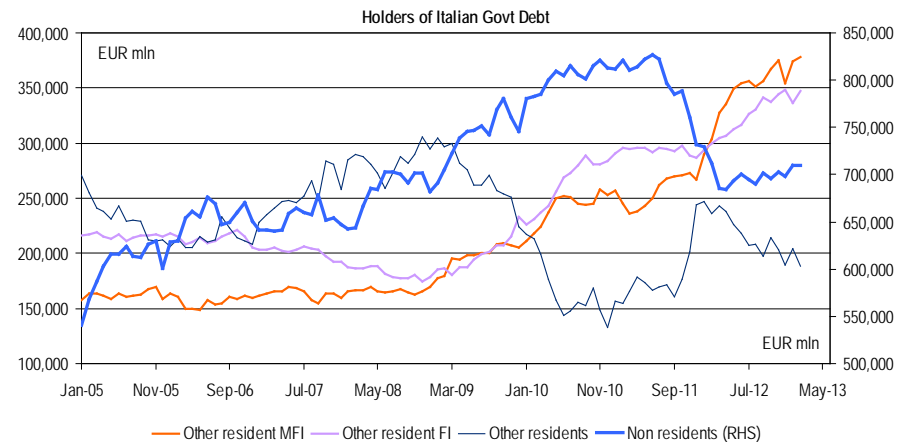
Trends in Foreign EGB Market Participation

Fragmentation of the non-resident demand patterns for core and non-core bonds



Non-resident share of French govies is stable throughout the crisis

Non-resident investors have liquidated Italian govies between 2011 and 2012... Draghi's OMT has been key in stabilising foreign demand

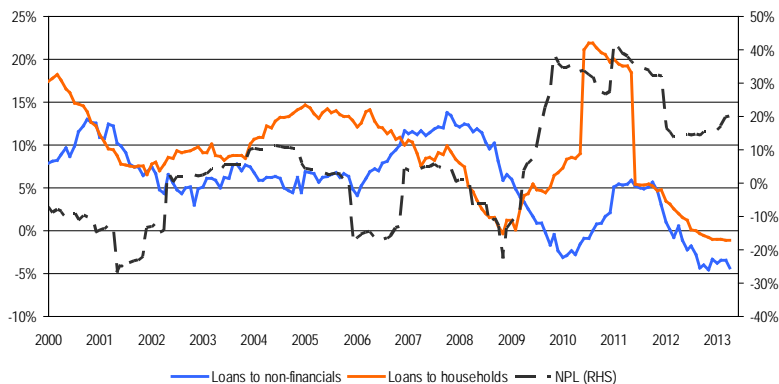


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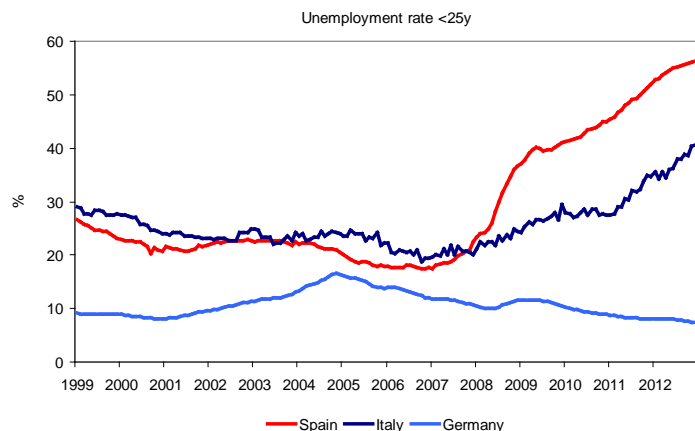
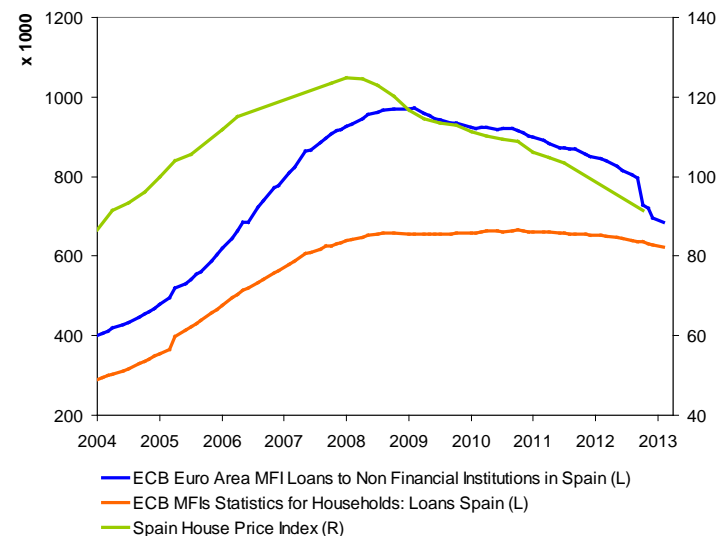
Real Fragmentation: Italy and Spain

Credit to real-sectors is contracting, house prices are falling. Rising youth unemployment

In Italy, lending to non-financials is back to levels seen in mid-2010 (-4% yoy), while NPLs rise at a rate of 20% yoy (now 6% of total loans)



House Prices are back to 2004 levels in Spain
Loans to households drifting lower



Divergence in labour markets, with striking contrast in youth unemployment versus Germany

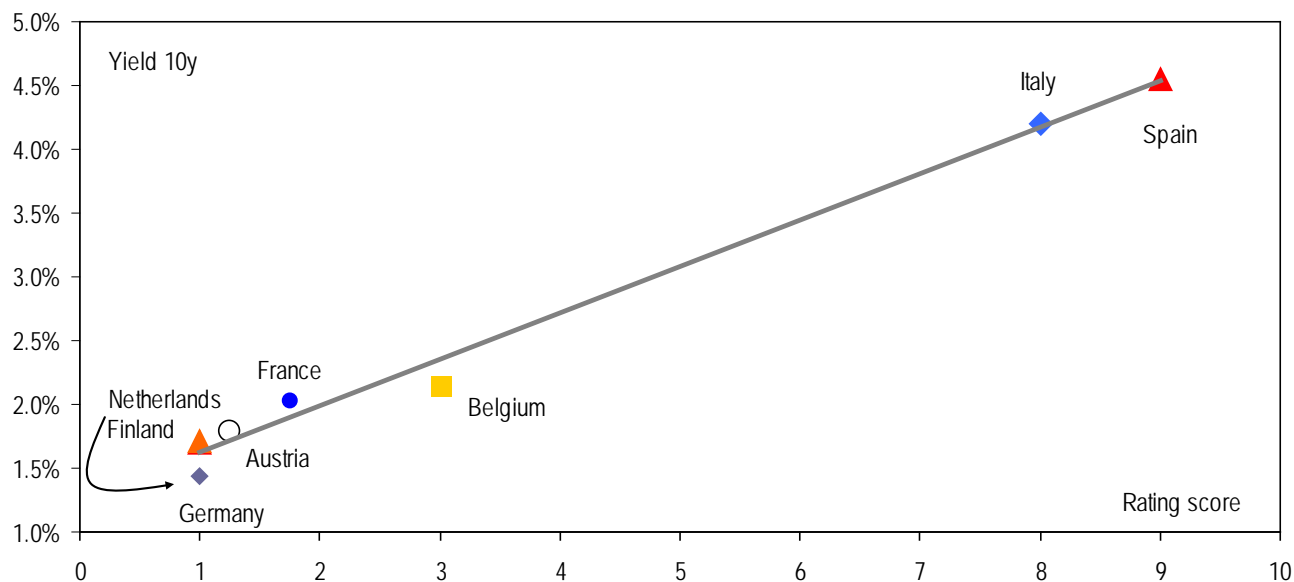
III. The Dealer Perspective

Dealer capacity to hold inventory in periphery has been impacted by several factors

- Changes in Risk Management
- Impact of Rating Downgrades
- Volatility has led to liquidity fragmentation
- Wider bid-offer spreads in periphery than core

III. The Dealer Perspective Credit Rating Fragmentation

EGBs...from AAA to almost sub-IG



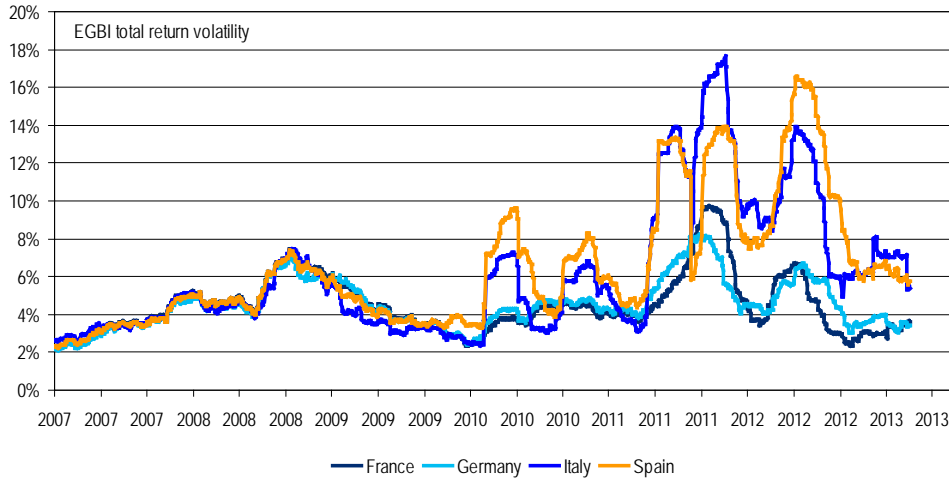
MARKET					RATING				
Isin	Bond	Maturity	Yield	ASW	S&P	Moody's	Fitch	DBRS	Score
EI966444 Corp	RAGB 3.4 11/22/22	9.5	1.79	8	AA+	Aaa	AAA	AAA	1.3
EI962882 Corp	BGB 4 1/4 09/28/22	9.3	2.15	51	AA	Aa3	AA	AAH	3.0
EJ341415 Corp	RFGB 1 5/8 09/15/22	9.3	1.70	-2	AAA	Aaa	AAA	AAA	1.0
EJ384577 Corp	FRTR 2 1/4 10/25/22	9.4	2.02	29	AA+	Aa1	AAA	AAH	1.8
EJ342271 Corp	DBR 1 1/2 09/04/22	9.2	1.43	-27	AAA	Aaa	AAA	AAA	1.0
EJ341690 Corp	BTPS 5 1/2 11/01/22	9.4	4.20	256	BBB+	Baa2	BBB+	AL	8.0
EJ006215 Corp	NETHER 2 1/4 07/15/22	9.1	1.71	3	AAA	Aaa	AAA	AAA	1.0
EJ525879 Corp	SPGB 5.4 01/31/23	9.6	4.55	285	BBB-	Baa3	BBB	AL	9.0

Source: Citi Research

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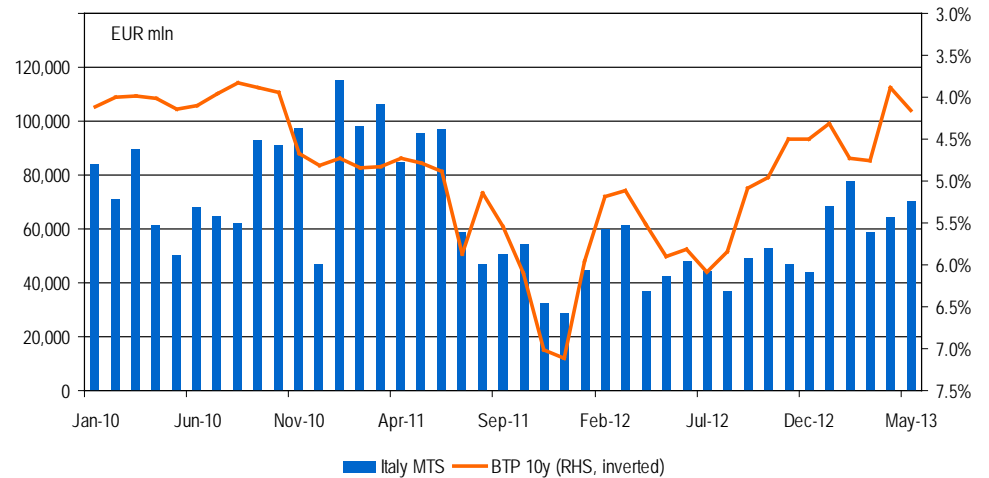
Liquidity Fragmentation

Volatility having a disproportionate effect on the liquidity of peripheral markets



Realised volatility between core and non-core has had a differential impact on VAR – both for dealers and end users of EGBs

Higher vol has translated into lower inventory, lower liquidity and wider bid/ask spreads for peripheral EGBs



Discussion Topics

- **Different funding approach**
- **Different bank lending policy**
 - **access to credits at reasonable levels limited to top rated borrowers who are accepted cross border**
- **Increased divergence of the economies**
- **Steps towards ‘reintegration’**
- **Impact of regulation**
- **Recent developments on banking union**
- **Too low rates in N Europe – leading to ‘bubble’?**

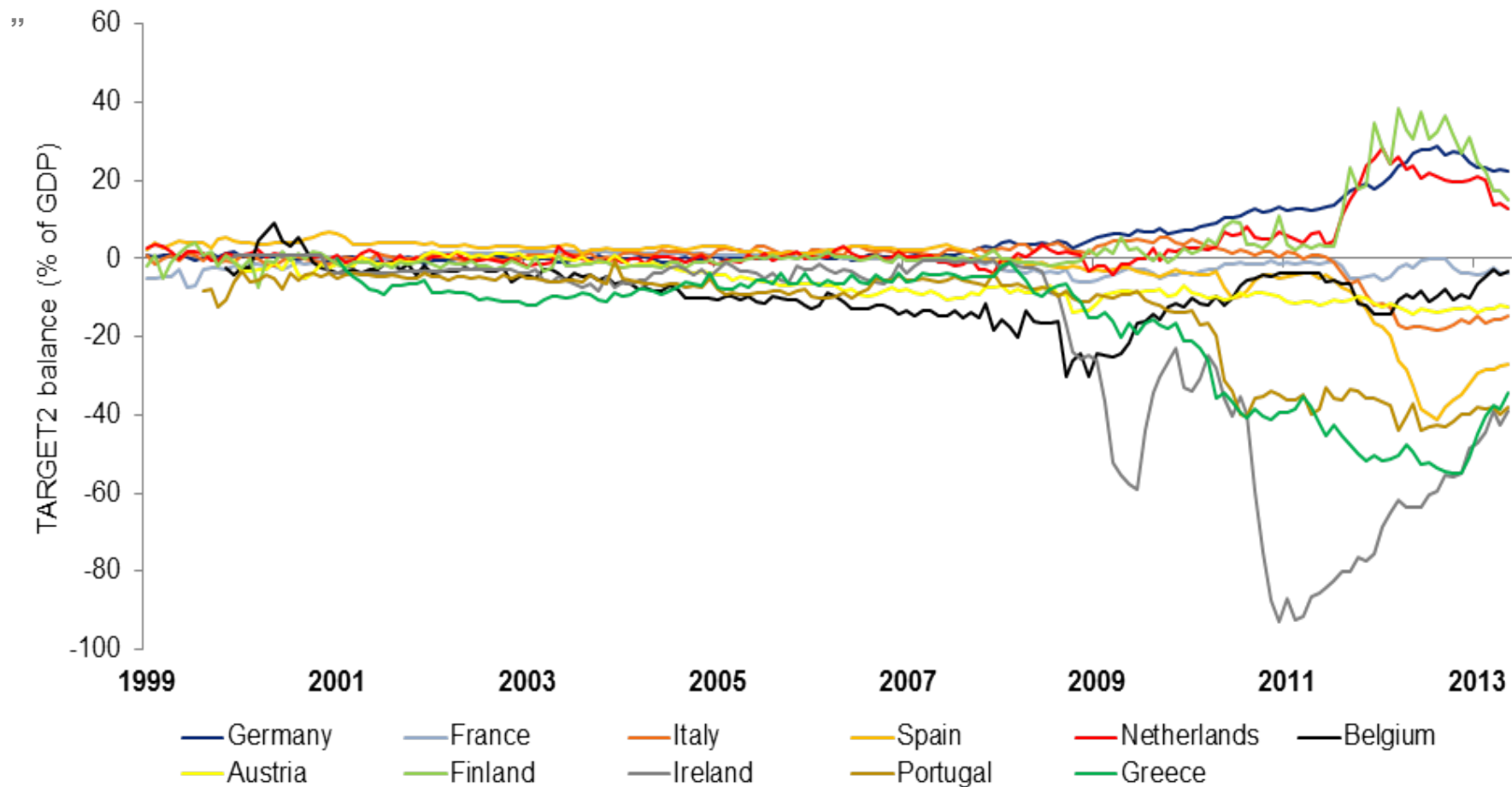
Euro area financial integration – Appendix

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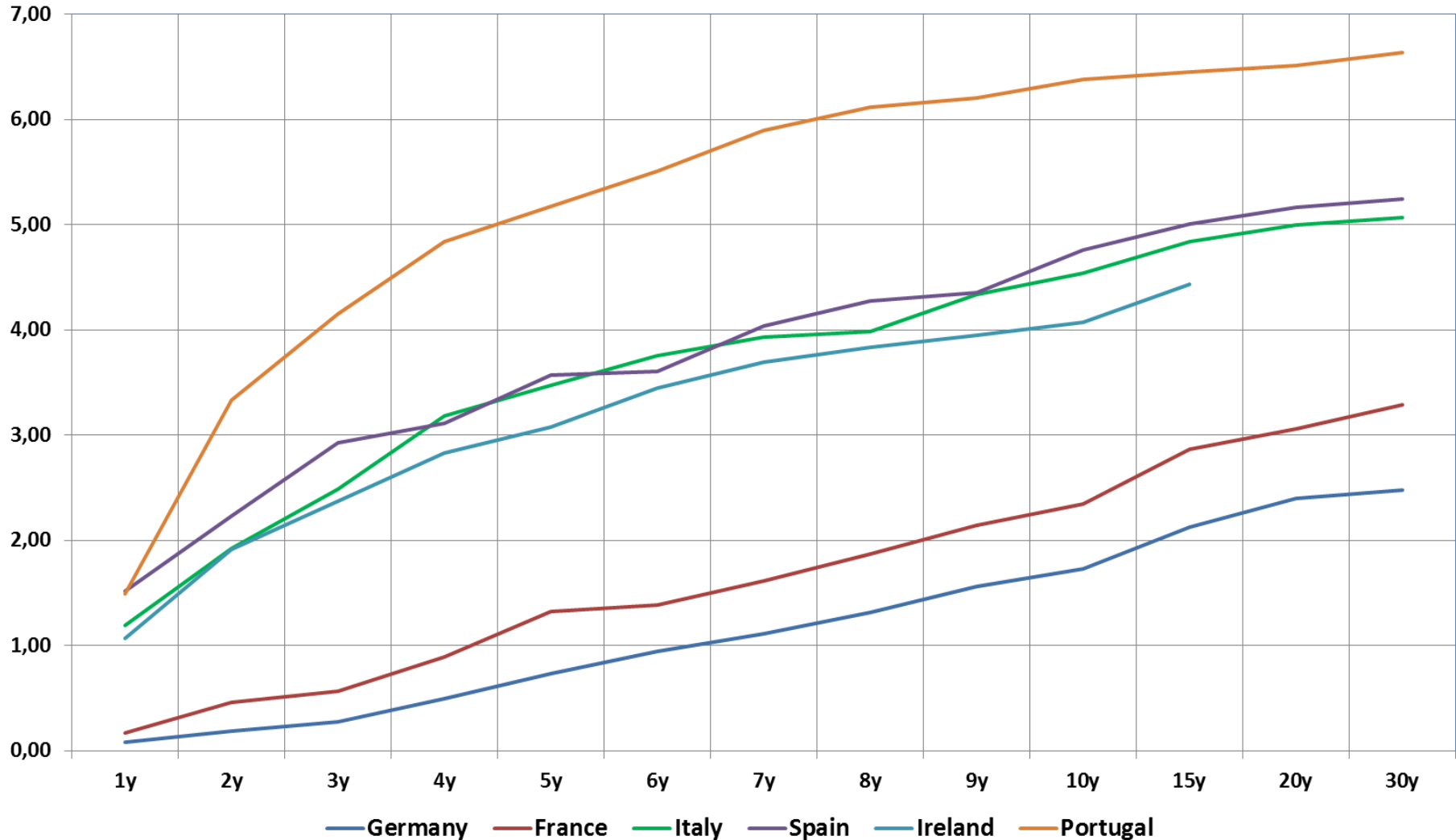
Frankfurt am Main, 09 July 2013

ECB – Bond Market Contact Group

TARGET2“ still shows fragmentation despite stabilisation (%GDP)



Yield Curves: Germany, France, Italy; Spain; Ireland and Portugal, 28.06.2013



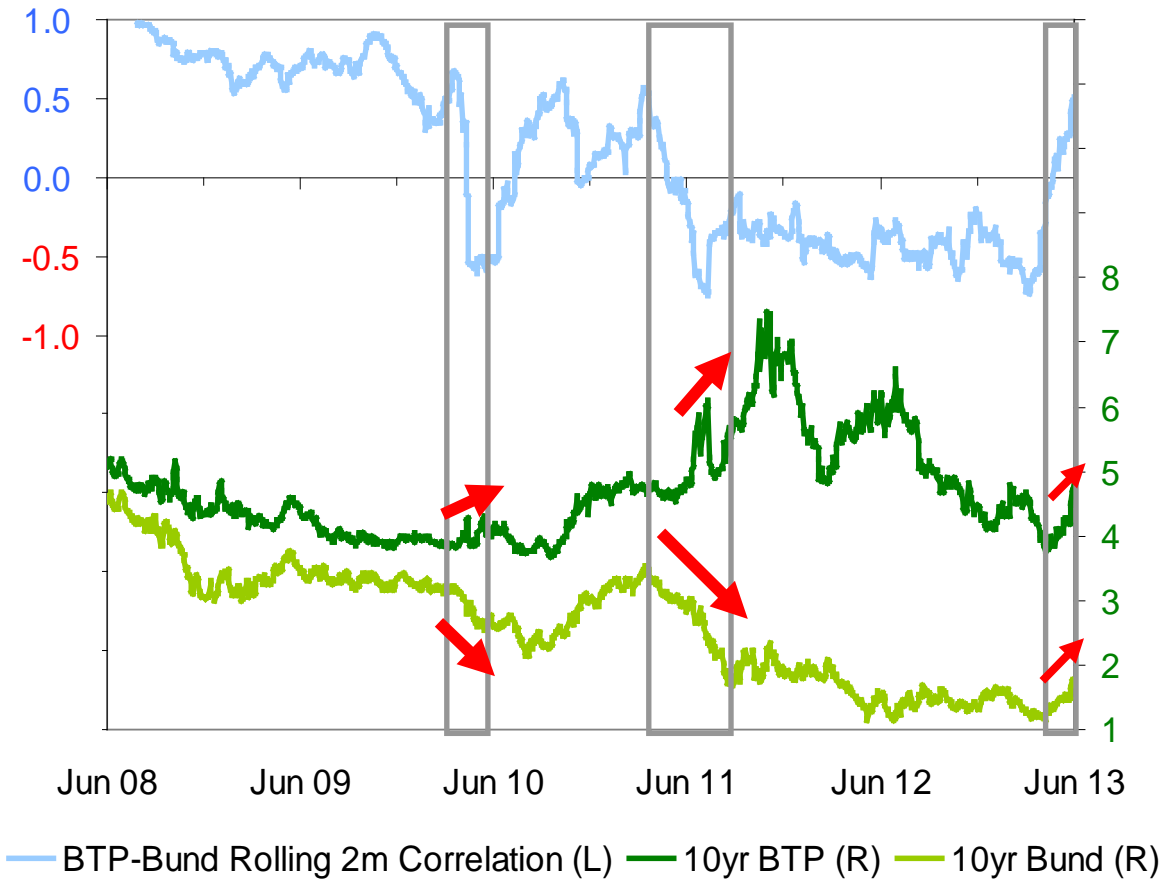
Fragmentation – reversible or permanent?

Path towards re-integration will take time and require much more than just Central Bank actions

- Fragmentation, or 'home bias' has created stability in politically turbulent environment (e.g. Italy, Cyprus)
- In recent bond market sell-off, periphery has been trading more like a Rates market than Credit Market
- Risk appetite for periphery has increased in line with lower volatility. But investors still constrained by ratings and regulation
- Re-integration will require structural reform and steps to improve competitiveness, in order to achieve better ratings – not the mandate of ECB.
- Central Banks could have some impact on minimizing volatility through market intervention

Core vs Periphery: Correlation

Heavy positioning and changing risk premia is distorting correlations



Large increase in the correlation between core and non-core in recent sessions.