



# ECB Bond Market Contact Group

## Bond market outlook and main developments

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# Recent developments and key themes

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Forward guidance, Fed tapering, AQR, VLTRO, excess liquidity, political concerns, downgrade risks...

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- **Central banks**

- Introduction of forward guidance by ECB & BoE this summer
- Fed tapering (decision not to taper in September)
- Asset Quality Review
- VLTRO
- Excess liquidity (making one year lows)

- **Politics**

- Political uncertainty in Italy continues
- US debt ceiling/fiscal shutdown
- Outcome of German election (strong result for Merkel)
- EM (Fed's prolonged accommodation eases EM pressures somewhat)

- **Economic data/Market levels**

- Improving economic data (PMI & GDP)
- Tight spreads (credit, Bono & BTP)
- Concerns over a Spanish downgrade
- Will financial assistance in Portugal and Ireland end soon?

# PMIs above 50 (“expansionary”)

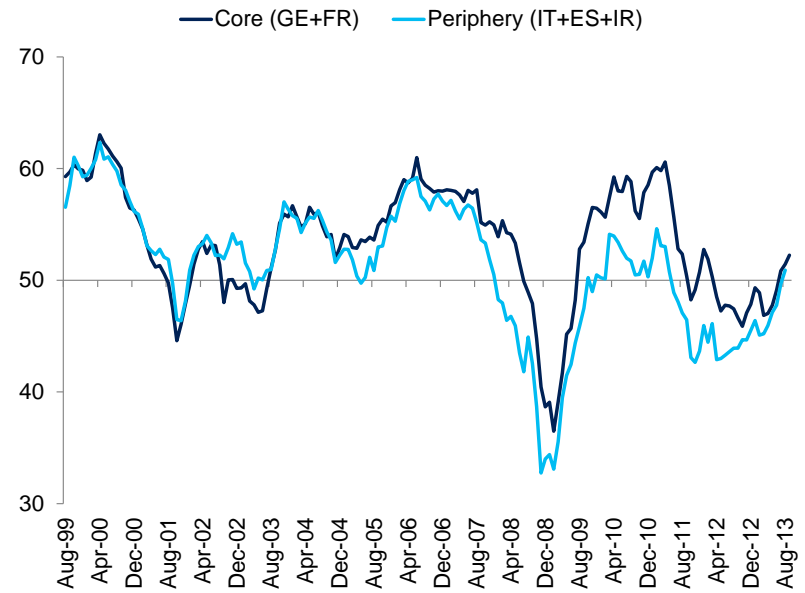
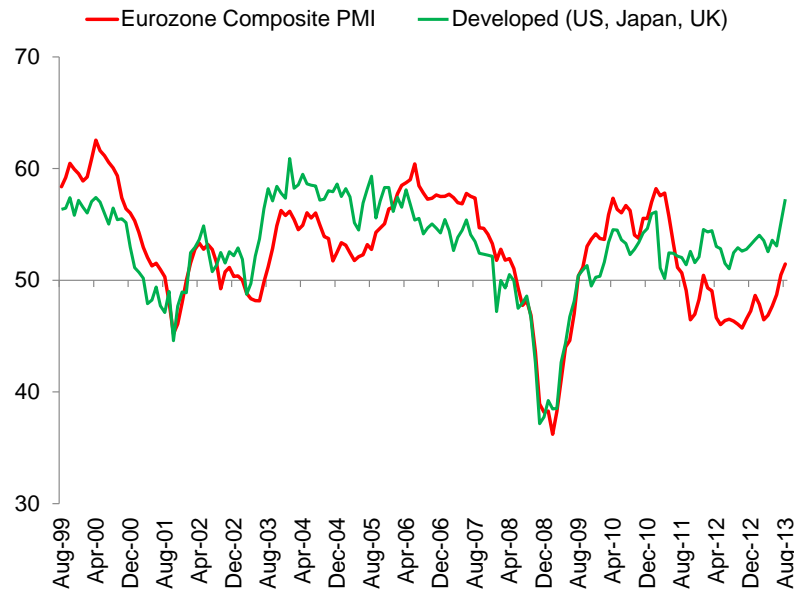
## Some improvements in the Euro Area, but still lagging the rest of the world

### • Euro Area

- Eurozone composite PMI above 50 but still lagging the rest of the world
- Core and periphery PMI data above 50
- 2Q13 GDP growth was positive for the first time in seven quarters

### • Developed (US + Japan + UK)

- PMI’s remain firmly positive (highest since May 2006)
- Positive GDP growth for all three countries in 2Q13

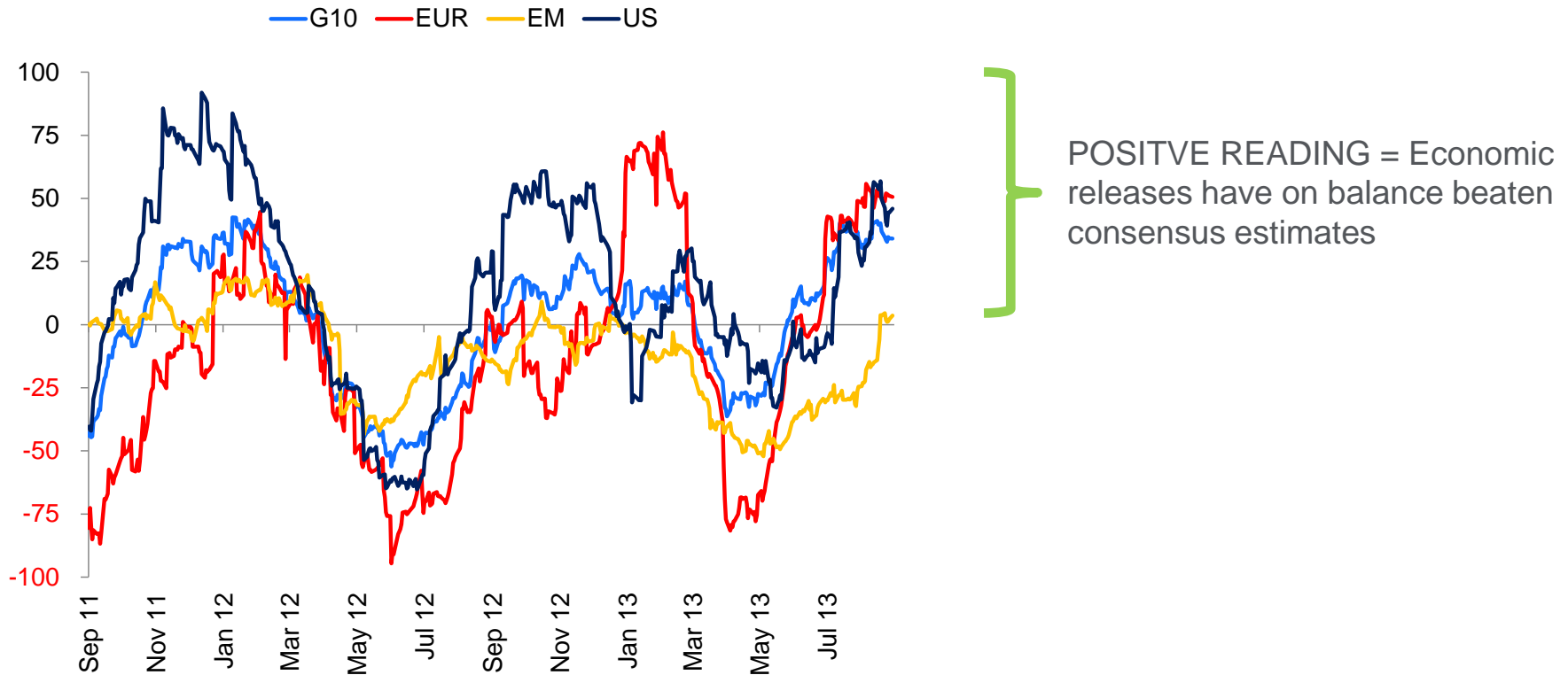


# Data releases vs consensus expectations

## The improvement in data has exceeded consensus expectations

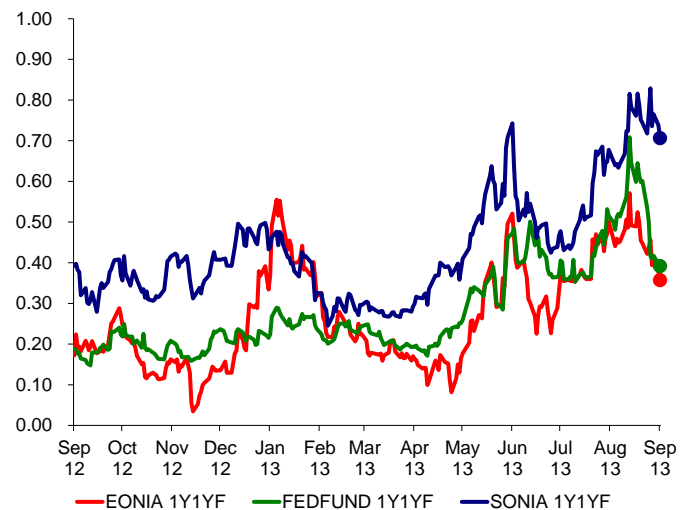
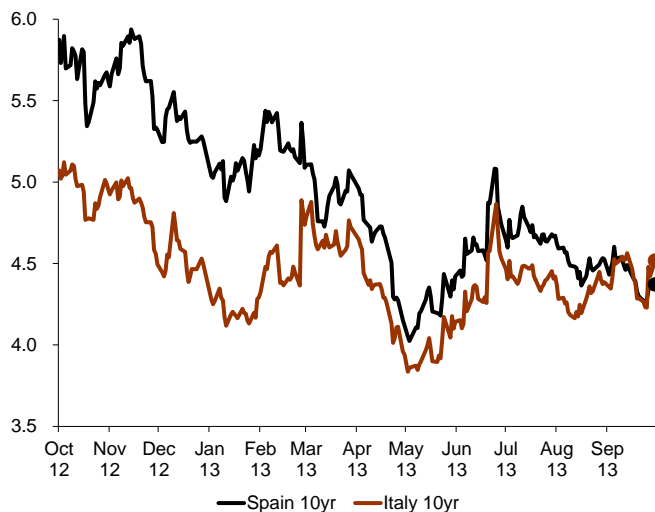
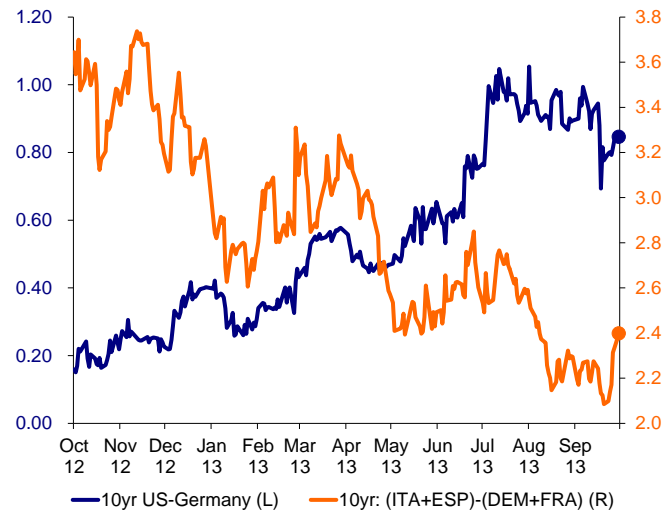
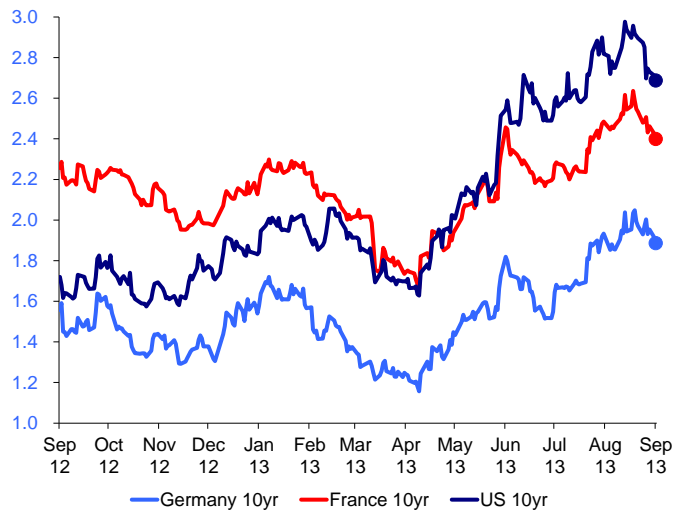
### ● Citigroup Economic Surprise Index

- G10, EUR and US economic data releases have strongly exceeded consensus expectations
- EM data releases have been roughly in line with forecasts
- EUR data releases have exceeded consensus estimates the most



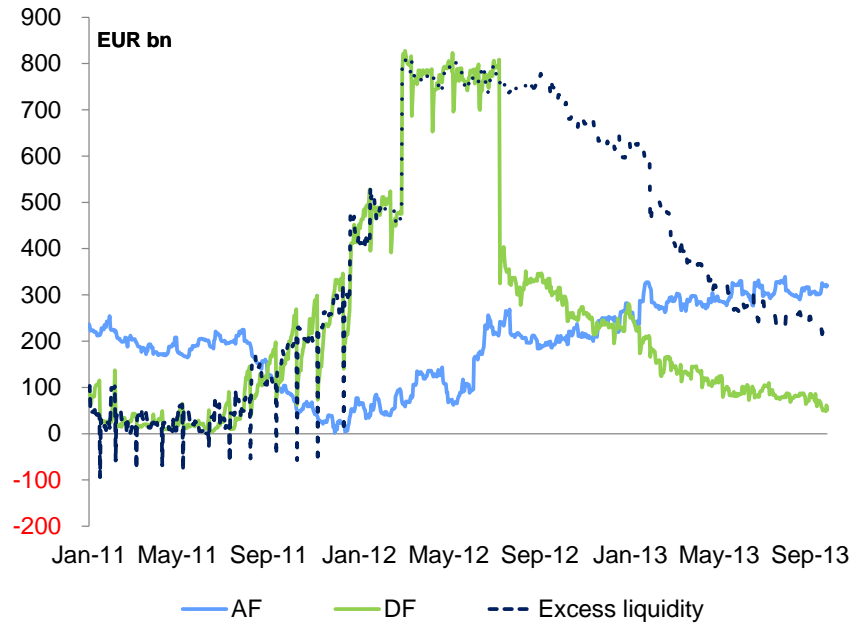
# Global Yields and Spreads

UST & Bund yields have broken ranges / EMU has core-non core bounced off the lows.  
 Bono's trading through BTP's / Volatile front-end



# ECB: Liquidity Analysis

Declining excess liquidity. EONIA fixings have been fairly stable. EONIA forwards below the refi-rate

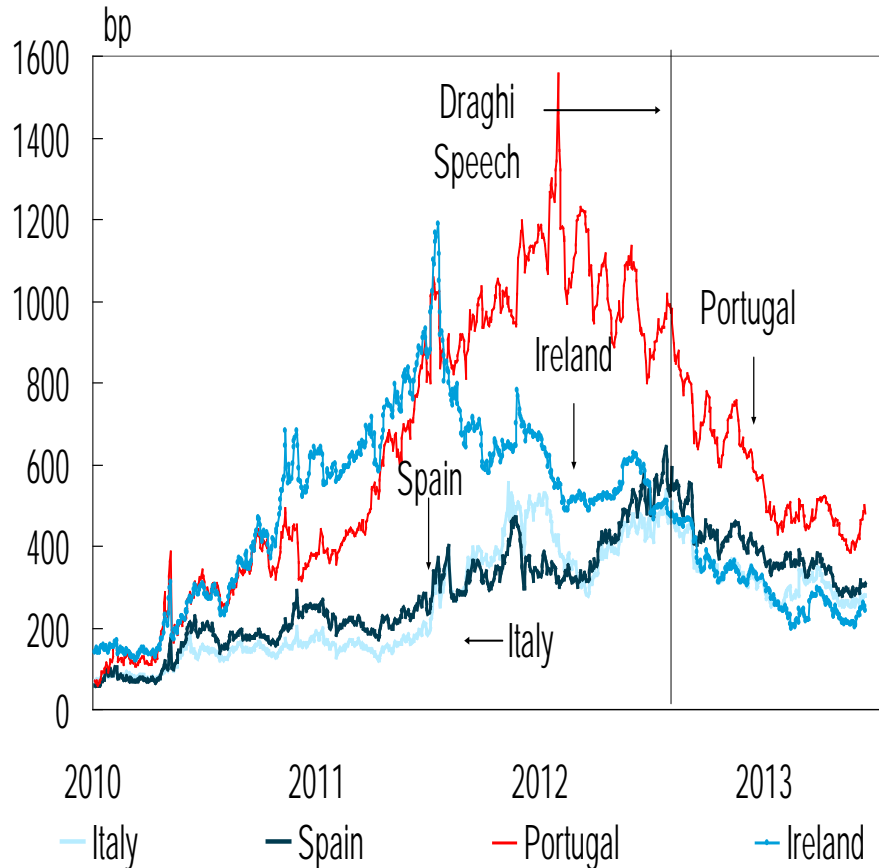


Source: ECB, Citi Research

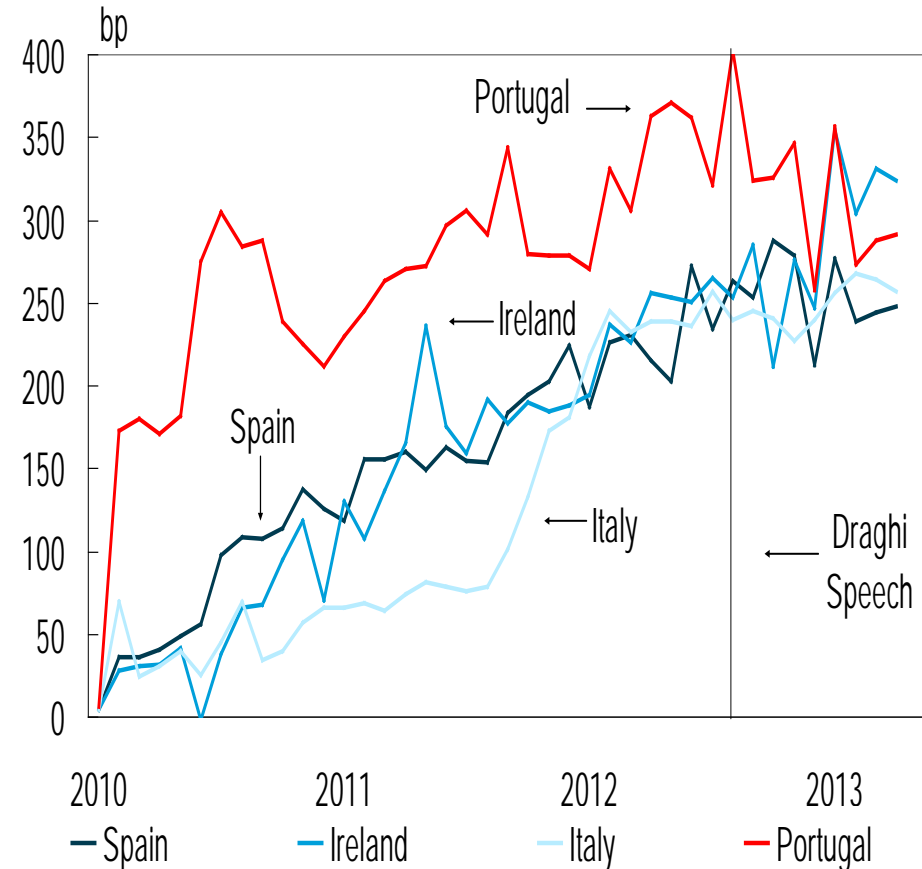
- Excess liquidity has declined by ~€597bn since early March 2013
- Current levels of excess liquidity ~€215bn have drawn attention to two main areas: (1) outlook for EONIA fixings and (2) will we get another LTRO?
- Little or no structural impact on average Eonia fixings so far (around 8bp over depo rate)
- EONIA 1Y1YF below the refi-rate (breached 50bp in early September)

# Financing Conditions Not Supportive of Economic Recovery

## 10-year Government Bond Spreads vs. Germany



## Lending Rates on New Business Loans (up to €1m, above 1Y) Spreads vs. Germany



Sources: ECB, BIS and Citi Research

# Forecasts: Global Yields, Spreads and Central Bank Policy

## Main highlights

### • UST

- Higher yields: 10s moving to average 3.50% in 1Q15
- Tapering to begin by end-2013 (base case) or early 2014
- Main risks to forecasts come in the form of a US growth shock (in either direction), and China and EM could be factors in this.

### • Bunds

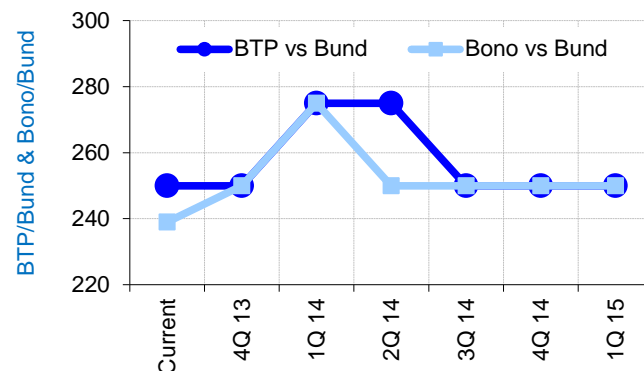
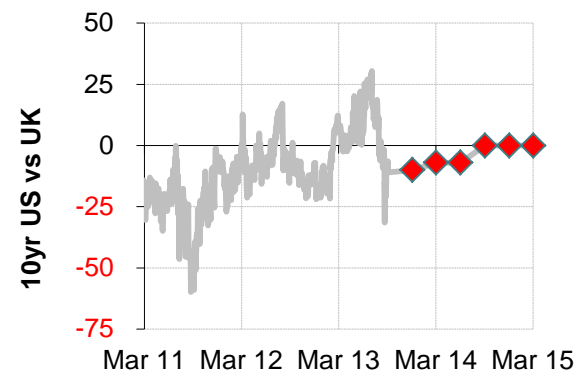
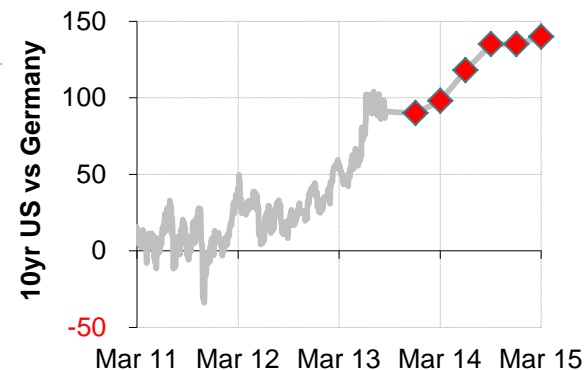
- Growth and inflation outlook continue to point to low core yields
- Bunds to range trade around 1.80% in the coming quarters
- ECB expected to keep monetary policy loose.

### • Gilts

- BoE to hike rates in 2015
- 2yr gilts to reach 1% by 1Q15
- 10yrs to move 10-15bp higher per quarter in 2014
- Bear steepening to eventually give way to bear flattening in late-2014

### • Spreads

- UST-Bund and gilt-Bund spreads to widen further
- UST-gilt spreads to remain close to flat
- BTP/Bund and Bono/Bund spreads to temporarily widen in 1Q14 (onset of supply and prospect of fresh elections in Italy)





# Peripherals: Growth, Ratings, Financial assistance

## • Euro Area

- As a whole the EA exited recession in Q2
- Nominal GDP remains down in YoY terms for peripherals
- Government debt/gdp ratios are likely to rise for a range of peripheral countries

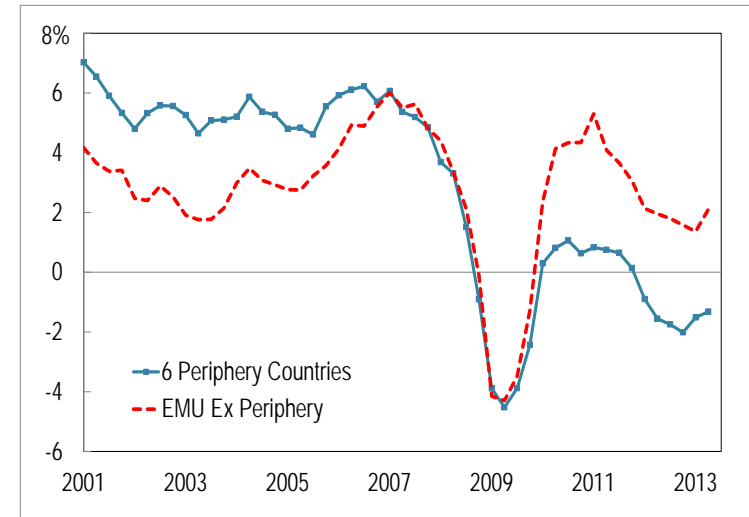
## • Italy/Spain

- Downgrade risks remain: Spain & Italy are both on Negative Outlook by Moody's and S&P
- Concerns over Spain being ejected from bond indices
- Political pressures in Italy remains

## • Ireland

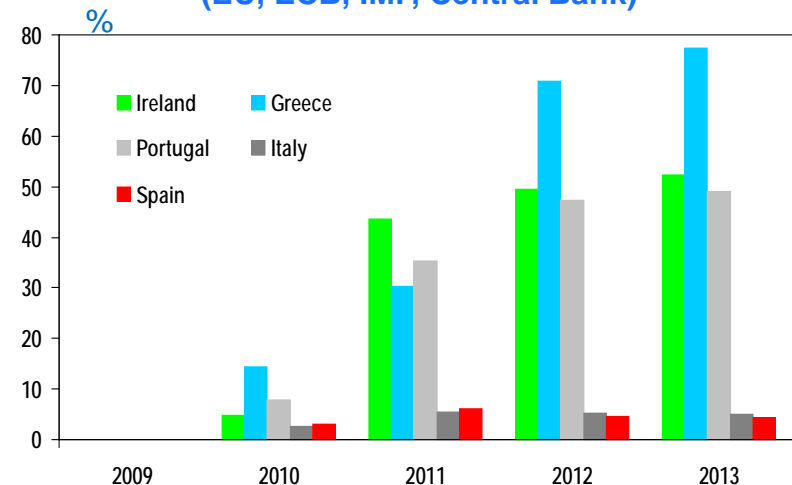
- Moody's revised its Ba1 rating Outlook to "Stable" from "Negative" on 20 September.
- Sub-IG (Moody's) and IG (S&P)
- 2 syndications this year (€7.5bn). Next step is to conduct regular bond auctions
- Conditional ESM program to extend post-2013? Would provide OMT backstop

### Euro Area – Nominal GDP YoY, 2001-13



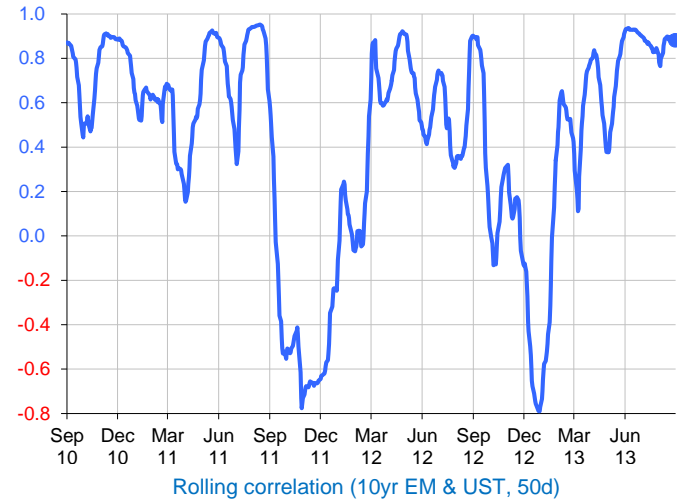
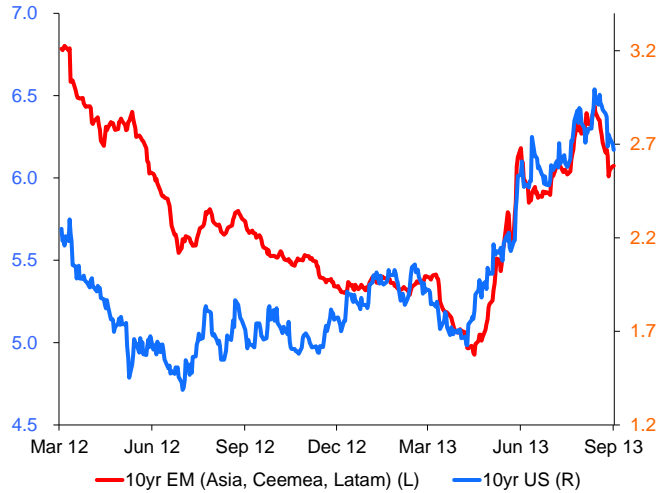
6 periphery countries are Italy, Spain, Portugal, Greece, Ireland and Cyprus

### Share of Govt Debt In Official Hands (EU, ECB, IMF, Central Bank)

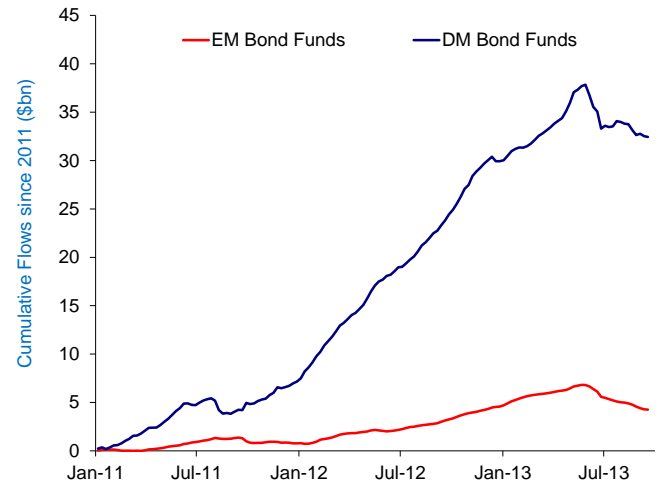
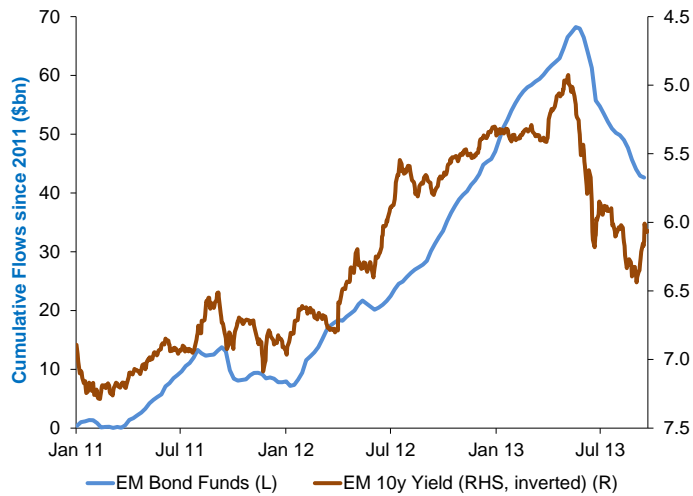


# Is risk on/off essentially taper or not taper?

**EM vs UST:** Correlation between EM yields and UST has picked up since Bernanke's comments on 25 May

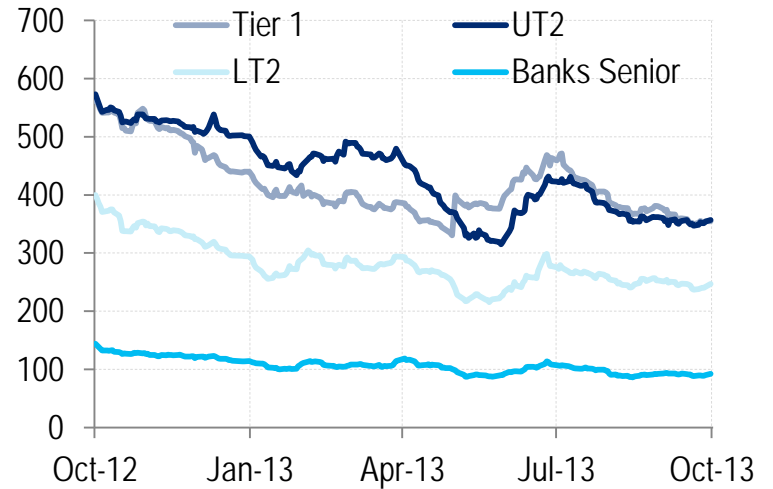
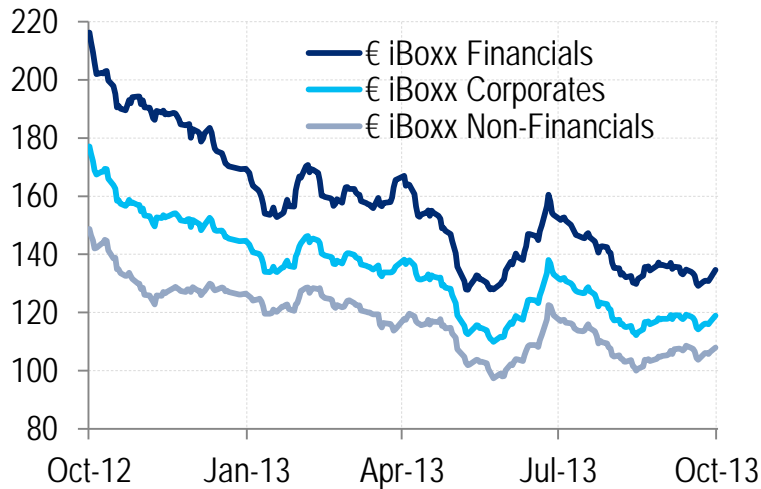


**Bond Flows:** Large EM outflows since mid-2013 has pushed yields much higher

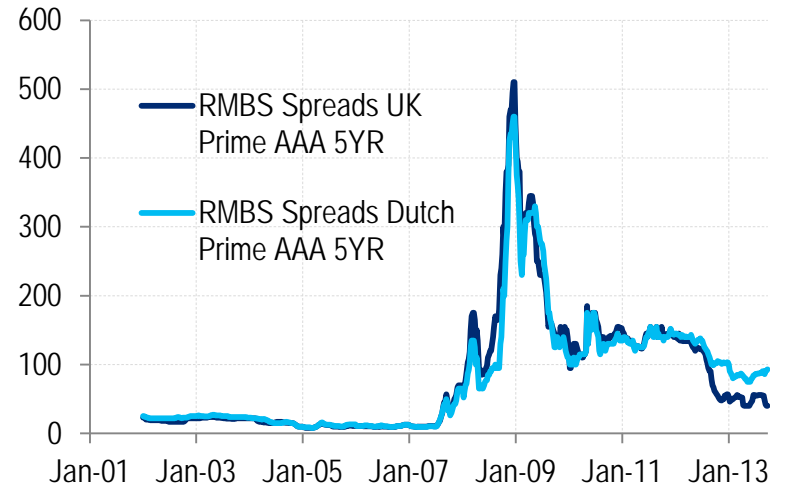
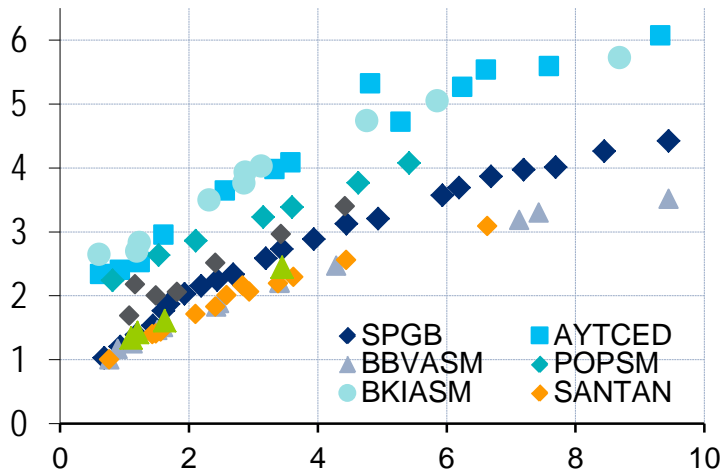


# Spread markets within the European bond universe

## Technicals supportive for senior and subordinated corporate spreads to grind in further

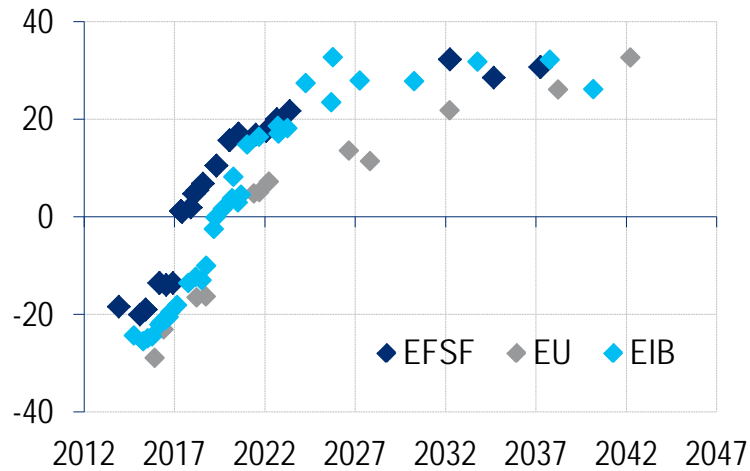


## Lack of supply beneficial for covered bonds (some of which now trade inside their govt curve)

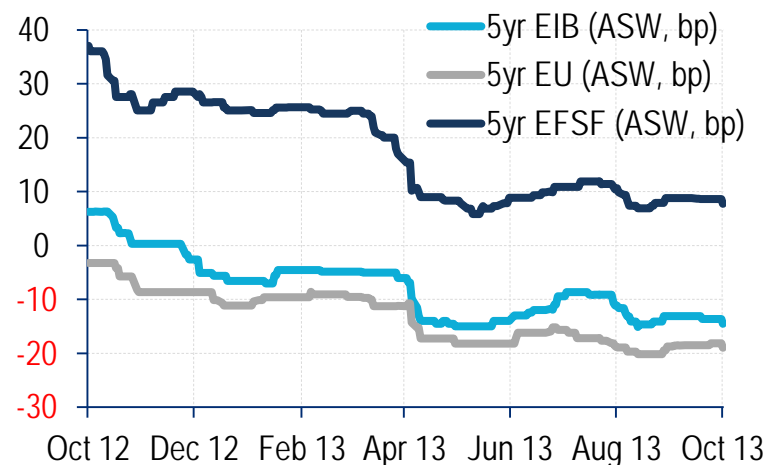


# SSA market welcomes a new issuer – the ESM to issue in October

## European suprationals (ASW curves, bp)



## Healthy demand & performance of supras



## ESM in brief

- Paid-in capital ultimately of €80bn
- Maximum lending capacity of €500bn
- Permanent intergovernment organisation established under international law
- €100bn allocated for Spanish banks
- €9bn allocated for Cyprus
- Provisional issuance schedule of €9bn for 2H 2013

Enhanced features likely to ensure core status