



Bond Market Outlook

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ECB BMCG meeting 1st July 2014

The impact of the June ECB package has been felt most in shorter dated periphery

Rates market has seen more notable moves since the June ECB meeting

| | Current | 4 June (before June ECB) | 7 May (before May ECB) | Change vs 4 June | Change vs 7 May |
|----------------------------|---------|--------------------------|------------------------|------------------|-----------------|
| 3m Euribor | 0.21% | 0.30% | 0.34% | -9 bp | -13 bp |
| 3m EONIA | 0.05% | 0.09% | 0.18% | -4 bp | -13 bp |
| Overnight GC Germany | -0.02% | 0.10% | 0.13% | -12 bp | -15 bp |
| Overnight GC Italy | 0.03% | 0.20% | 0.23% | -17 bp | -20 bp |
| Bobl yield | 0.36% | 0.48% | 0.61% | -12 bp | -25 bp |
| Bund yield | 1.25% | 1.43% | 1.47% | -19 bp | -23 bp |
| 5y Italy - Germany spread | 112 bp | 131 bp | 119 bp | -19 bp | -7 bp |
| 5y France - Germany spread | 19 bp | 25 bp | 25 bp | -6 bp | -6 bp |
| Itraxx Main | 61 bp | 64 bp | 68 bp | -3 bp | -7 bp |
| Itraxx Crossover | 239 bp | 251 bp | 270 bp | -12 bp | -31 bp |
| Eurostoxx 50 | 3236 | 3238 | 3160 | -2 | 76 |
| EURUSD | 1.365 | 1.360 | 1.391 | 0.005 | -0.026 |

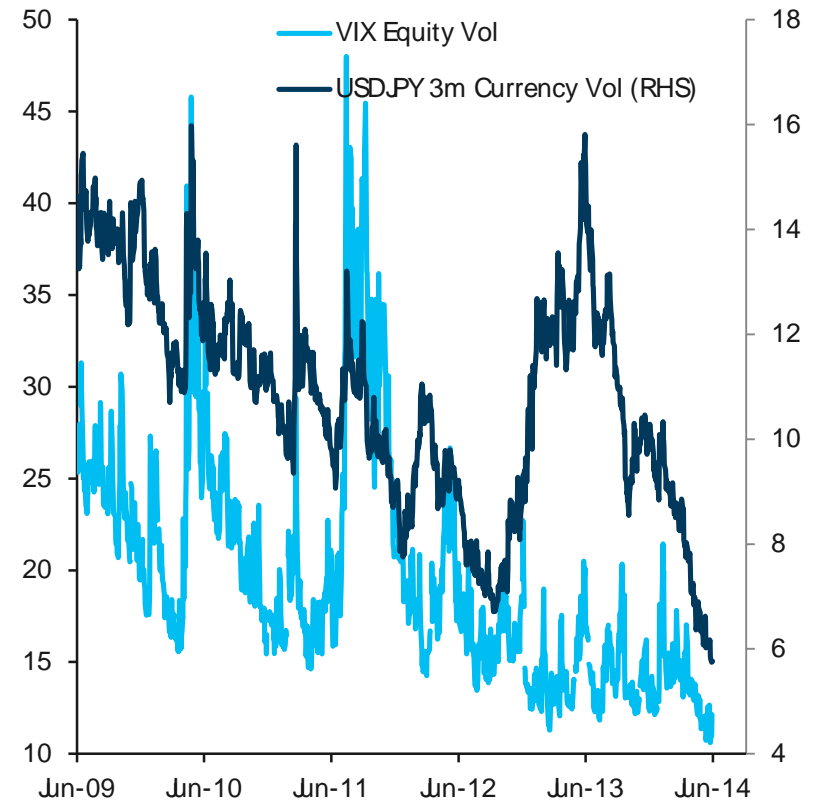
Source: Bloomberg, Barclays Research

ECB action has contributed to low volatility across asset classes

Rate volatility is not just historically low in EUR, but also in the US and UK



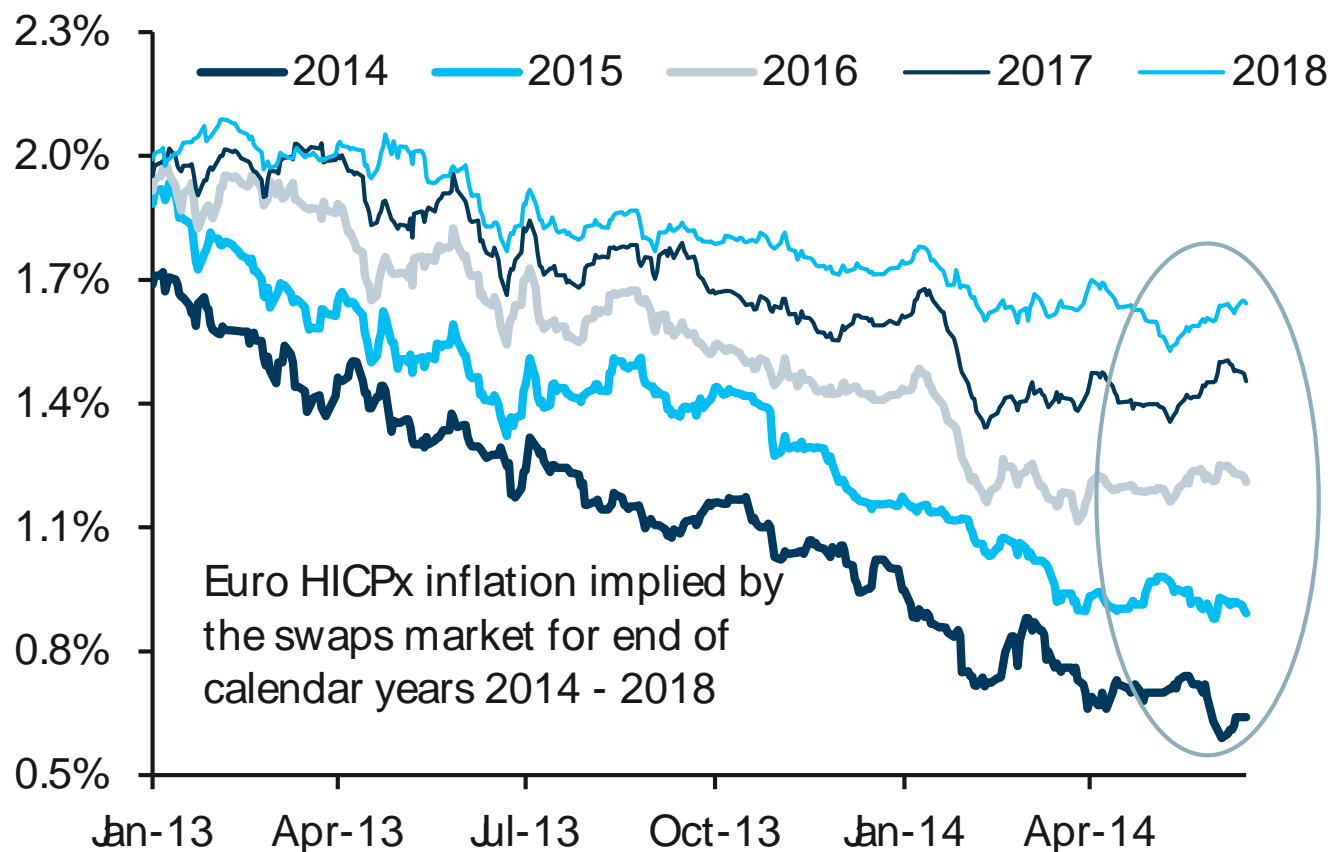
Equity and currency volatility also indicate very benign market conditions



Source: Barclays Research

Inflation expectations are also stabilising post the June ECB meeting

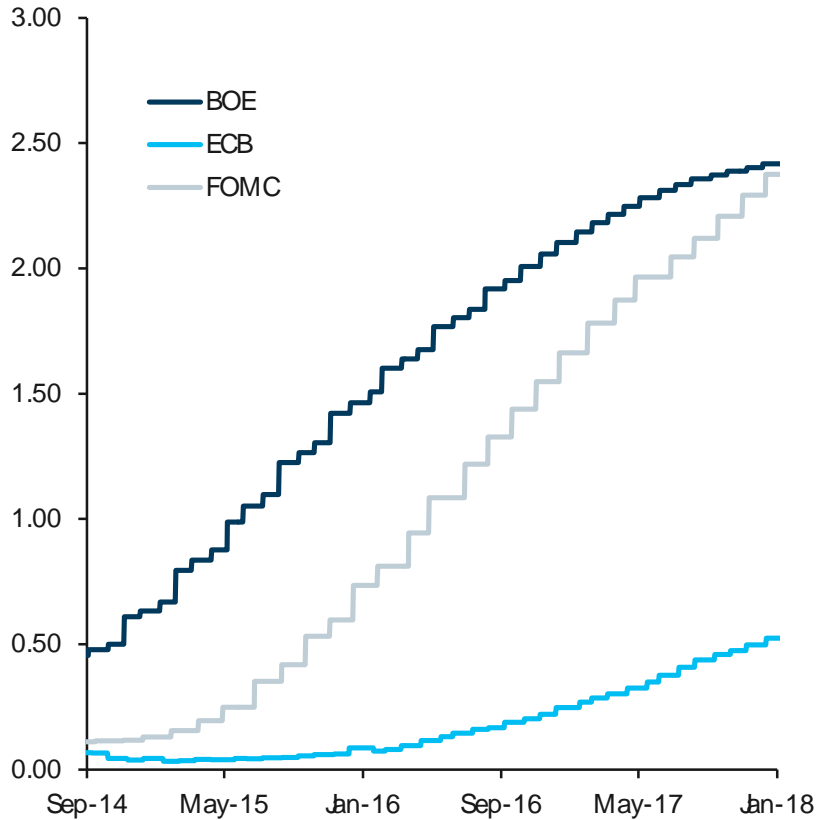
ECB has helped arrest the fall in inflation expectations, but the market remains below the ECB's projections



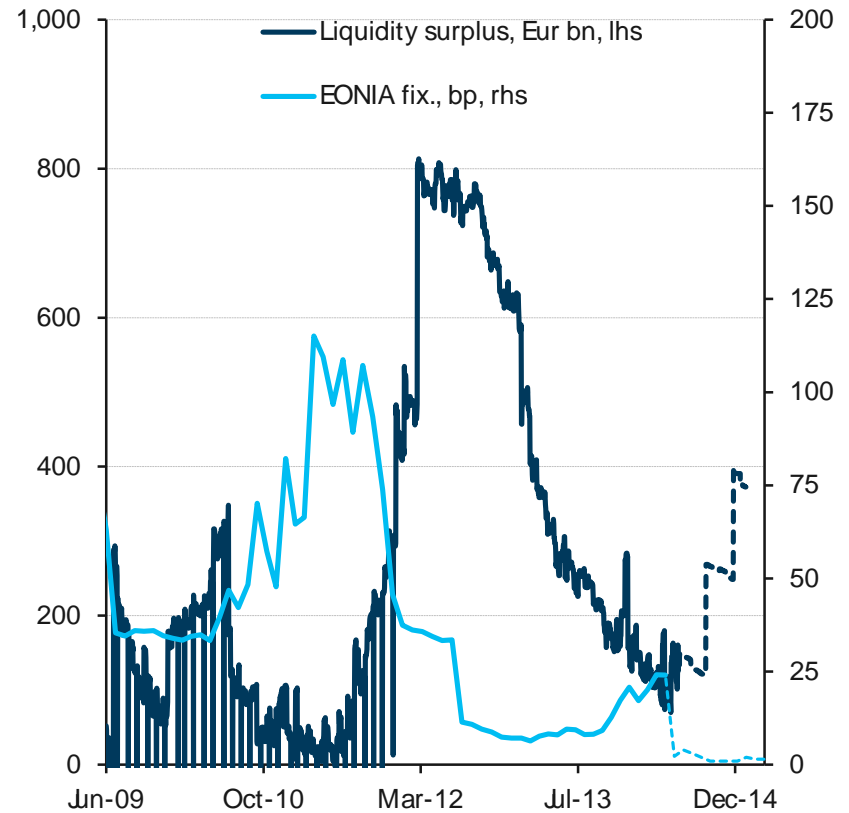
Source: Barclays Research

EUR short rate path is now largely contained

OIS market is pricing in a remarkable divergence of rate paths in EUR vs the US and UK



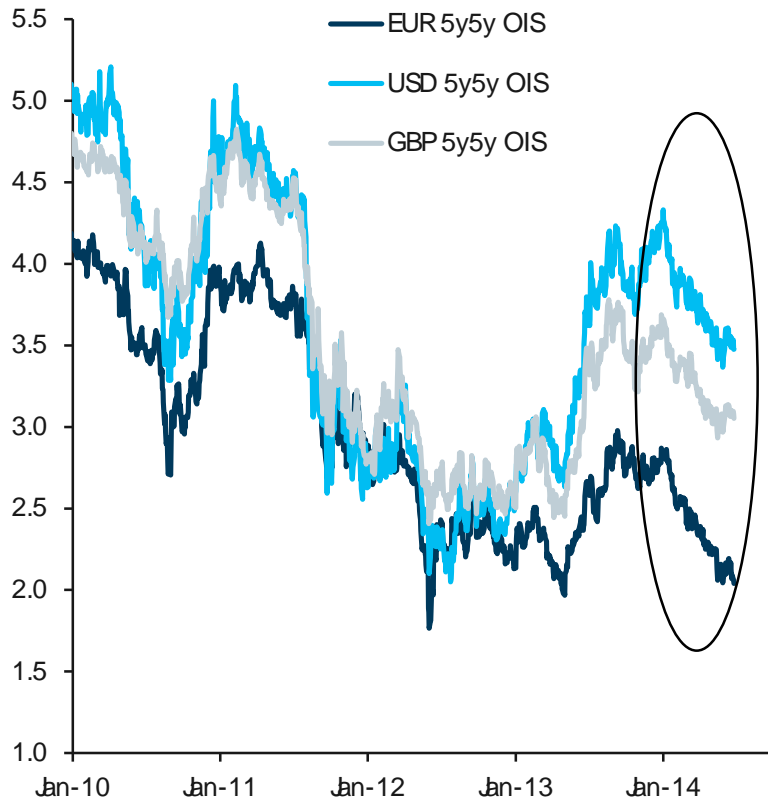
Liquidity surplus is likely to pick up post the TLTROs



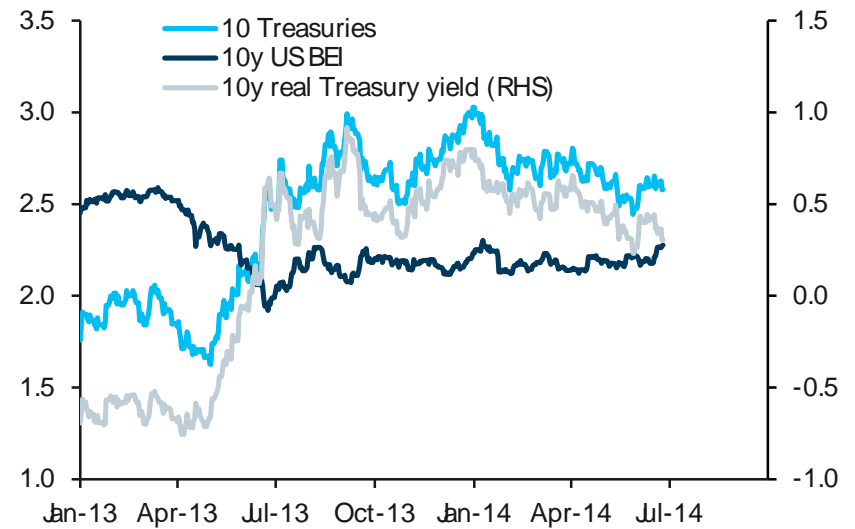
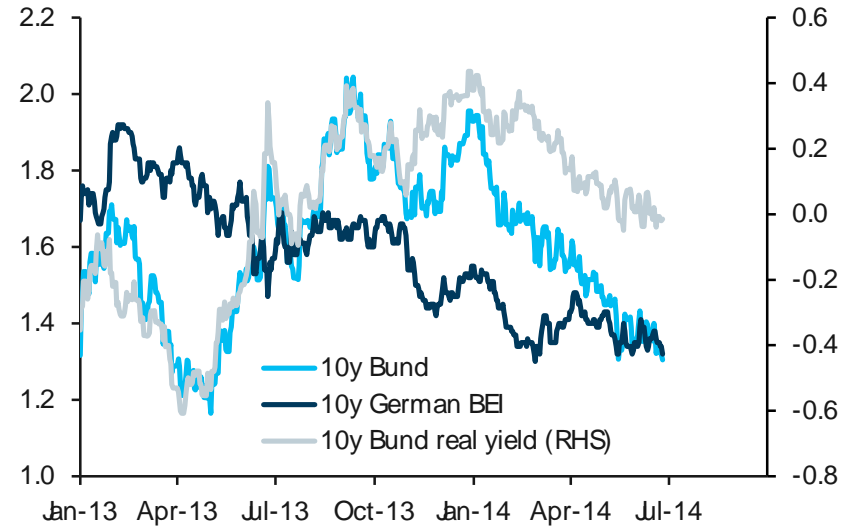
Source: Barclays Research

Long bond yields have rallied globally, not just in EURs

The rally in medium dated forwards since beginning of this year has been impressive



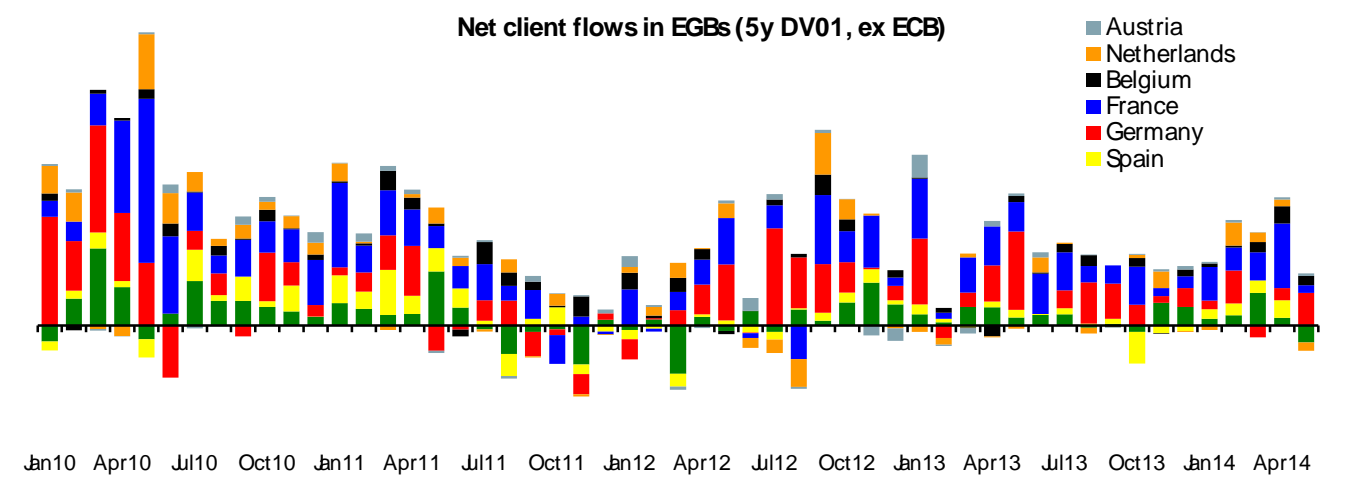
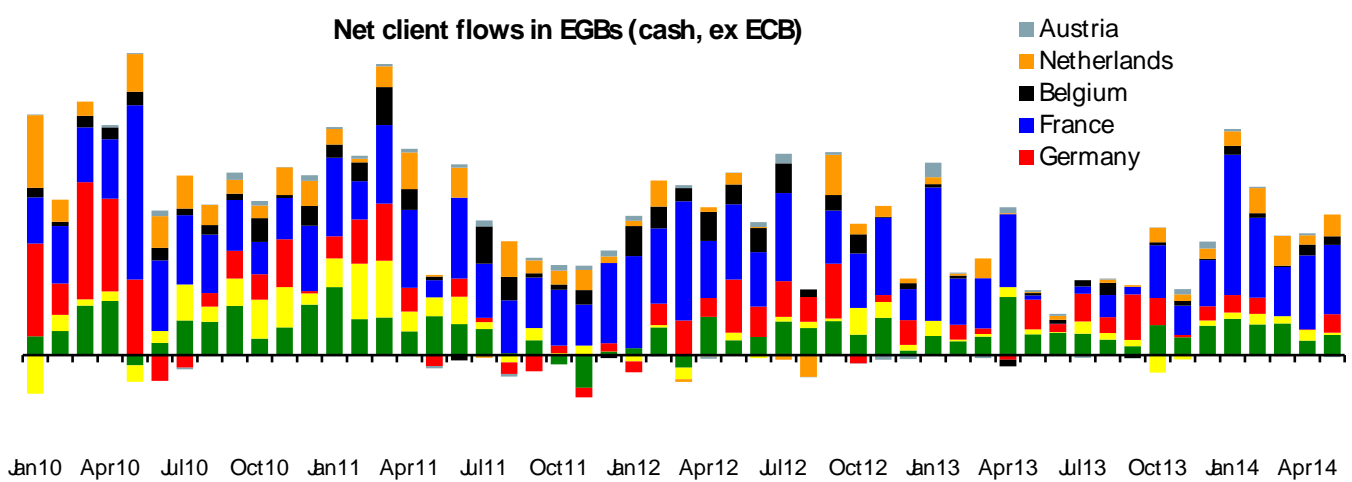
However, the nature of the rally has been different in EUR rates vs US despite the magnitude being similar



Source: Bloomberg, Barclays Research

EGB demand: activity is stabilising

Flows in European government bonds



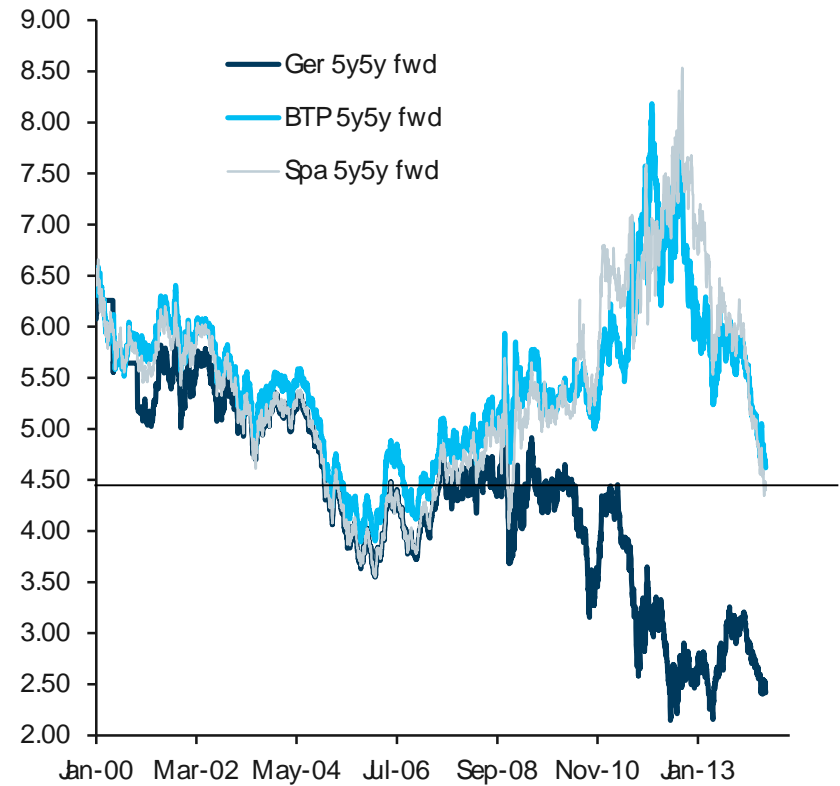
Source: Barclays Trading

Periphery spread curve remains steep

Periphery curve steepness is at all time highs in forward terms



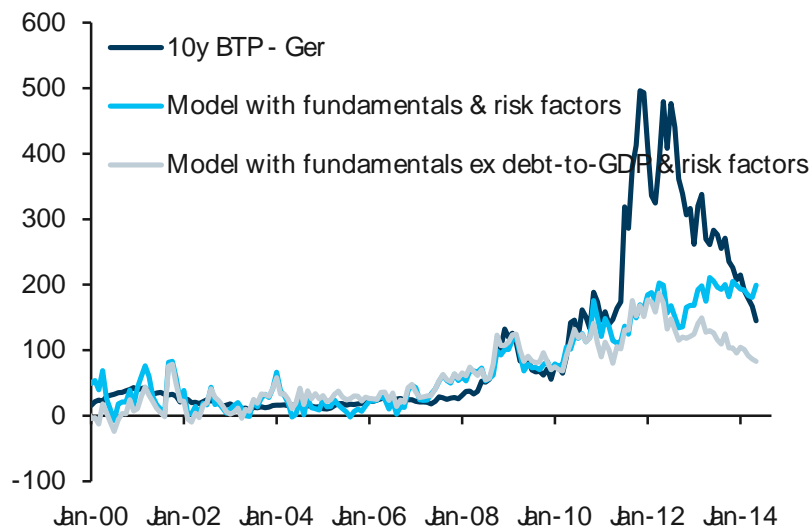
5y5y fwd rates in Italy and Spain are still not very low considering the levels in Germany



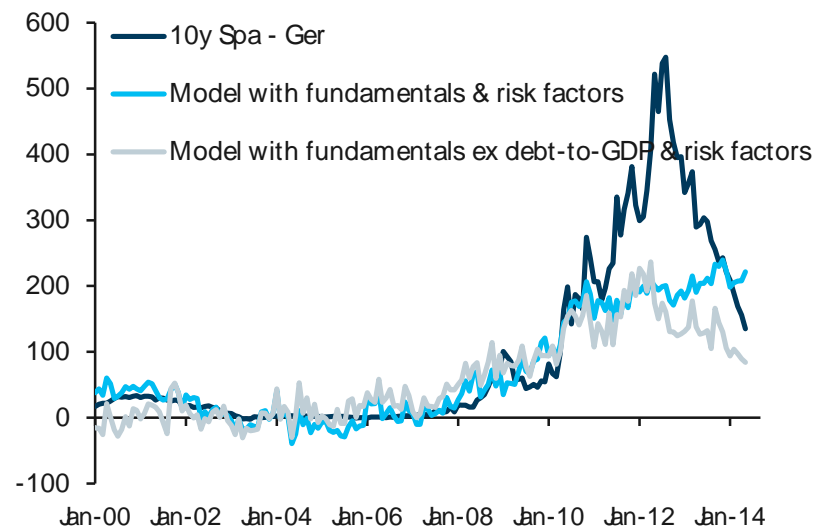
Source: Barclays Research

What is fair value for Italian and Spanish spreads?

Risk reward profile in core peripheral spreads is starting to become more balanced...



...as the ECB premium is priced in more and more by the day



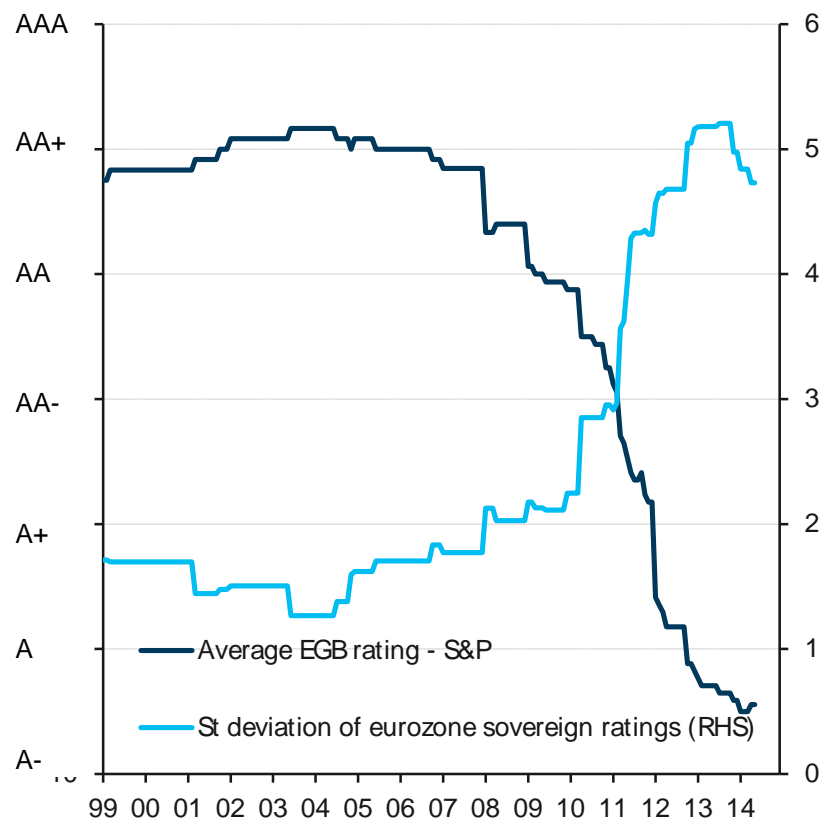
Supply burden for Spain and Italy is likely to ease during the summer

| | Gross issuance needs 2014 | Gross issuance till end of June (in €bn, % of total 2014, per month €bn) | Gross issuance remaining in second half of 2014 (in €bn, per month €bn) | Redemptions in second half of 2014 (in €bn) | Net issuance in second half of 2014 (in €bn) |
|-------|---------------------------|--|---|---|--|
| Italy | 240bn | 165bn, 69%, 27.5bn | 75bn, 12.5bn | 115bn | -40bn |
| Spain | 131bn | 84bn, 64%, 14bn | 47bn, 8bn | 38bn | 9bn |

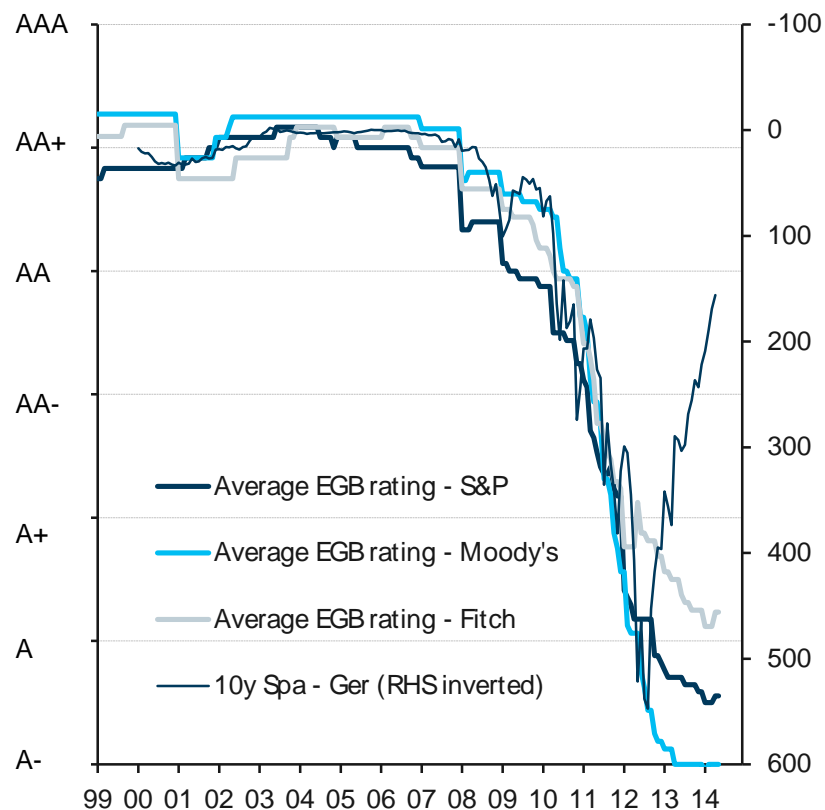
Source: Barclays Research

Rating downgrades have bottomed but structural reform efforts have slowed

Euro area sovereign ratings are bottoming out; the dispersion of ratings already has started to fall



Gradual rating upgrades could see the return of foreign investors to the periphery especially by more conservative investor segments



Source: Bloomberg, Barclays Research

Issuance progress for Eurozone countries

Supply burden remains less in the remaining part of the year after H1 frontloading

| Up to 26/ 06/ 14 | | | | | | % of 2014 | | | Estimated |
|-----------------------|-------|-------|-------|------|----------------|-------------------------|-----------------------------|-----------------------|------------------|
| | 2-3 | 5 | 7-10 | 15+ | All Maturities | Net issuance YTD €bn | Estimated gross issuance | Difference vs 2013 | Funding - '14 |
| Germany | 27.0 | 27.0 | 29.0 | 8.0 | 91.0 | 33.0 | 53% | 1% | 173 |
| France (inc buybacks) | 22.7 | 31.9 | 39.4 | 24.7 | 118.6 | 79.2 | 62% | 2% | 192 |
| Italy | 41.9 | 51.8 | 44.4 | 17.3 | 155.5 | 76.6 | 65% | 13% | 240 |
| Spain | 12.9 | 29.0 | 33.8 | 8.4 | 84.1 | 54.4 | 64% | 4% | 131 |
| Belgium | 0.0 | 2.5 | 10.1 | 8.8 | 21.4 | 8.7 | 65% | -2% | 33 |
| Holland | 12.8 | 8.6 | 9.6 | 5.0 | 36.0 | 18.8 | 72% | 2% | 50 |
| Portugal | 0.0 | 3.3 | 4.7 | 0.0 | 8.0 | 3.4 | 61% | NA | 13 |
| Finland | 0.0 | 0.0 | 5.0 | 0.5 | 5.5 | 5.3 | 42% | -6% | 13 |
| Austria | 0.0 | 2.0 | 6.4 | 1.6 | 10.0 | 6.9 | 40% | -9% | 25 |
| Greece | 0.0 | 2.0 | 0.0 | 0.0 | 2.0 | NA | NA | NA | 0 |
| Ireland | 0.0 | 0.0 | 6.5 | 0.0 | 6.5 | -0.3 | 82% | 82% | 8 |
| Slovakia | 0.5 | 0.4 | 0.3 | 1.7 | 2.8 | -0.9 | 40% | 40% | 7 |
| Eurozone Aggregates | 117.8 | 158.4 | 189.3 | 75.9 | 541.3 | 285.8 | 61% | 4% | 885 |
| Percentages | 22% | 29% | 35% | 14% | | | | | |
| Difference vs. 2013 | -15% | 7% | 4% | 3% | | | | | |

Source: Barclays Research

Forward looking rate market expectations

Revisions to long-term equilibrium rates and term premia caused us to lower our forecasts for long maturity yields

| 10y Govt. bond yields | US | Germany | UK | Japan | Euro government (Germany) bond yield | | | | | | |
|-----------------------|------|---------|------|-------|--------------------------------------|-----------|------------|------|------|------|------|
| | | | | | | Refi rate | 3m Euribor | 2y | 5y | 10y | 30y |
| Q3 14 | 2.9 | 1.55 | 3 | 0.65 | | | | | | | |
| Q4 14 | 3.15 | 1.65 | 3.1 | 0.85 | Q3 14 | 0.15 | 0.18 | 0.05 | 0.5 | 1.55 | 2.4 |
| Q1 15 | 3.25 | 1.75 | 3.25 | 1.05 | Q4 14 | 0.15 | 0.18 | 0.05 | 0.6 | 1.65 | 2.5 |
| Q2 15 | 3.4 | 1.9 | 3.4 | 1.25 | Q1 15 | 0.15 | 0.18 | 0.1 | 0.75 | 1.75 | 2.55 |
| | | | | | Q2 15 | 0.15 | 0.18 | 0.15 | 0.85 | 1.9 | 2.65 |

Source: Barclays Research

- **DURATION:** We have a bearish bias toward global developed market rates in H2, especially in the US and UK. In both, the market is pricing in a much less aggressive hiking cycle than we forecast.
- **CURVE:** We are underweight the intermediate sector against both the very front end and the back end in the US and UK.
- **CROSS-MARKET:** We expect continued divergence between US/UK and euro area/Japan rates. We believe Treasury-bund spreads, particularly in 5s, will widen over the next year.
- **EGB SPREADS:** We are moving from a strategic to a tactical overweight on peripheral bonds as fundamental unexplained cheapness has largely disappeared.

Risks for the baseline scenario

Low volatility environment is a concern and risks exist from different angles

- Any significant rise in volatility from extremely low levels in rates, FX and equity space
- Continuation of downside misses to Eurozone inflation prints
- Exit from Fed & BoE ultra accommodative policies: risks in both directions
- European politics heading into next year's elections in Finland, UK, Portugal and Spain
- Scottish referendum and potential Catalunya referendum
- Geopolitics and oil market implications

Source: Barclays Research

Topics for discussion

- What will be the medium to long term economic impact of the ECB's latest set of actions?
- Is the ECB closer or further away from EGB QE after its latest announcements?
- Are developed market central banks pushing volatility too low?
- Do low global real yields represent a new “bond market conundrum”?

Source: Barclays Research

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