



Bond market outlook

ECB Bond Market Contact Group
Franck Motte
Frankfurt, 21 October 2014



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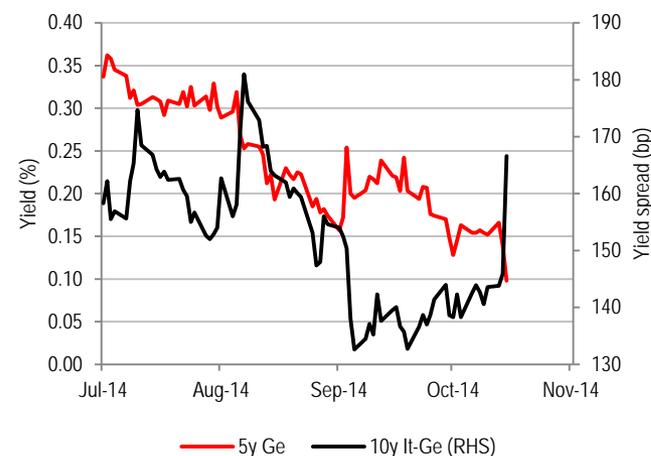
What has happened so far this year

Main levels, quarterly history for 2014

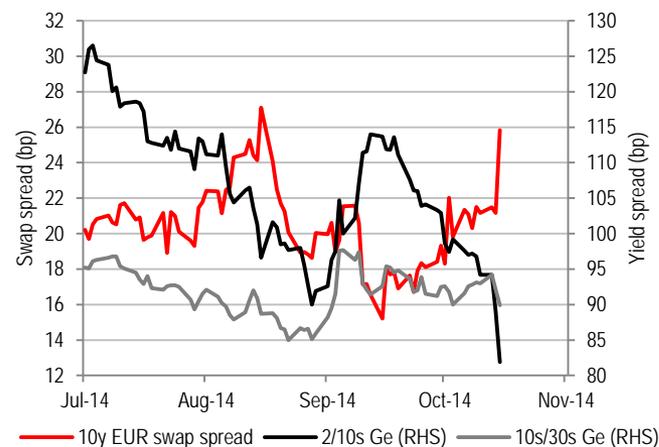
	Q4-13	Q1-14	Q2-14	Q3-14	Current
ECB Deposit Facility	0%	0%	-0.1%	-0.2%	-0.2%
ECB Main Refinancing Rate	0.25%	0.25%	0.15%	0.05%	0.05%
ECB Marginal Rate	0.75%	0.75%	0.4%	0.3%	0.3%
ECB Balance Sheet	€2,285bn	€2,152bn	€2,088bn	€2,038bn	€2,043bn
ECB Excess Liquidity	€275bn	€103bn	€167bn	€159bn	€120bn
3m Euribor	0.287%	0.313%	0.207%	0.083%	0.081%
3m Euribor-EONIA spread	13.1bp	14.9bp	15bp	11.9bp	9.5bp
Repo Funds Rate Italy	0.646%	0.528%	0.32%	0.197%	-0.015%
Repo Funds Rate Germany	0.222%	0.149%	0.138%	0.021%	-0.075%
2y Germany*	0.213%	0.159%	0.028%	-0.082%	-0.063%
5y Germany*	0.922%	0.629%	0.342%	0.148%	0.098%
10y Germany*	1.929%	1.566%	1.245%	0.947%	0.756%
10y France-Germany* spread	62.9bp	51.8bp	45.5bp	33.8bp	37.6bp
10y Italy-Germany* spread	219.6bp	172.6bp	160.1bp	138.6bp	166.6bp
10y Spain-Germany* spread	222.2bp	166.4bp	141.6bp	119.3bp	136.0bp
Italy 5y CDS (USD)	116.9bp	116.9bp	116.9bp	116.9bp	116.9bp
Spain 5y CDS (USD)	90.3bp	90.3bp	90.3bp	90.3bp	90.3bp
Euro STOXX 50	3109	3161.6	3228.24	3225.93	2892.55
EUR-USD	1.3743	1.3769	1.3692	1.2631	1.282

Source: HSBC, Bloomberg)

5y German* yield and 10y Italy-Germany* spread



EUR swap spread and German* curve spreads



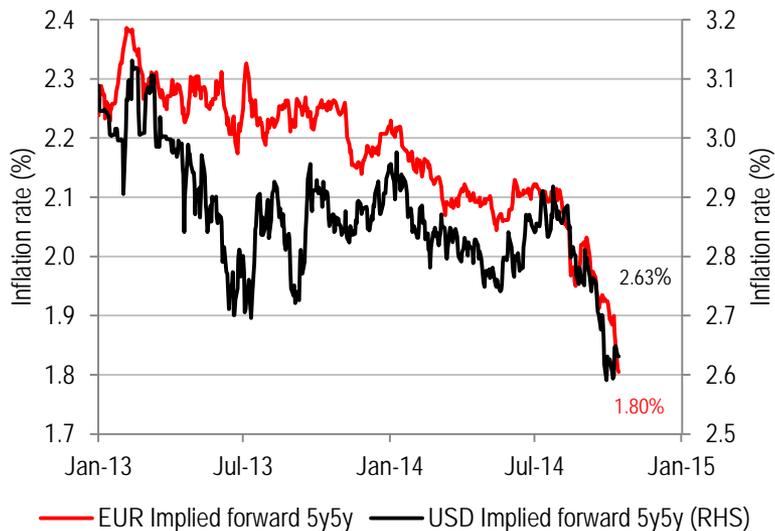
*Note: Bloomberg generic benchmark yields used

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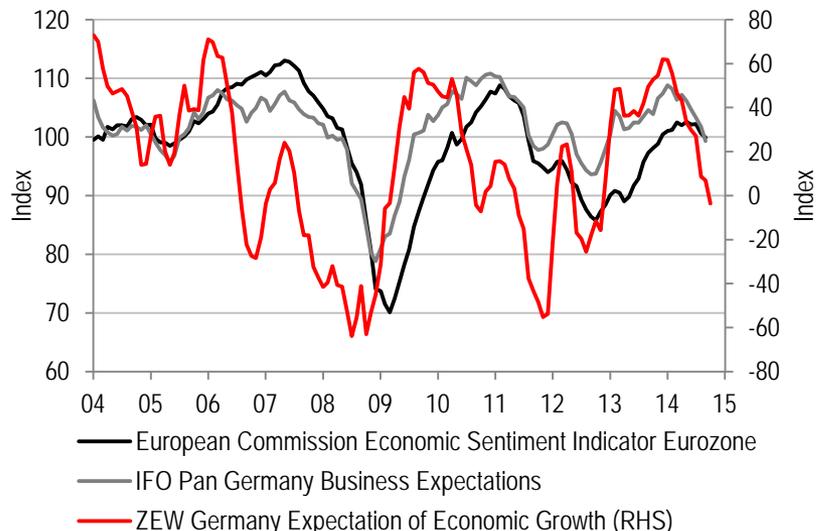


Declining inflation expectations and German business confidence

Inflation expectations have fallen sharply, both in the Eurozone and elsewhere



German business expectations leading the roll-over of sentiment in 2014



- **Some positives for Eurozone economy...**

- Trade surplus is rising
- Labour costs in Spain are declining

- **...but inflation is falling and Germany is slowing down**

- Market based measure of 5-year, 5-year forward inflation no substantially below 2%
- This is not merely Eurozone specific; even the US has reduced inflationary fears
- This is while Germany, the traditional engine of European growth, is experiencing a roll-over in sentiment

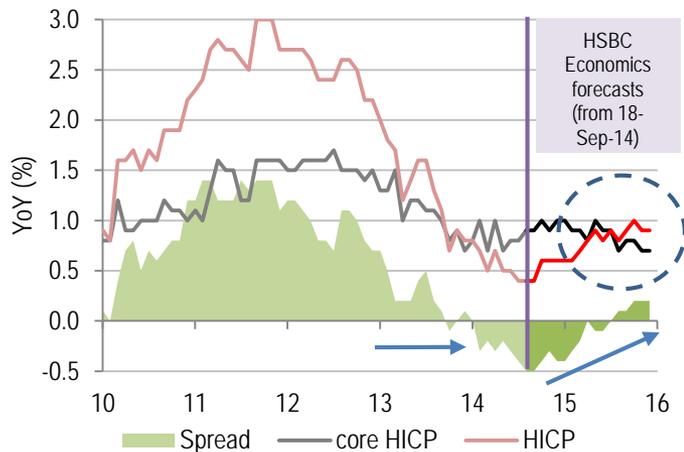
Source: HSBC, Bloomberg

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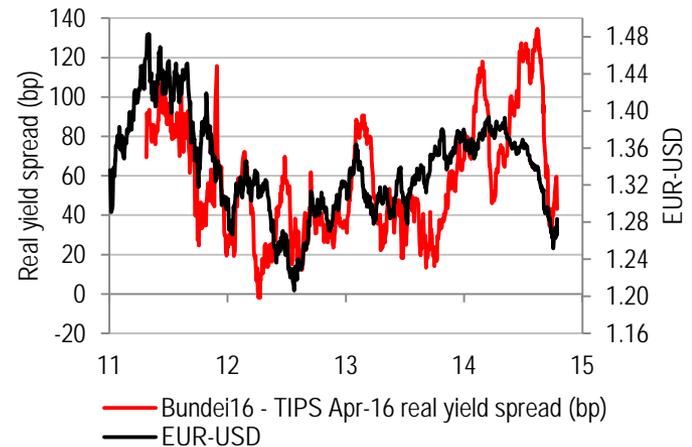


Averting deflation in the Eurozone

EU HICP headline, core and difference



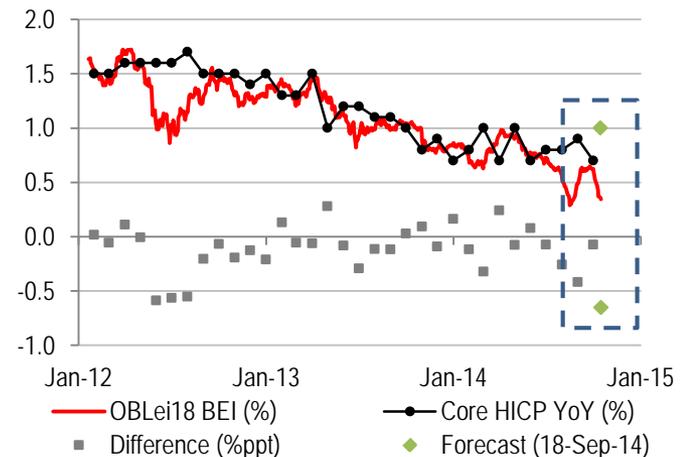
EU-US real rate difference and EUR-USD currency



• An ultimate rebound in Eurozone inflation?

- Persistence of weaker inflationary outturns is a growing issue for Eurozone and the ECB
- A weakening currency is a positive factor for the European economy, including providing the potential for upward impetus to inflation
- Additionally, headline HICP is below core due to base effects; however this is forecast to recede over coming months. Could this be a catalyst for stabilisation and some upward momentum for EU HICP?
- EU-US real rate differentials are affected by a weaker euro

OBLeI18 BEI, core HICP YoY and monthly spread



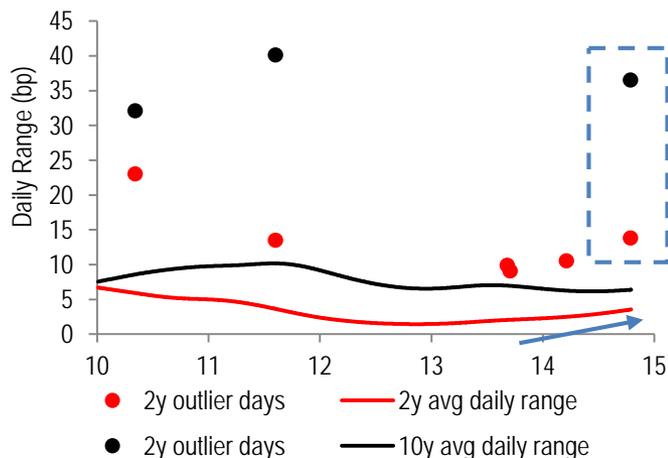
Source: HSBC, Bloomberg, HSBC Economics estimates (see 'Eurozone inflation briefing note', HSBC Global Economics, 18 September 2014)

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The last few days

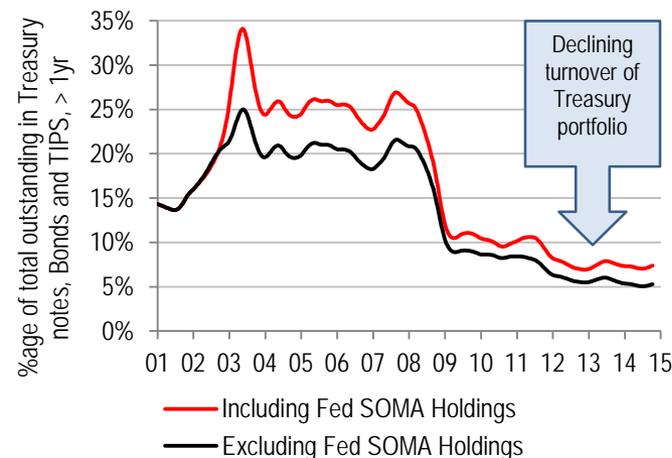
Daily range in UST not seen since Eurozone crisis.
Trend* in short-end daily range increasing



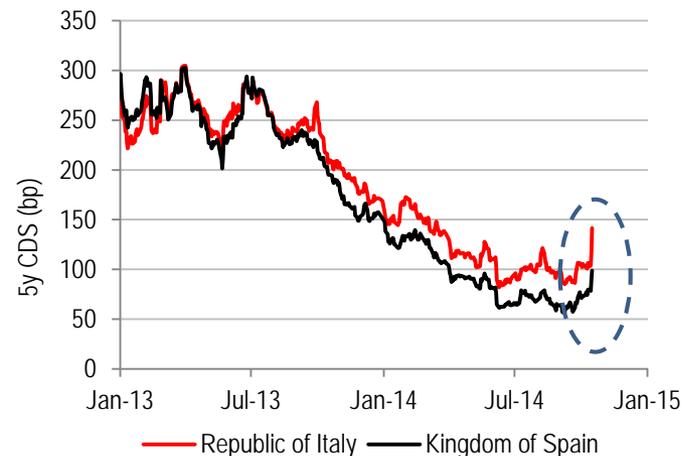
- **Recent increase in volatility**
 - Largest daily US Treasury yield moves since the Eurozone crisis in 2011
 - But in a backdrop of decrease market turnover, as a percentage of outstanding Treasuries
- **Eurozone concerns rekindled?**
 - Greece in focus ahead of AQR and stress test
 - CDS spreads have widened for other peripheral sovereigns, such as Spain and Italy

Source: HSBC, Bloomberg

Average daily turnover volume for primary dealer in US Treasury market continues to decline as a proportion of the overall market



Peripheral Eurozone concerns growing again?



*Note: Based on Hodrick-Prescott filter trend decomposition analysis

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ECB policy response

- **Conventional drivers of growth missing**
 - Public sector spending capped, net bond supply declining; private sector credit fuelled consumption impaired
 - Dependency on foreign demand for export and capital growth is growing
- **Monetary policy adjusted to offset these**
 - Negative rates, asset purchases, liquidity (MRO, LTRO)
 - ECB balance sheet and currency the new focus; strong forward guidance deployed
- **QE, credit easing or ?**
 - QE is instrument of last resort; look for credit easing first
 - Sovereign purchases according to the 'key' could have undesired effect
 - Is time running out? When are negative fiscal dynamics returning?
- **Focus on credit easing**
 - Purchases of ABS and covered bonds
 - December TLTRO will likely show an increase in the balance sheet
 - Some substitution-effect into periphery sovereigns
 - Where are the bonds for CBPP3?
 - Retained issuance? Already submitted to ECB
 - Success will depend on origination of new product

HSBC Economics forecasts

Growth and inflation to remain subdued over forecast horizon

%Year	GDP			Inflation		
	2014(f)	2015(f)	2016(f)	2014(f)	2015(f)	2015(f)
World	2.4	2.8	2.9	2.8	2.9	3.1
Developed	1.6	1.9	1.9	1.5	1.5	1.6
Emerging	4.4	4.9	5.2	6.4	6.8	6.8
US	2.1	2.6	2.5	1.8	1.7	1.8
UK	3.1	2.6	2.5	1.7	1.7	2.0
Eurozone	0.7	1.0	1.3	0.5	0.9	1.1
Japan	0.9	1.0	0.5	3.0	2.0	1.7
Brazil	0.4	1.0	2.0	6.3	6.3	6.0
Russia	0.0	-1.0	-1.5	7.2	7.0	6.4
India*	5.8	6.6	7.3	7.2	6.5	6.2
China	7.5	7.7	7.6	2.4	2.9	2.7

- Economic pick-up is seen as weak, with developing economies failing to get beyond a 1.9% GDP rate. UK is seen as decelerating and the US stalling post 2015. Eurozone is expected to have some rebound; however at forecast horizon this is a mere 1.3%.
- Inflation is likely to remain subdued. Eurozone is seen as troughing; however it is projected to only marginally nudge above 1%.
- Rate hikes are penciled in for the Fed, with the first move expected in June 2015 and reaching 0.5-0.75% by the end of that year, alongside the start of balance sheet shrinkage.
- Expectations are for the ECB to move to a broader asset purchase programme next year.
- Bond yields to remain constrained.

Rate and bond yield forecasts highlight diverging monetary paths, yet contained rises in yields

%Year	3-month money (%)*			10-year bond yield (%)*		
	2014(f)	2015(f)	2016(f)	2014(f)	2015(f)	2015(f)
US	0.3	0.8	1.8	2.1	2.7	2.7
Germany	0.1	0.1	0.1	1.0	1.2	1.3
France	0.1	0.1	0.1	1.3	1.6	1.7
Italy	0.1	0.1	0.1	2.2	2.3	2.3
Spain	0.1	0.1	0.1	2.0	2.0	2.0

Source: HSBC Economics and Fixed Income Research estimates (see 'The monetary tug of war', HSBC Global Economics, Q4 2014)

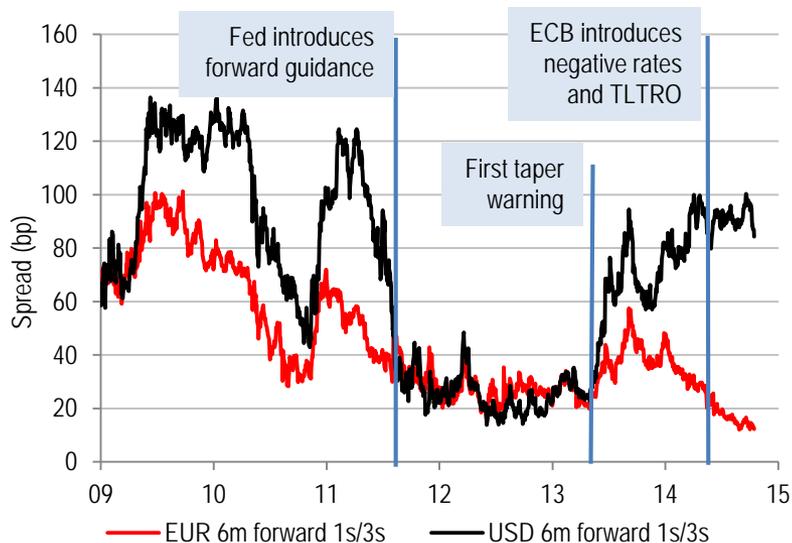
Note: *Fiscal year; ** Period end

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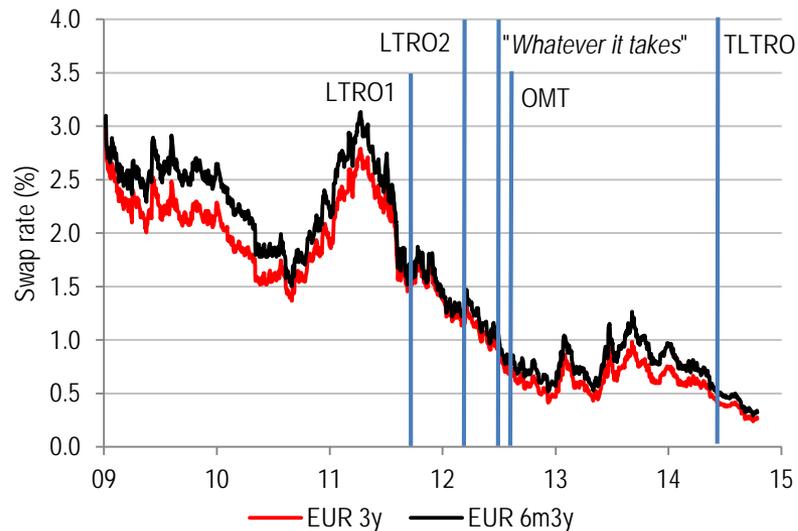


Central bank responses

USD-EUR divergence has become significant



Lower for longer rates in the Eurozone



- **Divergent paths seen for monetary policy between the large economic areas**

- While the Fed and the Bank of England are moving to tighten policy, with rate hike expected over the coming year...
- ...the ECB (and the BoJ) are likely to continue loosening policy
- Lower-for-longer has become entrenched in market yields

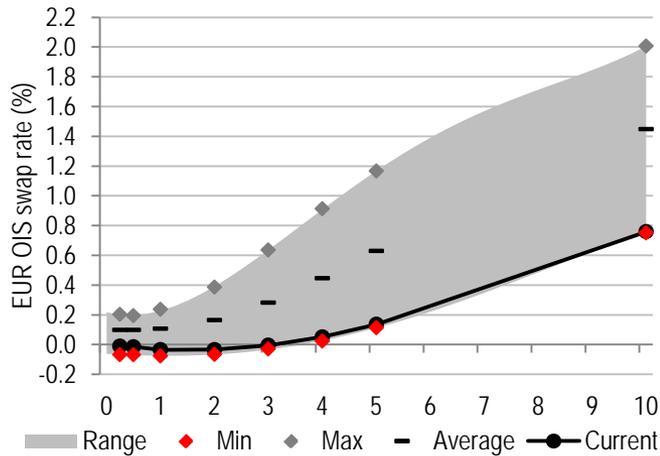
Source: HSBC, Bloomberg

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Shift to a Japanese term structure

EUR swap yields, more like Japan

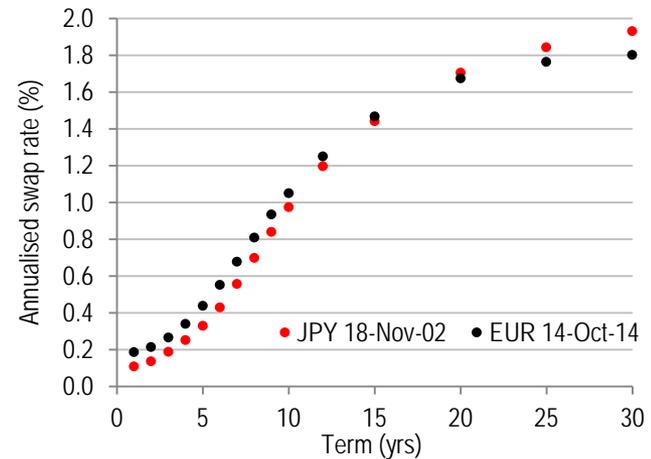


Note: Range since January 2013

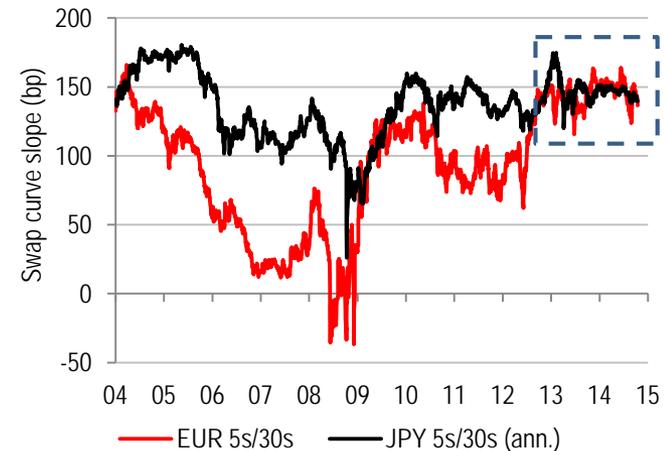
• Has the history lesson from Japan been learnt?

- Lower rate environment with increasing disinflationary risks is making the Eurozone look increasingly like Japan
- EUR term structure is reminiscent of the first time JPY swap rates fell (2000-03)
- EUR 5s/30s curve slope is the same as on the JPY curve

Echoes of late 2002



Eurozone Japanification of rates



Source: HSBC, Bloomberg

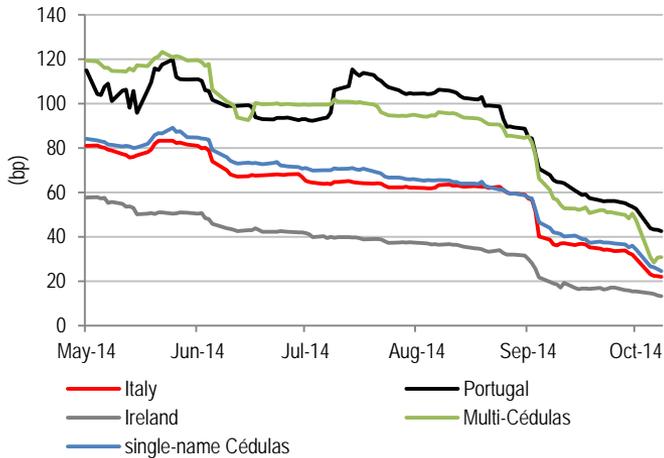
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Covered bonds: ECB is in the driver seat again

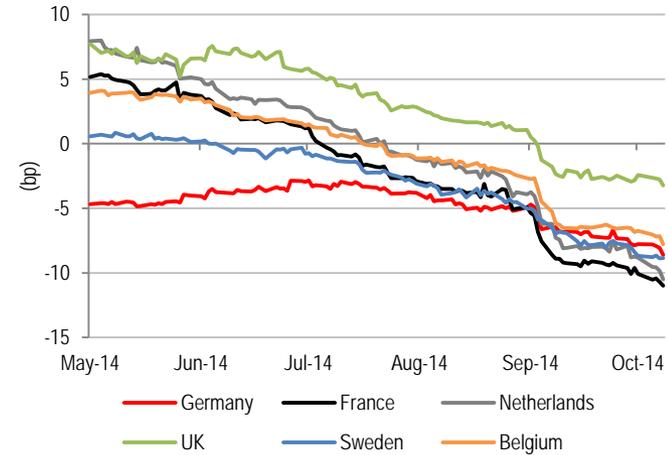
- **Where are the bonds for CBPP3?**
 - Following the CBPP3 announcement, we changed our recommendation on covered bonds from mildly bullish to bullish
 - However, it will be difficult for the ECB to purchase large volumes in the primary/secondary market
- **Spreads have reacted, but probably more to come**
 - Periphery covered bonds and the short-end of the curve benefit the most.
 - The secondary market is bid-only and the tightening should continue - though at a much lower pace.
 - Spread tightening will depend on how aggressive the ECB will pursue purchases
- **ECB actions have moved exit point further down the road**
 - The numerous ECB measures (rate cuts, TLTROs, CBPP3, ABSPP and potential sovereign QE) have moved the exit point further down the road.
 - Currently, we do not foresee any market-wide development until year-end that would justify profit taking at this time
- **We prefer periphery paper but all EUR covered bonds will benefit from the ECB back-stop**
 - We continue to prefer periphery paper as they still offer the highest spread tightening potential in this compressed market.
 - Many countries show first signs of an economic recovery and stabilisation of the housing market.
 - Core covered bonds will be supported by the additional ECB demand.
 - Non Eurozone covered bonds should benefit from second round effects of the CBPP3

Covered bond spread compression

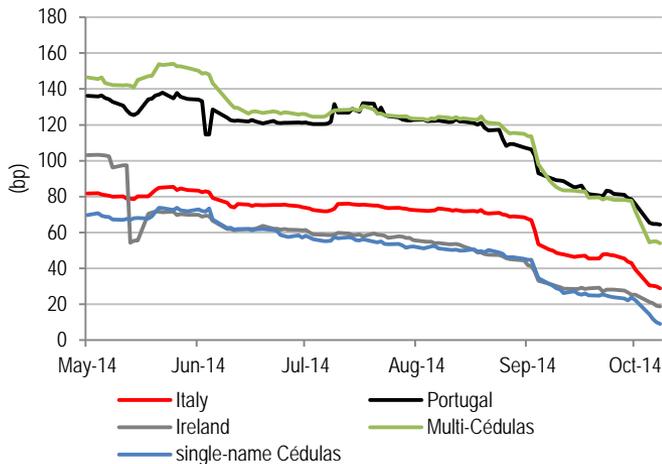
Periphery covered bond ASW spreads (3-5 year)



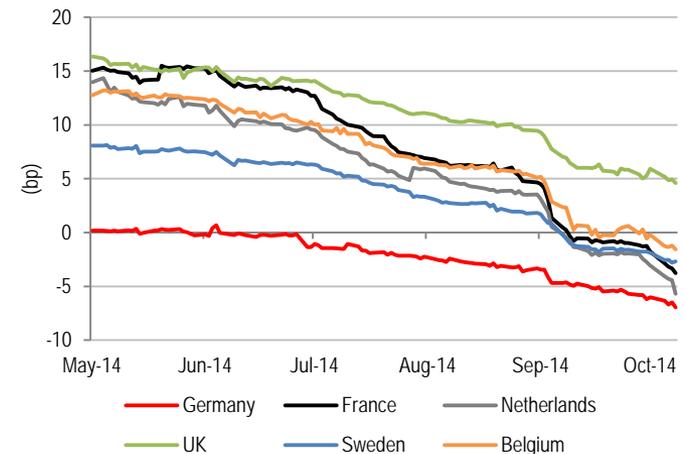
(Semi-) Core covered bond ASW spreads (3-5 year)



Periphery covered bond ASW spreads (5-7 year)



(Semi-) Core covered bond ASW spreads (5-7 year)



Source: HSBC Fixed Income Research, Reuters

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Points for discussion

- **Is QE priced in to the European markets?**
 - Is potential sovereign bond-based QE purchases reflected in current outright and curve levels
- **The effect of deflation on the stock of debt**
 - Increases in the real value of debt burdens
 - Accompanying recessionary environment compounds effect
- **Japanification: will the core Eurozone curve go to Japan's term structure**
 - Will core Eurozone curve map onto JGB term structure?
 - How will; peripheral markets react to such a development
- **Liquidity provision likely to be reduced going forward**
 - Could lead to increased market volatility
 - The potential is for this to be reflected across all asset classes, not merely bonds



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Covered bond yields and swap spreads

Changes in covered bond yield levels since ECB announcement

	1-3 yr	3-5 yr	5-7 yr	7-10 yr	10+ yr
Australia	-7.8	-12.7	-14.1	-12.4	-9.0
Austria	-9.4	-8.7	-12.9	-13.7	-8.0
Belgium	-10.0	-12.6	-13.6	-13.7	
Canada		-11.5	-7.4		
Denmark	-10.5	-3.4	-12.3	-10.8	
Finland	-9.2	-11.3	-9.5		
France	-8.0	-11.3	-12.8	-13.7	-14.6
Germany	-8.0	-10.3	-10.0	-8.1	-5.4
Ireland	-21.0	-21.1	-28.6		
Italy	-30.6	-39.2	-41.7	-45.6	-37.9
Netherlands	-9.8	-13.0	-14.6	-13.8	
New Zealand	-8.6	-8.8			
Norway	-10.1	-11.8	-12.1	-12.6	
Portugal	-40.0	-48.1	-46.6		
Spain (pooled Céd)	-38.5	-55.2	-64.3	-60.5	-87.9
Spain (single name)	-21.3	-37.8	-39.0	-42.7	-37.7
Sweden	-9.4	-10.6	-10.6		
Switzerland	-8.9	-10.6	-6.2	-10.6	
UK	-8.0	-4.5	-9.8	-6.9	-5.8
USA	-10.1				
All Covered Bonds	-14.8	-18.1	-19.2	-18.6	-46.2

Changes in covered bond swap spreads since CBPP3 announcement

	1-3 yr	3-5 yr	5-7 yr	7-10 yr	10+ yr
Australia	-1.1	-5.0	-6.6	-6.3	-4.4
Austria	-3.1	-4.1	-8.6	-7.8	-5.6
Belgium	-3.7	-5.1	-6.3	-8.3	
Canada		-4.5	-4.5		
Denmark	-4.4	-2.7	-5.1	-5.3	
Finland	-2.9	-4.5	-4.7		
France	-2.0	-5.4	-7.9	-11.1	-12.1
Germany	-1.7	-3.7	-3.5	-4.0	-3.3
Ireland	-14.8	-14.8	-22.6		
Italy	-25.9	-34.7	-38.0	-41.5	-34.3
Netherlands	-3.5	-6.5	-8.2	-8.8	
New Zealand	-3.1	-3.2			
Norway	-3.6	-4.9	-5.4	-6.8	
Portugal	-34.0	-41.6	-41.8		
Spain (pooled Céd)	-33.0	-51.6	-59.6	-56.7	-82.3
Spain (single name)	-15.2	-32.7	-35.6	-39.1	-35.8
Sweden	-2.7	-3.7	-3.9		
Switzerland	-2.5	-2.6	-3.0	-4.0	
UK	-2.2	-3.5	-4.4	-3.9	-4.1
USA	-3.4				
All Covered Bonds	-9.2	-12.3	-13.9	-15.2	-42.5

Source: HSBC Fixed Income Research, BondRadar

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