Bond market outlook
and other topics of relevance

ECB BMCG
16 May 2017
Key themes

› **Macro**: Positive euro area growth momentum but no signs of a sustainable increase in underlying inflation

› **Forward Guidance**: Market questions ECB exit sequencing

› **Asset Purchase Programme**: ECB uses in-built flexibility

› **Sovereigns**: French politics in the driving seat, Italy about to take over

› **Credit**: CSPP shields corporates but premium diminishes

› **Banks**: Diverse MREL issuance picking up despite legislative delays
Sentiment bubble or is the economy shifting gear?

Sentiment is driving euro area recovery…
Euro area manufacturing PMI and industrial production, yoy in %, 3m moving average

… as Emerging Markets recover!
World trade and imports of the Emerging Markets, change on year in percent

Source: Bloomberg, Eurostat, Centraal Planbureau, Commerzbank Research
Germany enjoys tailwinds from Asia

German exports to Asia, change on year in percent

Imports, Volume, change on year in percent, 5-months-average

Source: Destatis, Commerzbank Research
Headline inflation is past its peak

**Headline** HICP and ECB projection (black line) and Commerzbank forecast (grey), in %

**Core** HICP and ECB projection (black line) and Commerzbank forecast (grey), in %

Source: ECB, Bloomberg, Commerzbank Research
Trumpflation is running out

5y5y inflation expectations from ILS, in %

Option implied inflation expectations, from 5y HICPx Caps/Floors

Source: Bloomberg, Commerzbank Research
ECB projections unlikely to be beaten during remainder of this year

HICP: Commerzbank forecast, ECB projection (incl confidence bands), consensus, in %

Source: ECB, Bloomberg, Consensus Economics, Commerzbank Research
Rates: Money markets starting to question ECB forward guidance

ECB forward guidance:
“We continue to expect them (interest rates) to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases.”

Rate hike speculation from spring 2018
One week EONIA swap and ECB dated EONIA forwards, in %

Data and ECB uncertainty on the rise
2y2y EONIA, in %, and normalised swaption vol, in bp

Source: Bloomberg, ECB, Commerzbank Research
Programme looking increasingly stretched

ECB not meeting the capital key in 13 of the 19 euro area sovereigns
April buying vs. capital key target, in €mn

Portugal: BoP is now ‘short’ almost €6bn
Cumulative excess PSPP purchases vs. capital key, in €mn

Source: Bloomberg, Commerzbank Research
Testing the limits

**Bundesbank taking advantage of new parameters**
Weighted average maturity of PSPP buying, in years

**ECB maxing out in-built flexibility**
Deviation in PSPP purchases from the target implied by the ECB capital key, in €bn

Source: ECB, Commerzbank Research
QE exit could become most challenging for periphery

QE-adjusted net supply (issuance - redemptions & PSPP purchases), including CBK forecast*, in €bn

* Assumes €5bn tapering per month starting in Jan18

Source: Bloomberg, ECB, Commerzbank Research

Bunds               Core               Semi-Core   Periphery

2015                2016               2017        2018e      2019e
Who will fill the PSPP gap?

Net sovereign bond purchases* since the start of €QE by investor type, in €bn as of end-Q4 2016

Source: ECB, Eurostat, IMF, EIOPA, Commerzbank Research, *) general government bonds with 1y+ original maturity
Supply/demand imbalances driving short-end Bund valuations

Cash buying has taken over from GC squeeze as driver of asset swap spreads!
Generic 2y EONIA-Schatz and 3m EONIA-GC spread in bp

Bund premium stays elevated after French election
Bund-EONIA spread (vs generic 1st future) and 10y OAT-Bund spread (asset swap spread difference of on-the-run benchmarks), in bp

Source: Bloomberg, Commerzbank Research
French flows driving spreads

Oddchecker probability for Le Pen election win and 10y OAT-Bund spread (Nov26 ASW, rhs), in bp. Dotted lines denote 1st and 2nd round of presidential election.

Net sovereign bond purchases by Japanese investors, in € bn

Source: Japan MoF, Commerzbank Research
Italian domestic political issues taking over for BTP spreads

10y BTP-SPGB and OAT-Bund spread, in bp

10y BTP-SPGB spread in bp and Spain vs Italy PMI differential in points

Source: Bloomberg, Commerzbank Research
Greece outperforms on hopes for debt relief and ECB buying, Portugal outperforms on fundamentals *

Coming tranches to clear the table until hump in 2019 maturities
Loans to Greece falling due in coming years, in €bn

GGBs perform because of ECB, PGBs despite ECB!
10y PGB and GGB spread over Bunds, in bp

*see Ahead of the Curve, 11 May for details

Source: Bloomberg, Commerzbank Research
Credit squeezing tighter...

Risk-on, positive data/earnings, ECB buying and lack of supply are all squeezing Credit iBoxx € non-financials asset swap spread, in bp, and Euro Stoxx 50 Index

Protective ECB shield is more effective in Credit iBoxx € non-financial seniors and Italy sovereign index asset swap spreads, in bp

Source: Markit, Bloomberg, Commerzbank Research
… with CSPP lifting all boats!

Source: Markit, Bloomberg, Commerzbank Research
Banks: NPS issuance volumes picking up

- French banks expected political volatility in Q1 17 and planned for a flexible issuance process. Post-election, more issuance likely. French banks issuance:
  - BNP plans for €10bn p.a. NPS in 2017-19, had issued €4.6bn by mid-March.
  - Credit Agricole already meets 2019 requirements but plans to issue more NPS to protect other senior.
  - BPCE plans up to €3.5bn of NPS p.a.

- UniCredit plans €13.5bn of NPS by 2019, Santander €28-35bn (split between entities).

- Banks in Germany, UK and France are already en-route to compliance and have an established investor base for their NPS/HoldCo product. Non-G-SIBs, especially in other countries are challenged by the lack of legislative clarity on requirements and timescale and so are likely to concentrate on Tier 2 and “normal” senior for now.

- NPS adds to cost of funding, driving margin pressure and at the limit may slow balance sheet growth. No current sign of constraints to investible funds, especially with low rates and spreads. However, should this happen, e.g. following a bank failure, refinancing costs could rise significantly across the funding curve if fixed supply requirements meet very elastic demand.
MREL & French NPS: TLAC more important for now

- MREL legislative delays are affecting issuance dynamics of senior and Tier 2 across Europe. G-SIBs reacting more as TLAC perceived to be the proximate constraint.

- Legislative and structural frameworks for issuance of bail-inable senior only clear in France, Germany, Switzerland and the UK. Banks in other countries, apart from Spain, continue to issue Tier 2 or existing senior. From ‘other country’ G-SIBs, Santander has issued an “as and when” bond, ING has used its HoldCo, Nordea total capital ratio is 24%, UniCredit is only just post-rights issue but needs to issue.

- France has 4 G-SIBs so TLAC pressure drove legislative change and recent issuance.

- Commission package on CRR/CRD/BRRD updates and any subsequent Parliament changes raise risks that existing issuance doesn’t meet final requirements, hence non-G-SIBs more cautious.

- European Parliament currently refusing to fast-track NPS legislation: unclear if this is political bargaining or more fundamental. Delay means timeline of 2019 implementation increasingly difficult to meet.

- Non-G-SIBs likely to continue to delay NPS issuance as it is expensive compared with preferred senior especially if there is no regulatory benefit in near term until regulatory requirements are finally defined.
Estimated outstanding bail-inable debt

Outstanding NPS / holdco debt / statutorily subordinated senior for selected EU banks by country (€bn)

Source: Bloomberg, company data, Commerzbank Research
* € 6bn issued by Santander UK Group Holdings
Sample of banks: ACAFP, BNP, BPCE, SOCGEN, SANTAN, BACR, HSBC, LLOYDS, RBS, STANLN, INTNED, DB, CS, UBS
Overview of Creditors Hierarchies in the EU

Harmonised national insolvency of unsecured debt instruments on its way, i.e. new NPS layer

Loss absorption waterfall

Source: CBK   * Sec. Obligations as well as Retail & SME Deposits <100k under DGS   ** TLAC-eligible as long as TLAC-excl. liabilities ranking pari-passu with SU debt comprise <5% of total TLAC-eligible liabilities
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<th>All covered instruments</th>
<th>The proportion of issuers in each of these categories for which Commerzbank provides investment banking services</th>
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<tr>
<td>Overweight</td>
<td>33%</td>
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<td>Marketweight</td>
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<tr>
<td>Underweight</td>
<td>30%</td>
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<tr>
<td>Long/Buy</td>
<td>48%</td>
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<tr>
<td>Neutral</td>
<td>43%</td>
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<tr>
<td>Short/Sell</td>
<td>9%</td>
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