ECB Bond Market Contact Group

Bond Market Outlook

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20 November 2019
Macroeconomic outlook
US-China tensions have stopped the growth in global trade

Average tariff rates in US-China bilateral trade

Merchandise world trade volume, index

Sources: Peterson Institute, CBP, Macrobond, Union Investment
Direct effects: Economic slowdown

Estimated impact of a slowdown in global trade

<table>
<thead>
<tr>
<th></th>
<th>Estimated output elasticity to global trade</th>
<th>Cumulative output effect of trade tensions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
<td>Year 2</td>
</tr>
<tr>
<td><strong>EMU</strong></td>
<td>0.0%</td>
<td>0.3%</td>
</tr>
<tr>
<td><strong>Germany</strong></td>
<td>0.3%</td>
<td>0.2%</td>
</tr>
<tr>
<td><strong>France</strong></td>
<td>0.0%</td>
<td>0.2%</td>
</tr>
<tr>
<td><strong>USA</strong></td>
<td>0.1%</td>
<td>0.05%</td>
</tr>
<tr>
<td><strong>Japan</strong></td>
<td>0.3%</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

Baseline scenario: Annual world trade volume growth of 1.5%
Escalation scenario: Annual world trade volume contraction by 1.0%
Source: Union Investment
Indirect effects: A dent on confidence

Global Economic Policy Uncertainty Index

Manufacturing Purchasing Manager Indices

Sources: PolicyUncertainty.com, Markit, Macrobond, Union Investment
Germany: The labour market has turned

National labour market

Rising unemployment in the industrial core
Annual change in the unemployment rate, in percent

-Unemployed workers, in million (rhs)
-Unfilled vacancies, index (lhs)

Sources: BfA, Macrobond, Union Investment
Euro area: Subdued inflation

Euro area consumer price inflation
Annual change in percent

Core inflation fails to react to tight labour market
Seasonally-adjusted annual change in percent

Source: Union Investment, Macrobond
Euro area: Changing composition of lending to the private sector

Bank lending to the private sector
€ billion, 3 month moving average

Capital market funding to non-financial corporates
Percentage of total debt funding

Source: Union Investment, ECB, BIS, Macrobond
## Euro area: Baseline economic projections

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q1</td>
<td>Q2</td>
<td>Q3</td>
</tr>
<tr>
<td>Real GDP % y-o-y</td>
<td>0.3</td>
<td>0.4</td>
<td>0.2</td>
</tr>
<tr>
<td>Private Consumption % y-o-y</td>
<td>0.5</td>
<td>0.1</td>
<td>0.2</td>
</tr>
<tr>
<td>Government Spending % y-o-y</td>
<td>0.1</td>
<td>0.3</td>
<td>0.2</td>
</tr>
<tr>
<td>Private Investment % y-o-y</td>
<td>0.2</td>
<td>1.7</td>
<td>0.5</td>
</tr>
<tr>
<td>Exports % y-o-y</td>
<td>-0.5</td>
<td>1.1</td>
<td>0.4</td>
</tr>
<tr>
<td>Imports % y-o-y</td>
<td>-0.1</td>
<td>1.4</td>
<td>0.9</td>
</tr>
<tr>
<td>Net Exports EUR bn</td>
<td>136</td>
<td>133</td>
<td>127</td>
</tr>
<tr>
<td>Industrial Production</td>
<td></td>
<td>-0.9</td>
<td>0.1</td>
</tr>
<tr>
<td>Unemployment %</td>
<td>8.5</td>
<td>8.3</td>
<td>8.0</td>
</tr>
<tr>
<td>HICP % y-o-y</td>
<td>1.3</td>
<td>1.7</td>
<td>2.1</td>
</tr>
<tr>
<td>HICP (core) % y-o-y</td>
<td>1.0</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>M3 % y-o-y</td>
<td>3.6</td>
<td>3.8</td>
<td>3.7</td>
</tr>
<tr>
<td>Nominal GDP % y-o-y</td>
<td>3.4</td>
<td>4.3</td>
<td>3.8</td>
</tr>
<tr>
<td>Current Account EUR bn</td>
<td>102</td>
<td>92</td>
<td>79</td>
</tr>
<tr>
<td>% GDP</td>
<td>3.6</td>
<td>3.2</td>
<td>2.7</td>
</tr>
<tr>
<td>Fiscal Balance % GDP</td>
<td></td>
<td>-0.5</td>
<td>-0.8</td>
</tr>
</tbody>
</table>

Source: Union Investment
Bond market developments since June 2019
The ECB’s monetary policy decisions on 12 September 2019

**Tiering of central bank deposit rates**
Stock of excess reserves held at the Eurosystem, in € billion

- Reserves exempt from the negative deposit facility rate
- Total excess reserves

**Resumption of large-scale asset purchases**
Monthly asset purchases, in € billion

Source: Union Investment, ECB, Macrobond
The market has priced out further ECB deposit rate cuts and the scarcity premium on German government bonds has all but disappeared.

Short-term euro area interest rates, in percent

Source: Macrobond

—Market-implied policy rate in 12 months—ECB deposit rate—One-year German government bonds

Source: Macrobond
Declining yields and risk premia on Italian government bonds

Yield spread between Germany and Italy
Ten-year government bonds

Source: Macrobond
Market-based inflation expectations have stabilised at a very low level

Source: Macrobond

**Euro area inflation expectations and crude oil**

- Brent crude oil, in € per barrel (rhs)
- 10-year inflation swap rate, in percent (lhs)

**5-year 5-year forward break-even inflation**

- United States
- Euro area

Source: Macrobond
Corporate bonds: Outperformance of interest rate sensitive sectors …

Sector performance in the European corporate bond market

Spread changes from 31 Dec 2018 to 15 Nov 2019, in basis points

Spread changes from 12 Jun 2019 to 15 Nov 2019, in basis points

Source: Union Investment
... and of risky market segments

Instrument category performance in the European corporate bond market

Spread changes from 31 Dec 2018 to 15 Nov 2019, in basis points

Spread changes from 12 Jun 2019 to 15 Nov 2019, in basis points

Source: Union Investment
Bond market outlook
The impact of asset purchases on Bund yields: expectations ...

Source: Union Investment, Macrobond

Christian Kopf  |  Investment Bank report, 9 October 2018:
“Our intrinsic valuation model suggests that the QE premium embedded in the 10y Bund yield amounts to 140bp. … As we head into next year, the QE premium should decline. … A reduction of the QE premium by a quarter would see the 10y Bund yield rise towards 0.75% as the market factors in the end of ECB QE.”

Ten-year German government bond yield, in percent (lhs) – ECB Public Sector Purchase Programme holdings, in € billion (rhs)

Source: Union Investment, Macrobond
... and empirical observations

- Ten-year German government bond yield, in percent (lhs) – ECB Public Sector Purchase Programme holdings, in € billion (rhs)

Source: Union Investment, Macrobond
Long-term yields seem to be largely driven by expected short-term yields, while asset purchases have a very limited impact only.

The recent rise in ten-year German Bund yields can largely be explained by changes in the market-implied path for ECB deposit rates.

Source: Macrobond
**Bond market forecasts**

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>2-year US Treasury</td>
<td>1.59%</td>
<td>1.50%</td>
<td>1.40%</td>
<td>1.20%</td>
<td>1.10%</td>
</tr>
<tr>
<td>10-year US Treasury</td>
<td>1.81%</td>
<td>1.90%</td>
<td>1.70%</td>
<td>1.60%</td>
<td>1.50%</td>
</tr>
<tr>
<td>2-year German Schatz</td>
<td>-0.64%</td>
<td>-0.70%</td>
<td>-0.70%</td>
<td>-0.70%</td>
<td>-0.70%</td>
</tr>
<tr>
<td>10-year German Bund</td>
<td>-0.34%</td>
<td>-0.30%</td>
<td>-0.40%</td>
<td>-0.50%</td>
<td>-0.50%</td>
</tr>
</tbody>
</table>

- We expect the US economy to slow down into 2020, which should prompt two further Fed rate cuts. This should be sufficient to avoid a recession and allow for a modest steepening of the US yield curve.
- We have revised up our Schatz yield forecast as the ECB cut its deposit rate by 10 basis points only in September 2019. Further rate cuts seem unlikely due to financial stability concerns (cf. October 2019 GFSR).
- Persistently weak growth and low inflation coupled with downward pressure on global yields stemming for further Fed rate cuts should lead to somewhat lower long-term German government bond yields next year and an even flatter Bund yield curve.
- Peripheral government bonds and corporate bond markets remain well-supported.

Source: Union Investment
Bond market forecasts

Euro area government bonds
Yield to maturity, in percent

Corporate bonds
Asset swap spreads, in basis points

Emerging Markets bonds
Spreads over US Treasuries, in basis points

Sources: ICE BofAML Euro Periphery Index (EGLR), Euro Corporate Index (ER00), BB-B Euro High Yield Non-Financial Index (HEAG), JP Morgan EMBI Global Diversified Index (JPGCSOSD)
Key points

1. Trade tensions have led to a sharp slowdown of the global economy, but the euro area should be able to avoid a recession in 2020 due to resilient domestic demand.

2. Inflation remains subdued and inflation expectations have declined in most advanced economies, likely due to global factors which are not in the control of central banks.

3. The ECB’s asset purchases have a minor effect on long-term government bond yields only, but a rising impact on the funding to non-financial corporates and on corporate bond spreads.

4. Further ECB deposit rate cuts appear unlikely, since their marginal economic benefit would be dwarfed by mounting risks to financial stability (rising solvency risk for banks and non-bank financials, corporate debt build-up, asset bubbles, excess investment in lower quality and illiquid alternative assets).

5. Long-term yields in the euro area should gradually converge towards the current ECB deposit rate.
Topics for discussion

• What has driven the recent rise in euro area government bond yields?
• Why has the restart of the asset purchase programme not led to a decline in yields?
• Do the ECB’s large scale asset purchases result in scarcity premia in euro area bond markets?
• What are the main risks to euro area bond markets going into 2020?
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