Market Update
ECB Money Market Contact Group

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Inflation – Market Focus

Since President Draghi noted that the 5Y5Y inflation curve was a key indicator for the ECB Governing Council the market has been focused upon it. The trend continues downward, prompting markets to speculate about further accommodative policies.

Goodhart’s Law: *When a measure becomes a target, it can no longer be used as the measure.*

Source: Bloomberg.
Credit in Decline

Credit supply remains constrained in the Euro Area. Demand for and supply of credit appear slack, with credit growth in negative territory.

Source: Bloomberg.
Commodities: Continual Price Declines

Commodity prices continue to decline, further adding to the disinflationary environment.

Source: Bloomberg.
Unemployment: Entrenched

Unemployment is slowly trending lower at a Eurozone level, however persistently elevated unemployment remains in Italy, France and Spain.

The unemployment of the under 25’s across Europe is at chronic levels in Spain and Italy.

*Source: Bloomberg, Eurostat.*
The rise of sovereign indebtedness poses a serious constraint to future growth. The Eurozone is trending towards non growth, while Debt: GDP ratios are rising in most European nations.

Note also 2015 Eurozone supply issuance is expected to increase by 220bn EUR vs 2014 (see slide 14)
Bank Assets

European Bank assets

- Bank Deleveraging

Data of 25 key European banks, source Bloomberg.
The Citi Index measure hit heights rarely seen since the collapse of Lehman Brothers in October 14, as a range of fears from Russia & ISIS to Ebola exacerbated a risk off move in Markets triggered by poor US retail sales.

In the context of banks deleveraging we are seeing outsized moves in risk.
Equity Markets

Equity markets have been volatile in 2014

Source: Bloomberg.
Sovereign Credit

Interesting debt dynamics were noticeable during the recent market turbulence. As investors sought traditional safe havens, yields tumbled, but the German / France spread widened 10bps. Is the market perception of France as a core credit changing?

Source: Bloomberg.
European repo market behaviour is notably different to UK repo market behaviour at month end, as balance sheet focus distorts pricing. The decline in the magnitude of month end spikes would tend to indicate a strengthening of bank balance sheets.
ECB Measures: Forward Guidance is working

**Forward Eonia 2014, %**

**Euribor 2014, %**

Source: Bloomberg.
In spite of ECB Open Market Operations, notably the LTRO’s, the volume in the Eonia market has not picked up markedly, suggesting interbank market participants are still unwilling to increase lending.

Source: Bloomberg.
Both the FED and the BOJ have aggressively increased their balance sheets via QE programmes.

There has been lots of discussion about the ECB’s balance sheet target, with the launch of CBPP3 and ABS expected shortly. Looking at 2015 supply (overleaf) Sovereign QE remains a possibility.
Net new issuance of 221 bn EUR anticipated next year.

Scope if required for a meaningful Sovereign QE programme.
Currencies

EURJPY 2014

5y Cross Currency Basis, Key Currency Pairs

EURGBP 2014

EURUSD 2014

Source: Bloomberg.
CBPP3 – Will Add to Current Supply/Demand Imbalance

Global gross supply (benchmark covered bonds, major currencies)

Euro area net supply of EUR benchmark covered bonds

Monthly secondary turnover (EUR)

Universe of CBPP3-eligible covered bonds

Source: Barclays Research.
CBPP3 – Pronounced Impact on Covered Bond Spreads

Source: Barclays Live.
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