ECB BMCG,
Bond Market Outlook

Group Economic and Macro Strategy,

June 12, 2019

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AGENDA

1. **World Economy: Structural Changes**
2. **Market: Dovish Tilt**
3. **Discussion Points**

   3.a What's Next: Normalization or ..... Else (Sandbox for Discussion)

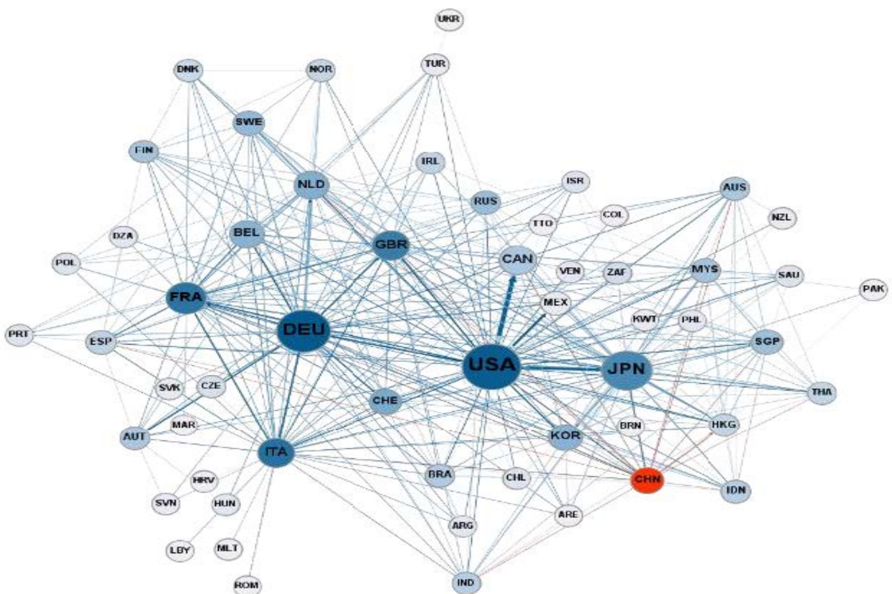
   3.b Few More Issues for Discussion

WORLD ECONOMY: STRUCTURAL CHANGES

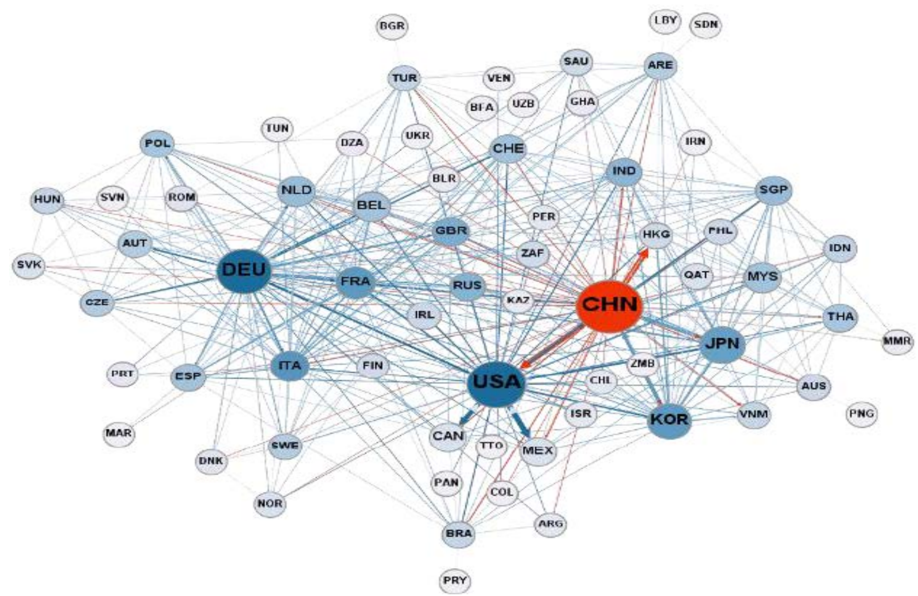
Section 1

GLOBAL VALUE CHAIN: 20Y APART SNAPSHOTS

Trade in Global Intermediates - 1995



Trade in Global Intermediaries - 2016



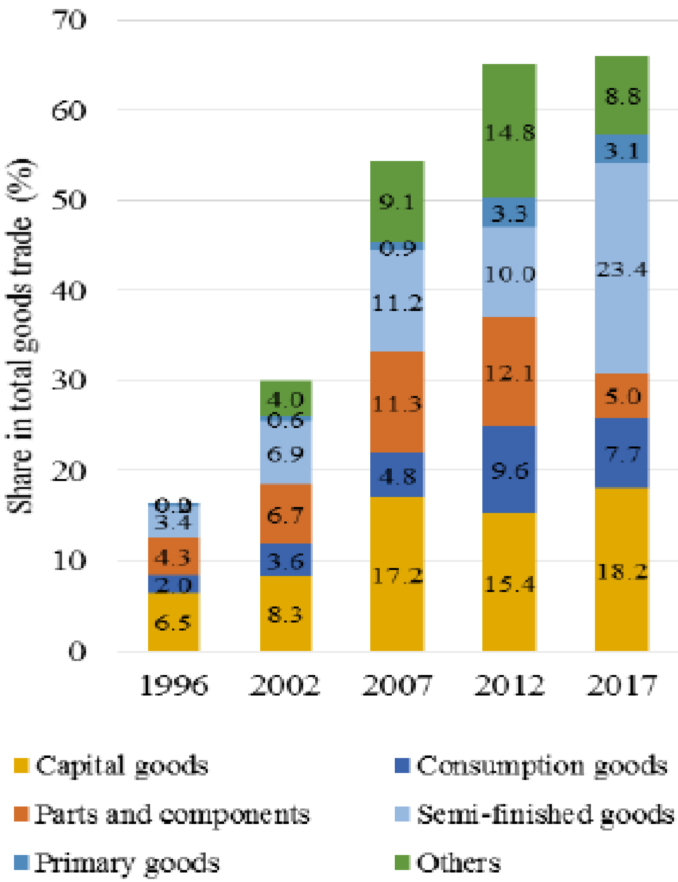
Comments

- The connecting lines illustrate the strongest trade flows in intermediate goods for each country
  - the central nodes (roots), are the main trade partners for several countries, distinguished from the peripheral countries (leaves). The node size represents a country's web-centrality. Strong connections imply dense cluster
- Over those **20Y, World trade volume grew by 203%** (5.4% per year on average) and **China has become central** in intermediate goods trade
- **Europe –US distance grows**. Intra-EU flows remains **Germany-centric**
- **ASIA-US distance is about the same** but **Asia in not clustered around China not Japan**
- **Trade is tri-polar**

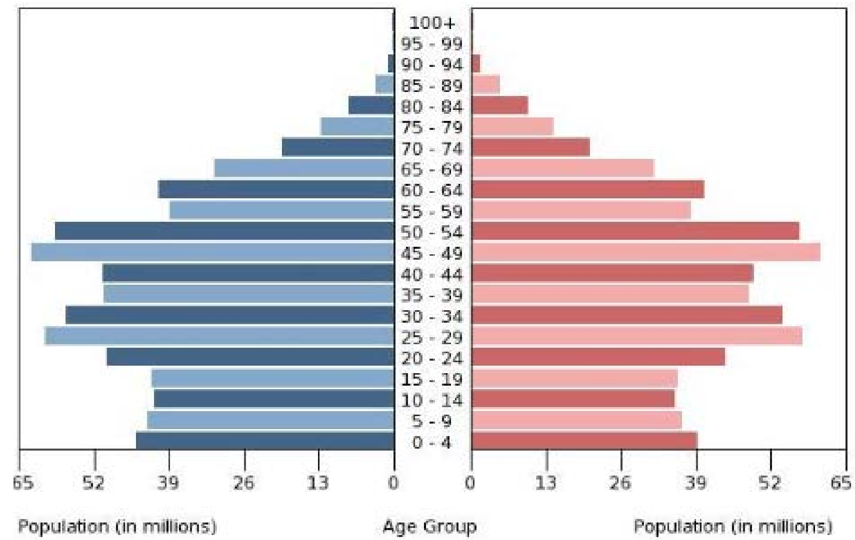
Note: Global Value Chains: Trading for Developmenyt, World Development Report 2020, The World Bank

China vs US Confrontation: Structural

New Products Trade[1] (share of Total, %)



China Population Pyramid

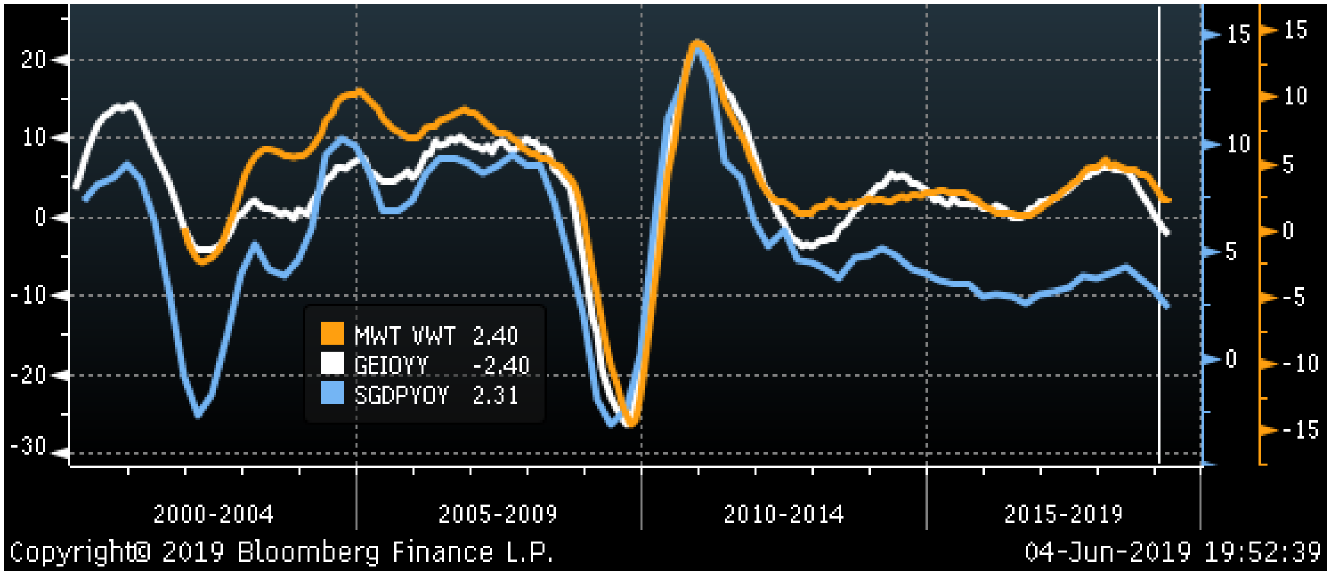


- China has huge **negative demographics**
- China needs to **climb above semi-finished goods trade** to defuse social tension.
- **Technology push is crucial** to climb the value chain
- **China will not back off** from the confrontation w/ US on technology

Note:
1) Global Value Chains: Trading for Developmenyt, World Development Report 2020, The World Bank
2) The World Factbook, Central Intelligence Agency

Global Value Chain: Germany GDP, S'pore GDP, and Trade

Germany Factory Orders y/y 12M MAv (white); World Trade y/y 12M MAv (orange); S'pore GDP y/y (blue); Vertical line is BMCG past meeting



- Current German factory orders growth is at historically low level. These levels spell **"Germany's standing still"**
- **Germany dances to global growth's tune** with Singapore and trade volume
- Global economic momentum have been **softening since 1q18** (and BMCG's most recent gathering)
- German Factory Orders correlates strongly with global trade volume (Germany is a link in the global value chain) and Singapore GDP (whose economy export sector, at 173% of GDP, makes it a proxy for global growth)
- **Trade tensions do not bode well for global growth**

MARKET: DOVISH TILT

Section 2

Drive Seat Switch: US Rates Lead

Market: Dovish Tilt **Section 2**

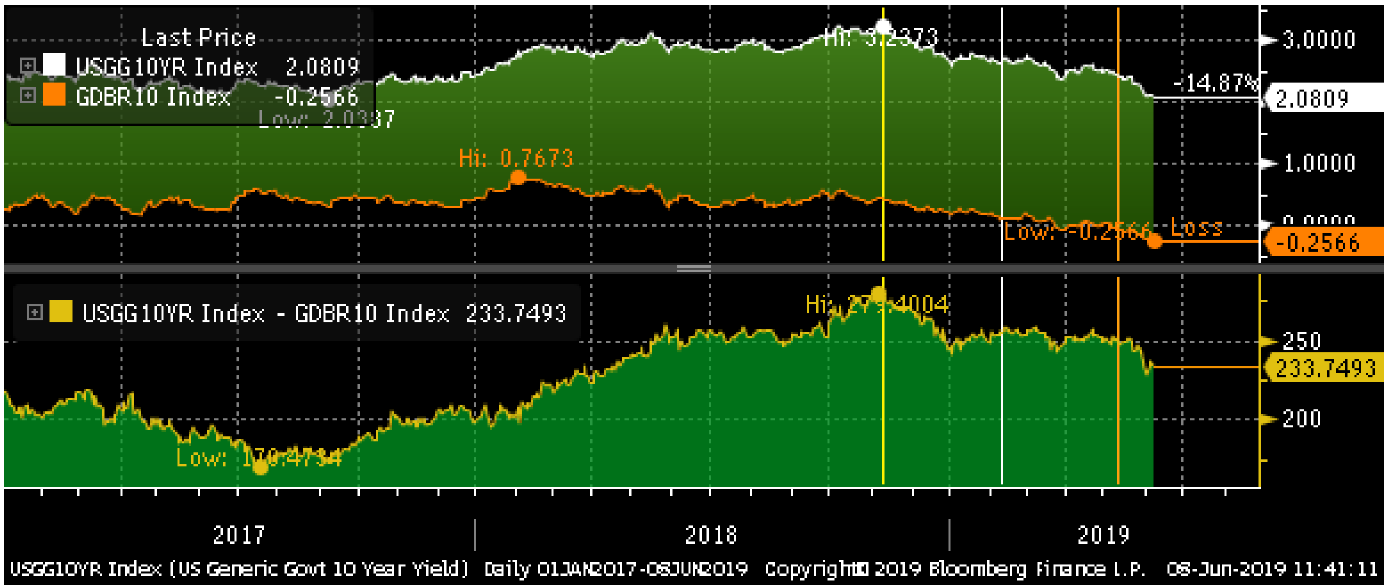
(Swap 1Y1Y – Swap 1Y) US (white); EU (orange);

- **From 2015 (ECB QE starts) to 3q18, EU yields anchors US yields**
- **Ever since**, it is **US yields pushing EU yields lower**

Note: Vertical lines are Nov 8, 2018 (yellow), previous BMCG meeting (white), Mr. Trump stops trade talks with China

SOUR TRADE TALKS MAKE THE PUSH STRONGER

10Y US Treasury (white); 10Y Bund (orange); 10y (Treasury-Bund) (lower panel)



- **US yields leading the way** both on levels and steepness
- Bunds at -0.26% is close to historical low
- At the end of July 2018 the market value of bonds yielding negative in the JPM Global Government Bond Index was about USD 5.4tr. On May the 30th they were worth some USD 8.5tr (+58%)[1]

Note: Vertical lines are Nov 8, 2018 (yellow), previous BMCG meeting (white), Mr. Trump stops trade talks with China (orange)
1) Data courtesy of JPM

EZ and US Inflation Expectations: CBs Called into Action?

Market: Dovish Tilt **Section 2**

EU Infl 5Y,5Y (white),
EU Infl 9Y,1Y (yellow), EUR-priced CRB RIND (green)

US Infl 5Y,5Y (white),
US Infl 9Y,1Y (yellow), CRB RIND (green)

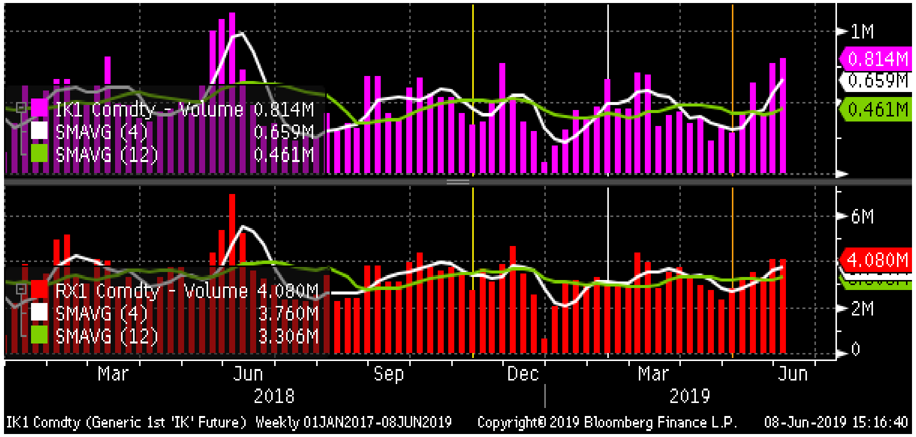
- In **EU**, market prices for **forward inflation** protection are **below 1q15 levels** (ECB's QE starts) and some 100bp below 2014 levels
- In **US, ** broadly stable inflation expectations since 2017 some 60bp below 2014 levels
- **Market leans toward further Central Banks intervention**

Current - Implied Yield On Dec 20 (bp)	08/11/2018 Nov Fomc	12/02/2019 Feb BMCG	09/05/2019 No US-Chn talks	Most recent
ECB – Depo[1]	37	17	9	-6
FED - Upper Bound	89	6	-25	-72
BOE - Ref Rate	60	26	24	-9

Note: Vertical lines are Nov 8, 2018 (yellow), previous BMCG meeting (white), Mr. Trump stops trade talks with China (orange)
1) ECB – Depo = -0.4%; FED – Upper Bound = 2.5%; BOE – Ref Rate = 0.7%%

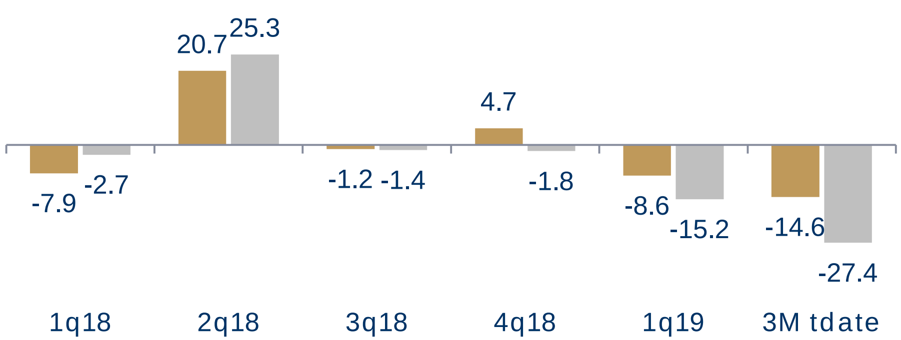
VOLUMES SHOW BOND MARKET IS BURST PRONE

BTP Fut Volumes (mauve); Bund Fut Volumes (red)

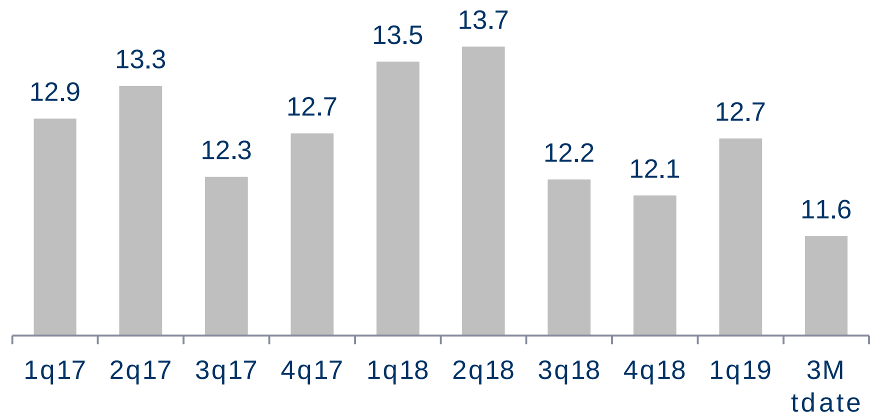


- 3 Month average volume traded have been decreasing since 3q18.
- BTP Future share of most liquid futures is declining
- **BTPS are burst prone**: weekly volume may part significantly with longer term averages

3M Bund Fut Volumes y/y (%, gold); 3M BTP Fut Volumes y/y (%, grey)



BTP Fut Volume Share of the two[1] (%)



Note: Vertical lines are Nov 8, 2018 (yellow), previous BMCG meeting (white), Mr. Trump stops trade talks with China (orange
1) BTP Fut Volume / (BTP Fut Volume + Bund Fut Volume)

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Market Doubts Italian Consolidation Path

10Y (BTP-Bund) (white); 10Y (BONOS-Bund) (orange)

- The current low yield environment makes **Italian government bond yields/spread enticing**
- **Short positions on Italy are costly**
- Recent market dynamic suggests **negative views** on Italian government bonds require **time framed catalysts** (e.g. elections, rating agencies actions, public finance calendar)
- Market pricing shows **doubts about the Italian fiscal consolidation path are resilient**

Note: Vertical lines are Nov 8, 2018 (yellow), previous BMCG meeting (white), Mr. Trump stops trade talks with China (orange)

Discussion Points

Section 3

What's Next: Normalization or ..... Else (Sandbox for Discussion)

Subsection 3.a

"….. Else" Scenario

What's Next: Normalization or ….. Else (Sandbox for Discussion) **Section 3.a**

Economy

- **Full blown Chn-US trade war** or another geopolitical event makes **global trade drop sharply**
- **In US: growth slows sizably**, US firms' leverage suggests they will cut costs via layoffs. Firms' top-line is under further pressure
- **In EU: Germany and Italy would be badly hit. Public spending boost the most likely way forward** as monetary policy tools do not directly address aggregate demand
- **In Asia**: a combination of **fiscal and monetary policy accommodation cushion the blow**

Market

- **Fed would begin an easing cycle.** The current floor (roughly at 1.75% at Dec20) will be likely pushed lower
- US **curve to bull steepen** aggressively
- **Bund yield significantly** deeper in negative territory
- Risky assets would re-price briskly as structural change acceleration verges on disruption
- JPY to strengthen
- USD less clear cut
  - In Dec18 equity rout accelerated as Fed signaled hike path was alive and resolution of US-Chn trade issue was postponed. USD weakened

SPX (white); EUR (green); DXY (mauve, inverted scale)

“NORMALIZATION” SCENARIO

Economy

- **US-Chn trade rift continues. US stance harder the stronger the equity sentiment**. Global value chains diversion continues
- **In US: growth fragility rise** as growth itself slows moderatedly.
- **In EU: Growth slows** and **inflation remain elusive. Infrastructure and defense** public spending sustain growth in 2h19
- **In Asia: economic policy** is focused to divert global value chain

Market

- **US yields** hover around current levels, US curve with **a bullish steepening bias** as the Chn-US trade rift is structural.
- **Fed could cut rates**; 10Y Treasury at 1.80% is possible
- **Pressure for the USD to weaken would increase** as the fiscal policy impulse fades
- **Bund would probably bounce off yields low only well into 2h19** as fiscal policy spending (coordinated or otherwise) sustains economic activity
- **Risky assets would probably show a weakening bias** as uncertainty rises due to the structural changes in production processes

Few More Issues for Discussion

Subsection 3.b

Few More Issues for Discussion

- How low could the ECB depo rate go if needs be?
- What would be the consequences of implementing tiering on excess reserve on a fragmented money market?
- Due to the current structural tensions on trade, global value chains will likely divert and shorten. Will financial flows remain long-hawl or will shorten with value chains?
- Would the longer run yield levels be affected by a tri-polar (e.g. America, Europa, Asia) economic system?

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