Market Update

ECB Money market Contact Group

Munich 27 Sept 2016

Welcome to UniCredit

The Brexit Process

Timetable: *It could lead up to a decade or more of uncertainty*

TIME

UK PM triggers EU Art. 50 (TEU)
The process begins when the Member State that wishes to leave notifies the European Council.

Two years negotiating period begins
The European Council agrees by consensus the guidelines for the European Commission to negotiate the withdrawal agreement (1) .

Withdrawal agreement is approved
The final agreement would need to be agreed by both parties: the EU side and the departing Member State (2).

UK leaves the EU
Upon approval of the withdrawal agreement, EU treaties cease to apply

New relationship between UK and EU

Possible extension
After the two year of negotiation, in case of no agreement, the UK and European Council may extend the negotiating period by unanimous vote

Period is extended and negotiations continue

Period is not extended; EU treaties cease to apply; UK exits without clear terms

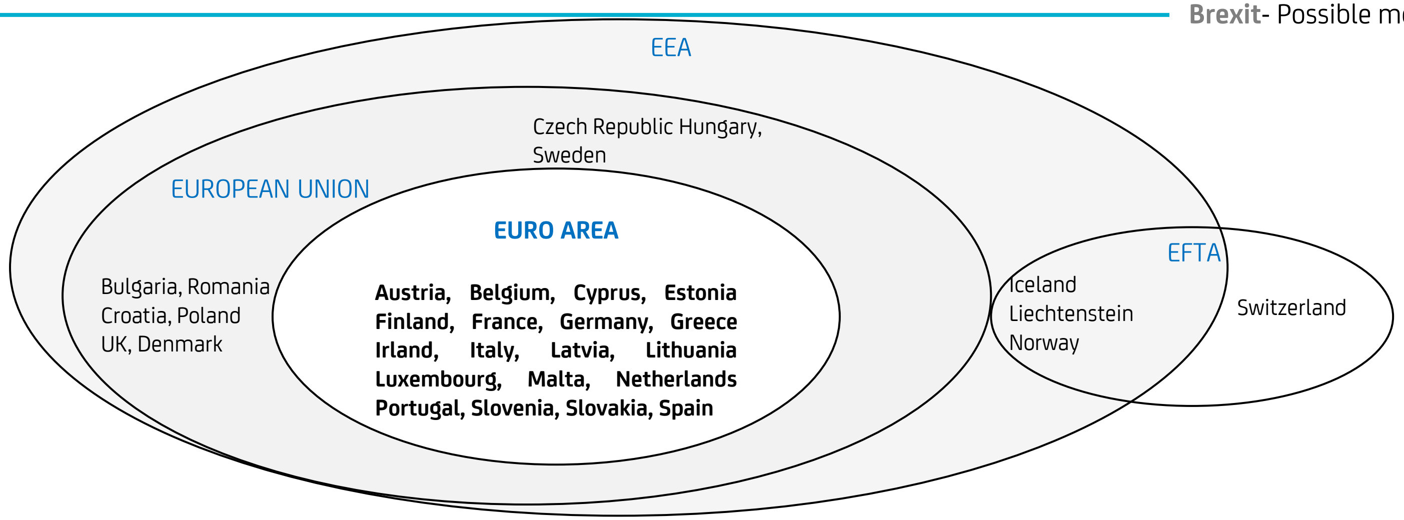
(1) Consensus requires every Member State (minus the departing State) to vote in favor. the departing State will be not able to participate in the discussions regarding its withdrawal agreement within the European Council

(2) On EU side the **Council of the European Union** agrees to withdrawal agreement by *enhanced qualified majority voting*(Qualified majority voting is a system used for EU Member States to reach an agreed position. Under the Lisbon Treaty, a majority must include 55 per cent of countries, representing 65 per cent of the total EU population. But Article 50 of the Treaty on European Union stipulates that the voting rule to be used is that set out in Article 238.3(b) of the Treaty on the Functioning of the European Union, which requires 72 per cent of Member States "i.e. 20 out of the remaining 27 Member States" comprising 65 per cent of the EU population.)This means that no single Member State could veto the deal. **The European Parliament** would also need to approve the deal. This would require a simple majority

Source:HM Government, "*The process for withdrawing from the European Union*", February 2016

The Brexit Process

Possible models for UK – EU relations



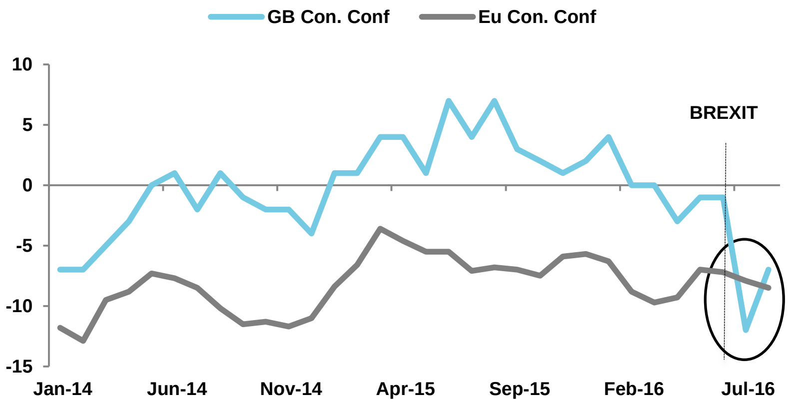
- European Free Trade Association (**EFTA)** + European Economic Area (**EEA**) (**Norway Model**)
  - Considerable **access to the Single Market**;
  - **UK will required to follow most of rules of EU** membership(including the free movement of people and make contributions to EU spending), though **without a vote** in how those rules are made.
- EFTA + bilateral agreements (**the Swiss model**)
  - **Limited access to the Single Market**, offering some combination of tariff-free trade, open access to the services market and guarantees that companies operating in UK are treated in a fair and non-discriminatory way;
  - **Often require adhering to EU rules**(Swiss' case) without the benefits of single market access(for example, accepting the free movement of people, making a significant contribution to EU spending, etc);
  - The UK would lose the benefit of EU Free Trade Agreements with other parts of the world: **renegotiating these would take years**
- **WTO** membership
  - This would **not include any preferential access to the Single Market**, or to any of the 53 markets with which the EU has negotiated Free Trade Agreement. It would be the most definitive break with the EU
  - Access to the EU market under WTO rules and subject to the EU's external tariffs
- Free Trade Agreement (**FTA**)
  - An approach based on a Free Trade Agreement would not come with the same level of obligations, but would mean UK companies had reduced access to the Single Market in key sectors such as services
  - Canada's FTA, the most advanced EU FTA so far, still limits access for financial services and certain Canadian manufactured goods and requires Canada to accept EU rules when exporting to the EU
  - **Could take several years** (EU-Canada agreement has taken seven years and it is not yet in force)

Source:HM Government, "*The process for withdrawing from the European Union*", February 2016

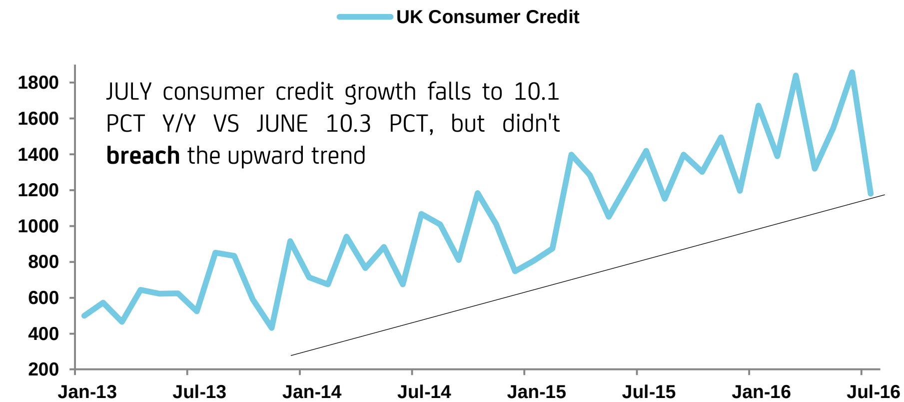
Overview of market development

Brexit spillovers: Uncertainty remains elevated *but* overall the latest data from UK are better than expected

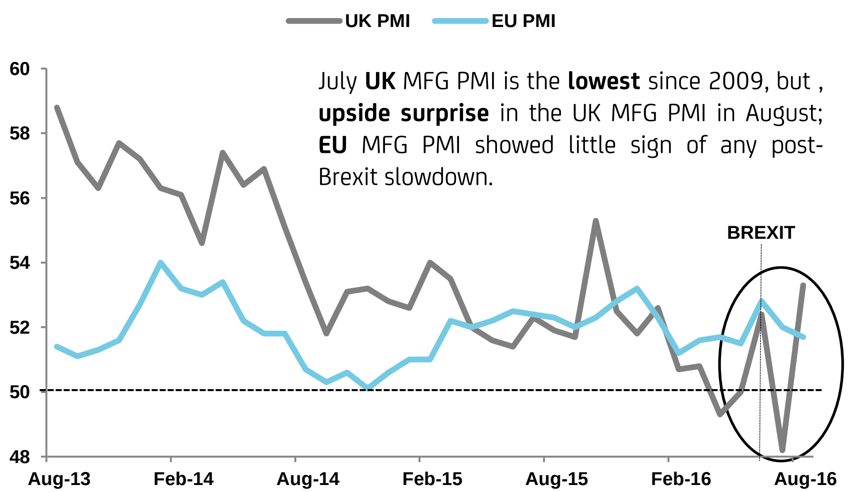
UK Consumer Confidence vs EU Consumer Confidence



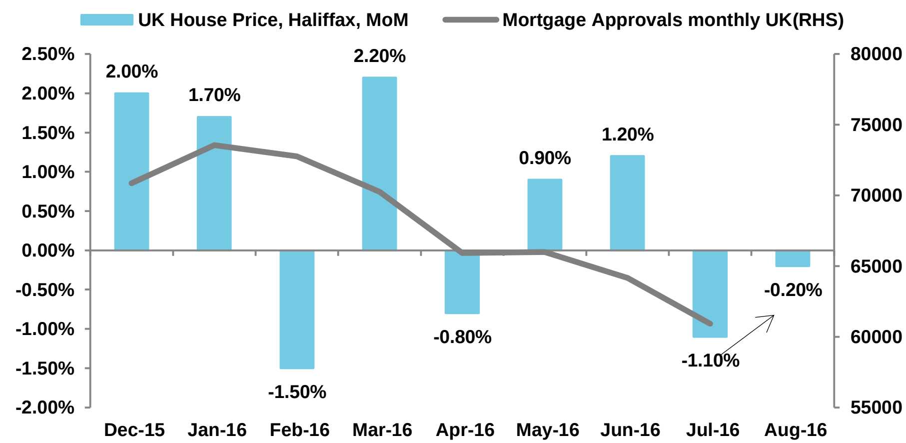
UK Consumer Credit Growth (MLN)



MFG PMI UK vs EU



UK House Price MoM Change



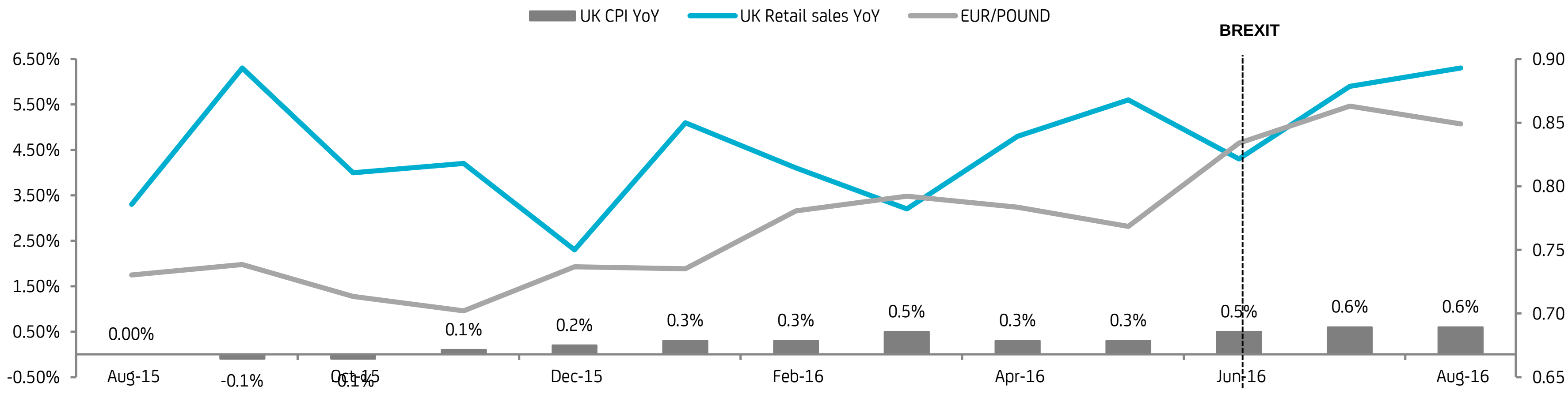
The House Price growth showed a sharp Slowdown. According to the forecast the House price growth will keep slowing in the second half of this year and dip on average across the country by one per cent in 2017.

Source: Reuters, Bloomberg

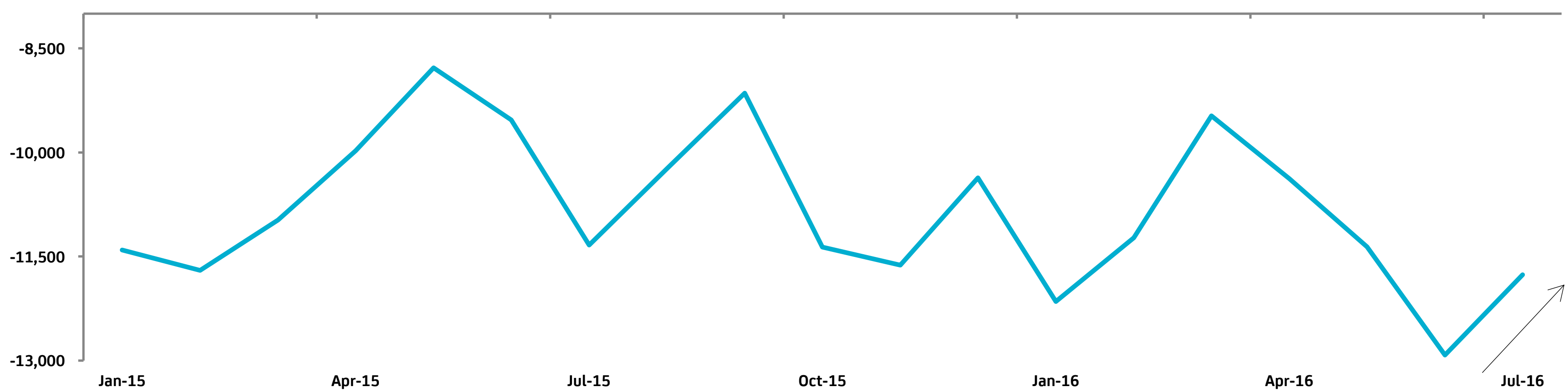
Overview of market development

Lower pound is pushing higher UK inflation, retail sales and reducing the trade deficit.

Eur/Pound, Retail Sales & UK CPI YoY



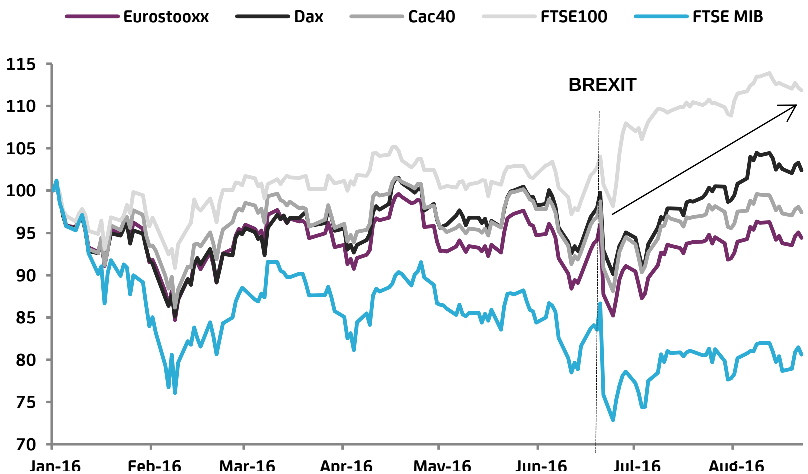
UK Trade balance(mln)



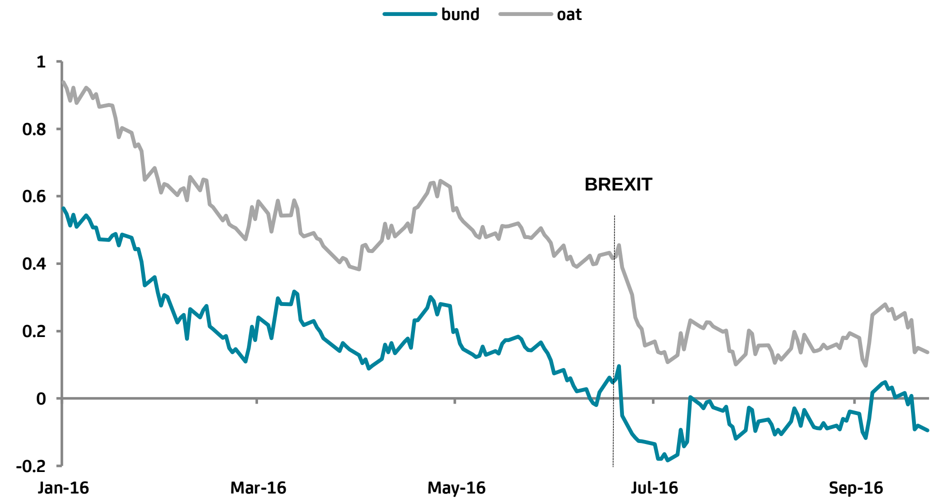
Overview of market development

Resilient to Brexit: Financial market stress is still elevated but adverse impact is much lower than expected.* The effect on financial markets reabsorbed almost in full. *(1/2)

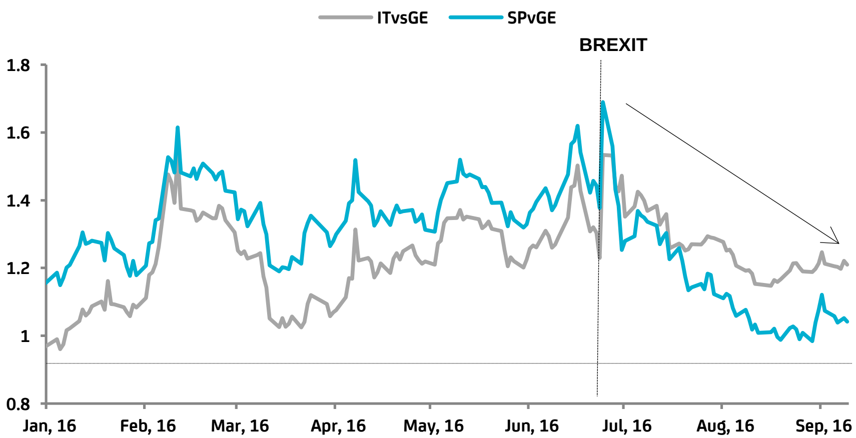
Equity Capital Markets



Development of Core Govt Bonds



Periphery-core spreads



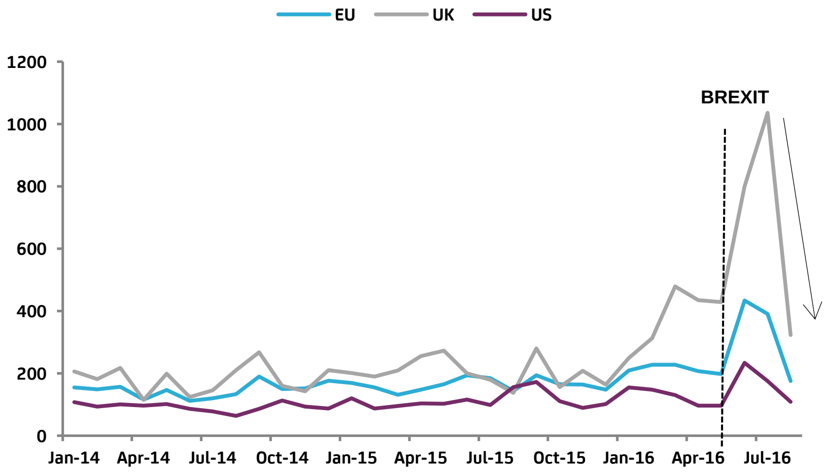
- ECM: After a sharp drop following the unexpected "leave vote", the major European equity indexes are almost recovered.
- **Strong really of UK equity market**, fuelled by both BOE stimulus package and the expectation of further easing
- Brexit induced flight into safe-haven assets, pushing for the first time the 10y Bund below zero
- The post-brexit riskoff mood is slowly fading away in EU. **Tightening in periphery-core spreads** easing back to the levels prevailing at the beginning of the year. The 10y **BTP-Bund spread tightened by over 10bp**, fundamentals have not improved for the recent tightening in peripheral spreads to be justifiable.

Source: Reuters, Bloomberg

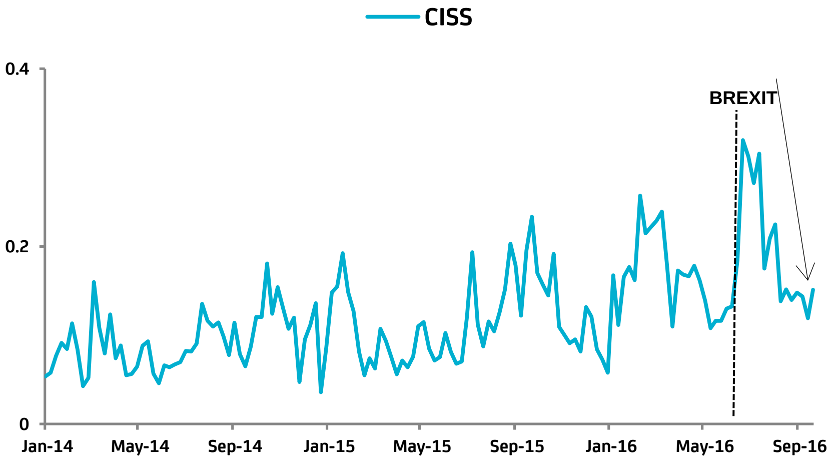
Overview of market development

Resilient to Brexit: Financial market stress is still elevated but adverse impact is much lower than expected. Little impact on sentiment(2/2)

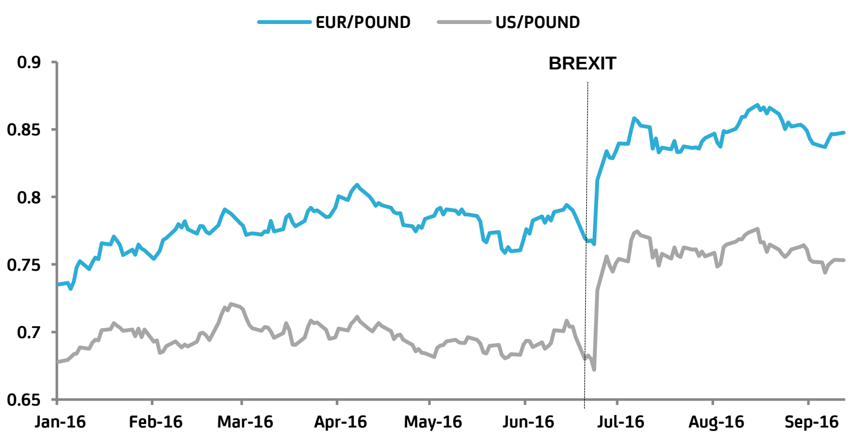
Economic Policy Uncertainty*



ECB Composite Indicator of Systemic Stress



FX Markets



- Pound/ EUR is trading at levels prevailing in 2013, while Pound/USD is at its **lowest** levels. Weak Pound is pushing higher inflation and retail sales in UK.
- After a spike following the "leave vote" the **Economic policy uncertainty** index - a widely used measure, counting the number of newspaper article references- **is falling back everywhere**.
- The ECB CISS is almost back to the levels pre –brexit

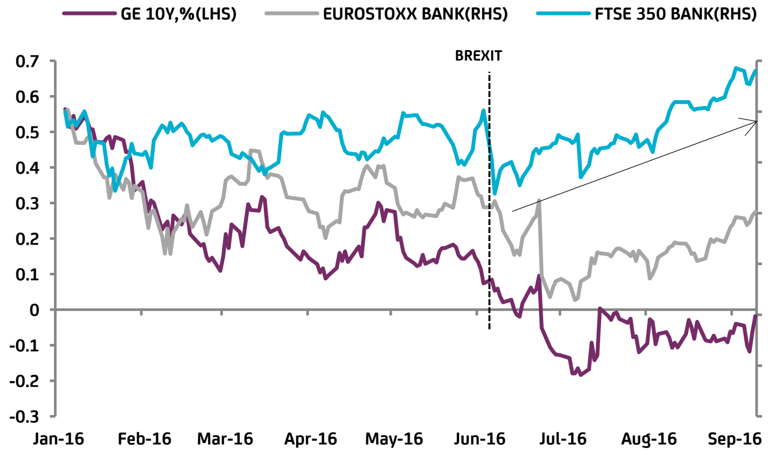
Source: ECB Statistical Data Warehouse, Reuters, Economic Policy uncertainty

*Economic Policy uncertainty: is an index derived from three types of underlying components. One component quantifies newspaper coverage of policy-related economic uncertainty. A second component reflects the number of federal tax code provisions set to expire in future years. The third component uses disagreement among economic forecasters as a proxy for uncertainty

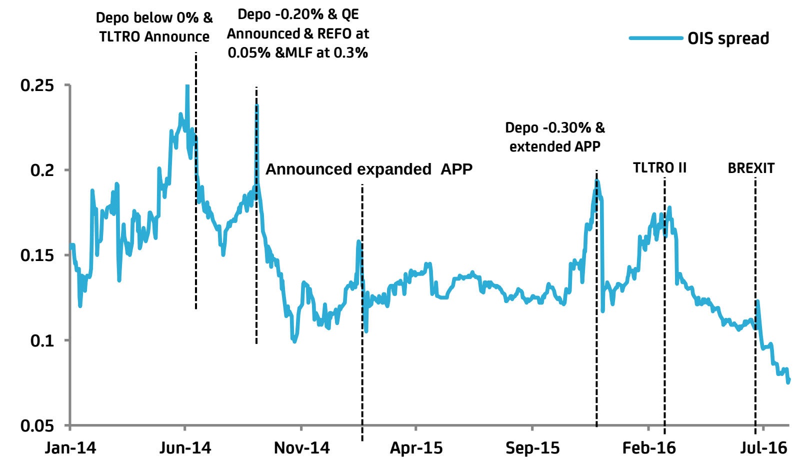
Overview of market development

European Banks are under pressure but the credit risk premium is still at lowest level

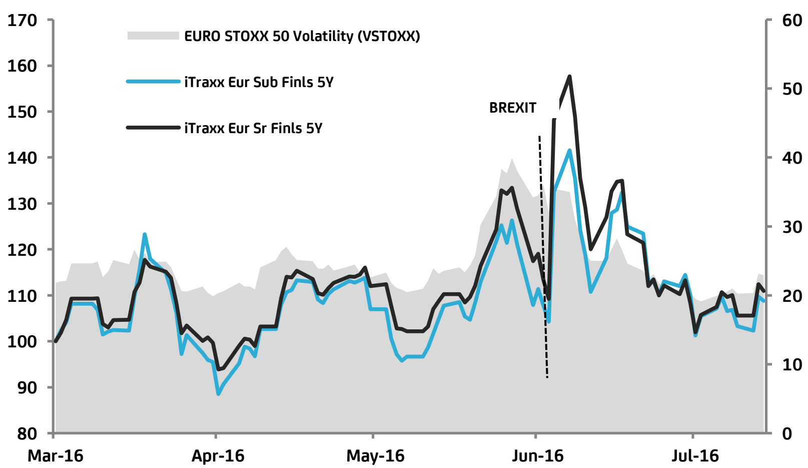
Financials follow long-term rates



Euribor – OIS Spread 3m



CDS Pricing



- Nevertheless Brexit and the pressure on European Banks the 3m Euribor-Eonia spread **have tightened** sharply over the past month. A continuous decline in the 3mEuribor - OIS spreads reflects abundant liquidity conditions, market expectations of the ECB's accommodative stance and a declining credit risk premium

- CDS are pricing at **pre-Brexit** level.

- Strong performance of UK banks. After the drop following Brexit, the **FTSE 350 Bank** is trading at **highest** level YTD. Differently, the Eurostoxx Banks is paring back the lost, but it hasn't recovered yet.

Source:Reuters and UniCredit Database as of 18 July 2016

* On 5 June 2014 first series of TLTRO was announced, while on 10 March 2016 a second series TLTRO II was announced. On 5 June 2014 deposit facility rates were set below zero for the first time, On 4 Sept 2014 the depo rate was cut to -0.20 and on the 3 Dec 2015 the depo was cut by 10 bps to -0.3%

Brexit: Central Banks' Monetary Policy Decision

BOE *first mover, BCE is waiting for more evidences*

Brexit — 23-June-2016

14-July-2016 — BOE Monetary Policy Decision:
NO ACTION
- The Bank of England's Monetary Policy Committee voted by a majority of 8-1 to maintain Bank Rate at 0.5%, with one member voting for a cut in Bank Rate to 0.25%.;
- The MPC voted unanimously to maintain the QE at £375 billion.
- Most members of the Committee expected monetary policy to be loosened in August

21-July-2016 — ECB Monetary Policy Decision:
NO ACTION
- Decided to keep the key interest rates unchanged;
- No change in APP's features: confirm that the monthly asset purchases of €80 billion are intended to run until the end of March 2017

27-July-2016 — FED Monetary Policy Decision:
NO ACTION
- The Board of Governors of the Federal Reserve System left unchanged the interest

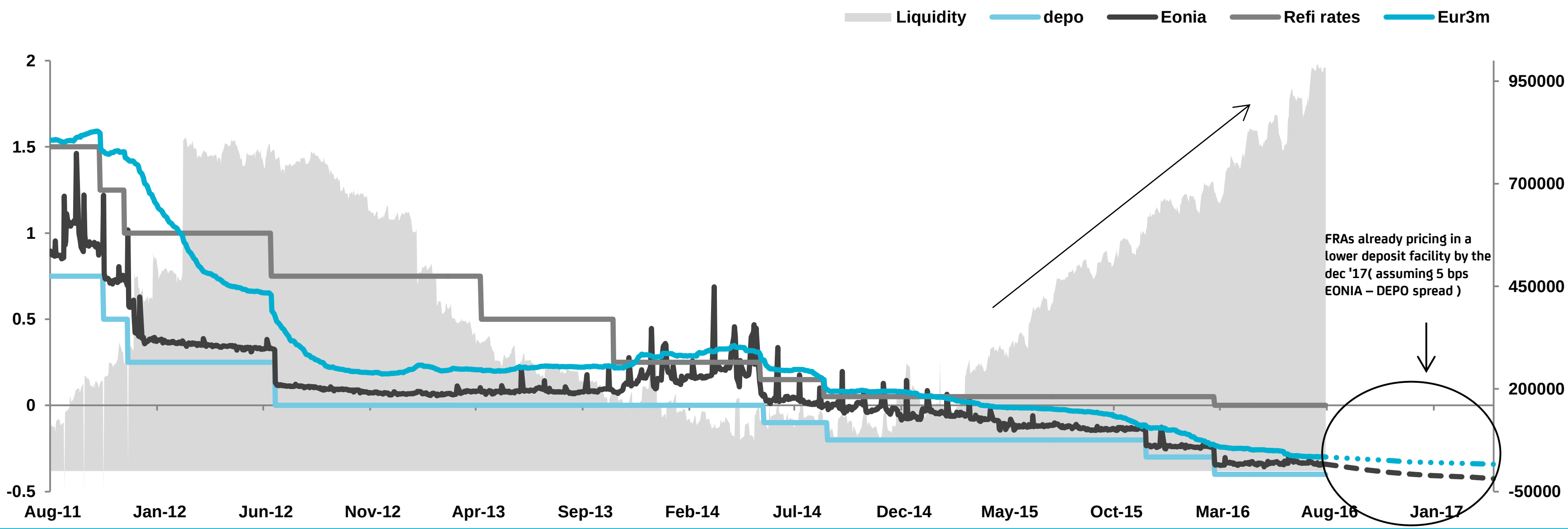
28-July-2016 — BOJ Monetary Policy Decision:
ACTION
- An Increase in purchases of ETF. BOJ will buy ETFs at an annual pace of 6 trillion yen
- Increase the monetary base at an annual pace of about 80 trillion yen

4-Aug-2016 — BOE Monetary Policy Decision:
ACTION
- The Bank of England's MPC voted unanimously to cut the Bank Rate at 0.25%. It is the first cut since 2009
- BoE will expand QE with an extra £60bn
- Bank will also extend QE to buy corporate bonds
- A Term Funding Scheme that offers cheaper funding to banks

9- Sept- 2016 — ECB Monetary Policy Decision:
NO ACTION
- NO NEED extra stimulus at the time being
- All the options are on the table

21- Sept-2016 — BOJ Monetary Policy Decision:
ACTION
- Introduce QQE With **Yield Curve Control**

21- Sept-2016 — FED Monetary Policy Decision :
NO ACTION
- left interest rates unchanged
- likely hike by the end of the year



Source: Reuters, Bloomberg, ECB data warehouse

Brexit: ECB's Forecast

ECB September projections broadly unchanged versus June

- ECB conf. Sept'16 :" *Overall, while the available evidence so far suggests **resilience of the euro area economy** to the continuing global economic and political uncertainty, baseline scenario remains subject to downside risks*".
- "*... The Governing Council will continue to monitor economic and financial market developments very closely.... If warranted, we will act by using all the instruments available within our mandate. Meanwhile, the Governing Council tasked the relevant committees **to evaluate the options that ensure** a **smooth implementation** of our purchase programme*."
- "..... *Looking ahead, we continue **to expect the economic recovery to proceed at a moderate but steady pace**...However, the economic **recovery in the euro area is expected to be dampened** by still subdued foreign demand, partly related to the **uncertainties following the UK referendum outcome**...*"

Main Marcoeconomics ECB esitmates

	2016			2017			2018		
	Previous	Revised	Delta	Previous	Revised	Delta	Previous	Revised	Delta
GDP(%yoy)									
Euro area	1.7	1.7	0	1.7	1.6	-0.1	1.7	1.6	-0.1
CPI(%yoy)									
	0.2	0.2	0	1.3	1.2	-0.1	1.6	1.6	0

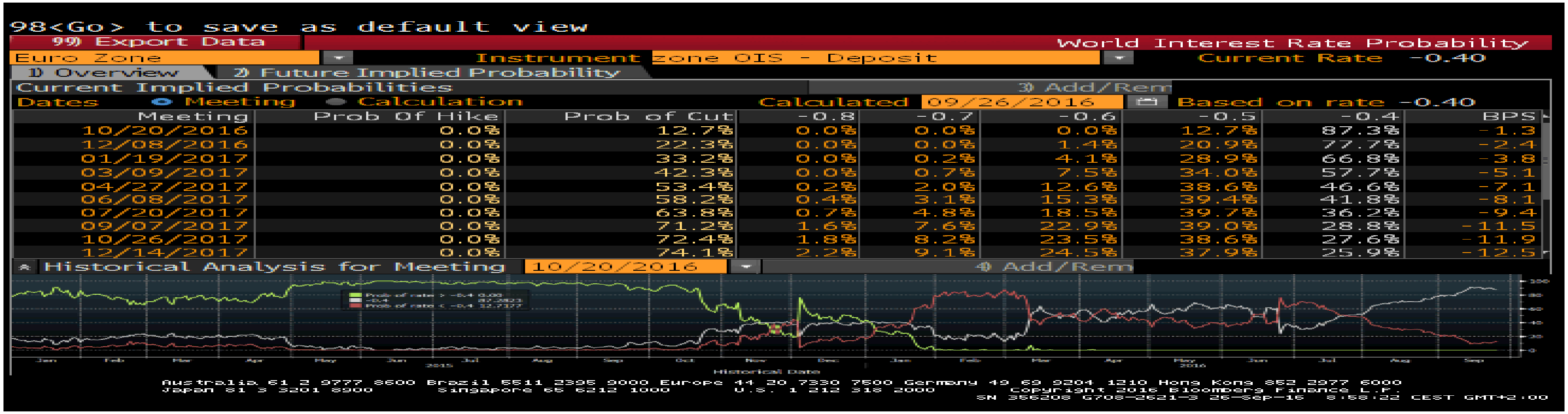
Source:ECB, press conference 08-Sept-2016

 *

Markets expectation

Money markets do not expect the possibility of another cut

Implied probabilities of further DEPO rate cuts priced into OIS forward CURVE



98<Go> to save as default view

99) Export Data — World Interest Rate Probability

Euro Zone — Instrument zone OIS - Deposit — Current Rate -0.40

1) Overview — 2) Future Implied Probability

Current Implied Probabilities — 3) Add/Rem

Dates: Meeting / Calculation — Calculated 09/26/2016 — Based on rate -0.40

Meeting	Prob Of Hike	Prob of Cut	-0.8	-0.7	-0.6	-0.5	-0.4	BPS
10/20/2016	0.0%	12.7%	0.0%	0.0%	0.0%	12.7%	87.3%	-1.3
12/08/2016	0.0%	22.3%	0.0%	0.0%	1.4%	20.9%	77.7%	-2.4
01/19/2017	0.0%	33.2%	0.0%	0.2%	4.1%	28.9%	66.8%	-3.8
03/09/2017	0.0%	42.3%	0.0%	0.7%	7.5%	34.0%	57.7%	-5.1
04/27/2017	0.0%	53.4%	0.2%	2.0%	12.6%	38.6%	46.6%	-7.1
06/08/2017	0.0%	58.2%	0.4%	3.1%	15.3%	39.4%	41.8%	-8.1
07/20/2017	0.0%	63.8%	0.7%	4.8%	18.5%	39.7%	36.2%	-9.4
09/07/2017	0.0%	71.2%	1.6%	7.6%	22.9%	39.0%	28.8%	-11.5
10/26/2017	0.0%	72.4%	1.8%	8.2%	23.5%	38.6%	27.6%	-11.9
12/14/2017	0.0%	74.1%	2.2%	9.1%	24.5%	37.9%	25.9%	-12.5

Historical Analysis for Meeting 10/20/2016 — 4) Add/Rem

Historical Date

Australia 61 2 9777 8600 Brazil 5511 2395 9000 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2016 Bloomberg Finance L.P.
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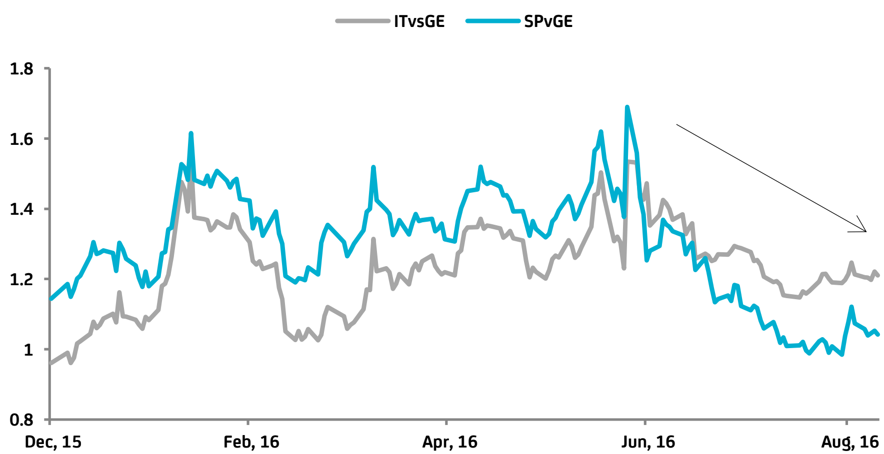
Periphery-core spreads



- Markets have **decreased** their expectation of a near term DEPO rate cut. Probably because in a context of rising excess liquidity further DEPO cut might hurt banks' profits
- Markets are pricing in **less then 15%** chance of a 10bps cut for Oct Meeting, in 23% for the Dec meeting,
- The **Bund Scarcity problem** is driving the markets betting on QE amendments. Sovereign spread are repricing to pre-crisis level. BTP-BUND is now trading at 130bps, while BONOS –BUND 110bps
- Over a medium term, the direction of yields will depend on the type of changes that are implemented in the program to ensure a **smooth continuation**. If the ECB opts for a solution to reduces the buying pressure on BUND(i.e. remove capital key rule), this might help **German yields to rise** and core-Periphery spreads to tighten. On the other hand, if the ECB decides to remove the floor for buying Bunds, this might have the opposite effect.

Source: Reuters, Bloomberg