Bond market outlook for the year ahead

June 2018

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HSBC

Topics

Global macro

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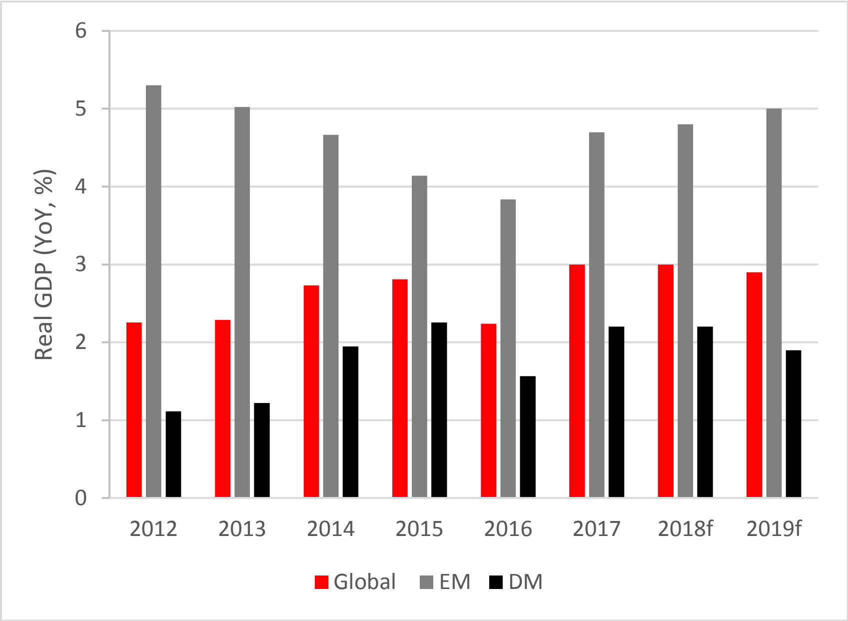
Global macro

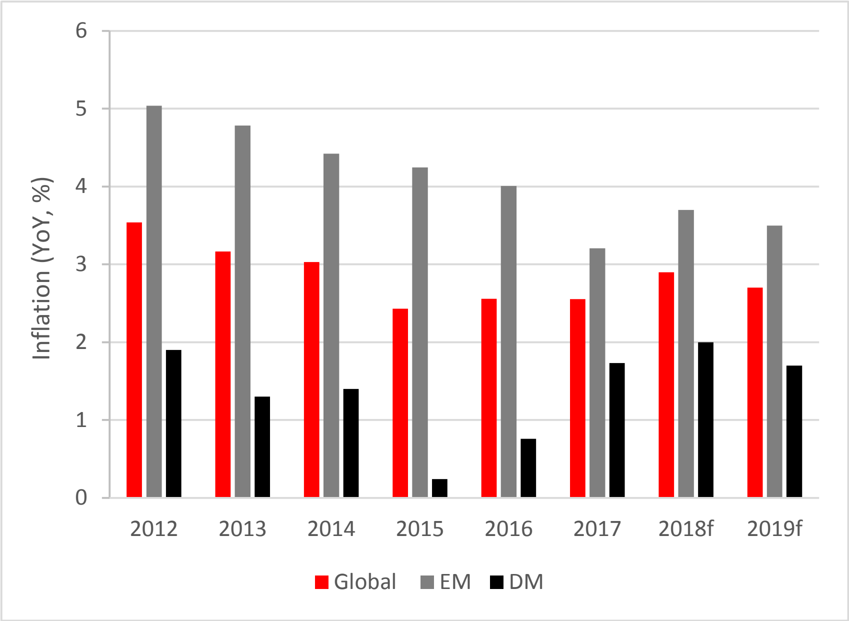
Global economic outlook

Real GDP



Source: HSBC Global Research (incl. forecasts)

Inflation



Source: HSBC Global Research (incl. forecasts)

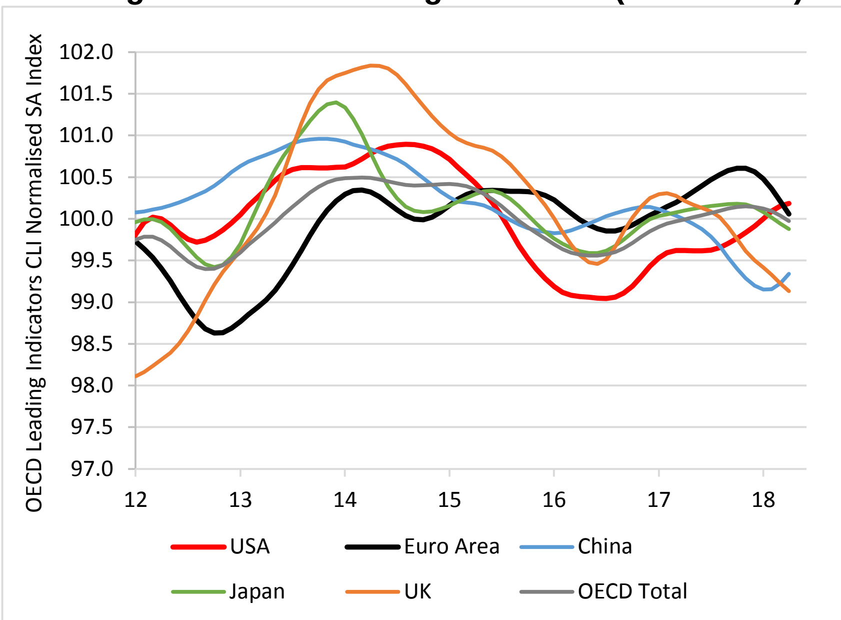
- Global expansion, monetary policy and potential inflection point
  - US fiscal stimulus provides short-term boost, but with longer-term risks. Meanwhile, growth in the Euro-area and Japan have seemingly peaked. EM to see solid growth, but China demand mix is changing and will have varying degree of global impact
  - Expecting a total of three rate hikes this year, but slower pace in 2019 as tightening financial conditions begin to be felt. ECB is seen as terminating its QE programme by end of 2018; however, only one 15bp deposit rate rise in 2019. In Japan, the BoJ's yield-curve control is likely to remain in place; whereas elsewhere EM faces different degrees of monetary independence
  - Slower growth, rising oil prices, higher inflation and/or faster tightening are all risks, but trade wars bigger. Initial impact seen via asset markets and business sentiment, but then weaker world trade and therefore GDP growth would be deflationary

Source: HSBC Global Research

Global macro

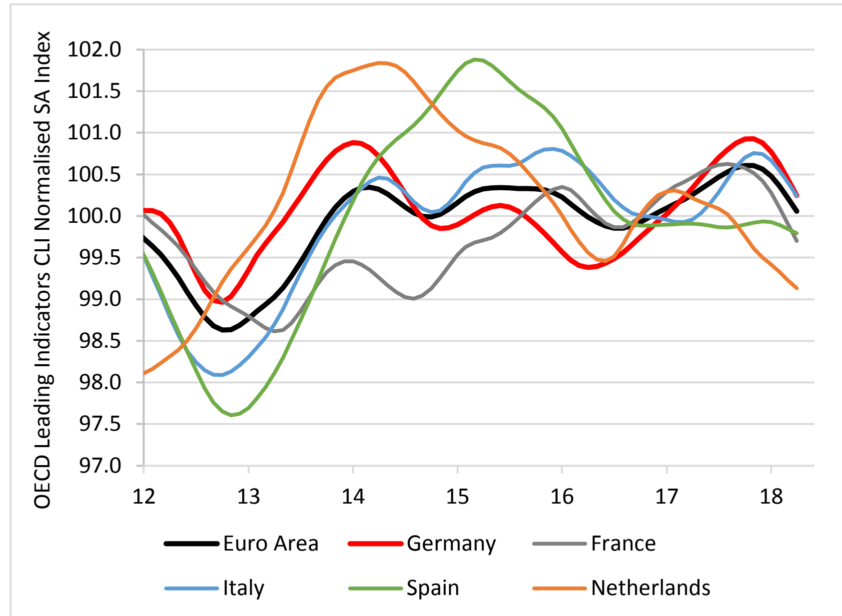
Positive growth momentum highlighted in LEIs, especially in US

Various global OECD leading indicators (normalized)



Source: HSBC, Bloomberg

OECD LEIs for Euro-area and its main economies



Source: HSBC, Bloomberg

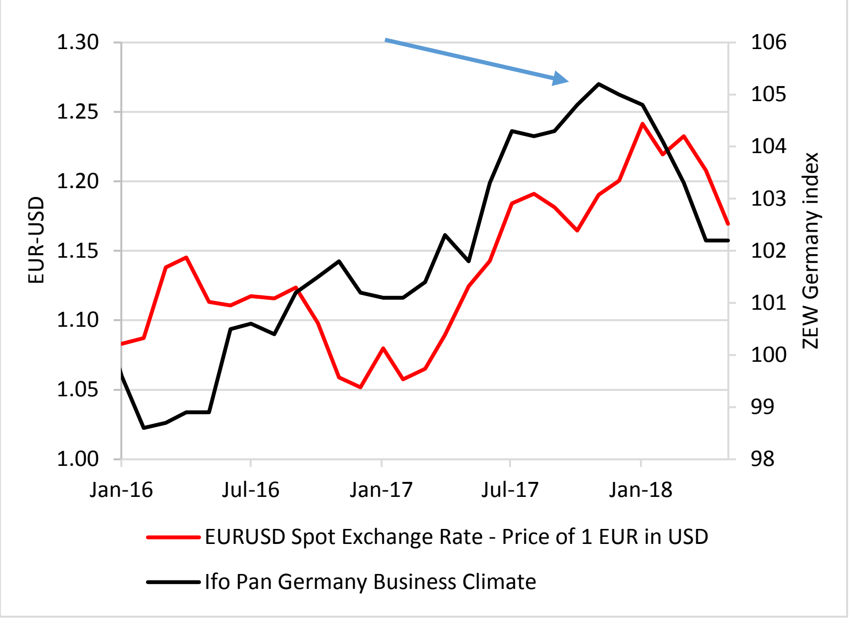
- Global macro environment retains a positive outlook; however, some diverge this year
  - Period since 2016 has seen significant positive momentum for leading indicators, especially in US and Euro-area
  - Within large economies, China and UK have exhibited a negative turn, although this has been driven primarily by domestic issues
  - Of interest is the seeming shift in momentum to the positive for China this year, notwithstanding on-going concern over debt levels
  - 2018 has seen some slowdown in momentum for the Euro-zone, which has been consistent amongst the main economies
  - Notable has been the resilience shown by the leading indicators in Spain through past few years
  - Impact of strengthened Euro currency has been a likely factor

Source: HSBC Global Research

Global macro

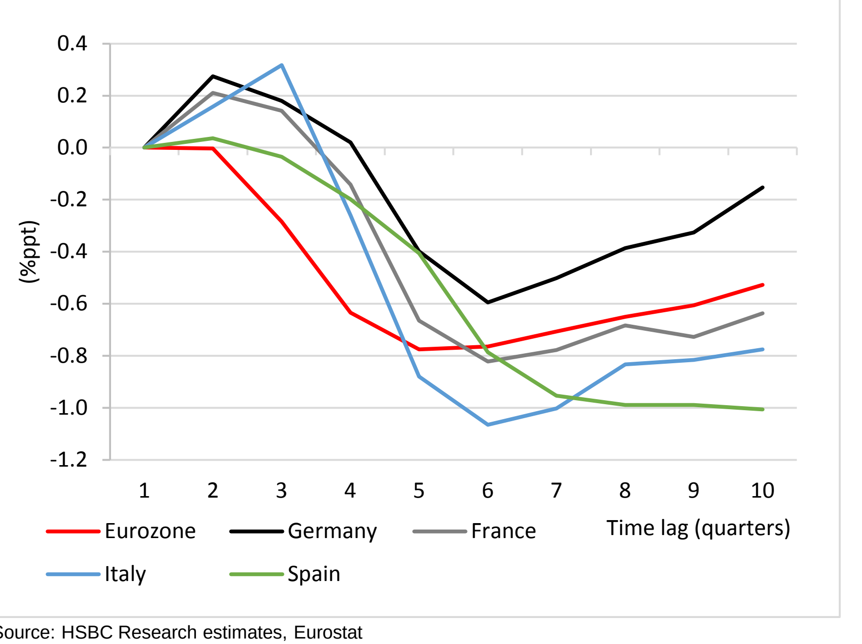
Impact of a strengthening euro on the export sector

With the EUR-USD rate rising to above 1.25, export-based economies, such as Germany, saw a pull-back in Ifo index



Source: HSBC, Bloomberg

Change in exports (goods and services) following a 1%ppt increase in the exchange rate[1]



Source: HSBC Research estimates, Eurostat

- Significant rally in the euro since 2016 has reached important levels
  - Some of the softness exhibited in the early 2018 Euro-area economic data is associated with the strength of the currency
  - Exports are impacted by a high-enough strength of the euro, and the latest data shows a weakening Ifo index for Germany
  - HSBC Global Research shows that the time lag for the impact of a 1%ppt increase in the euro is 5-7 quarters

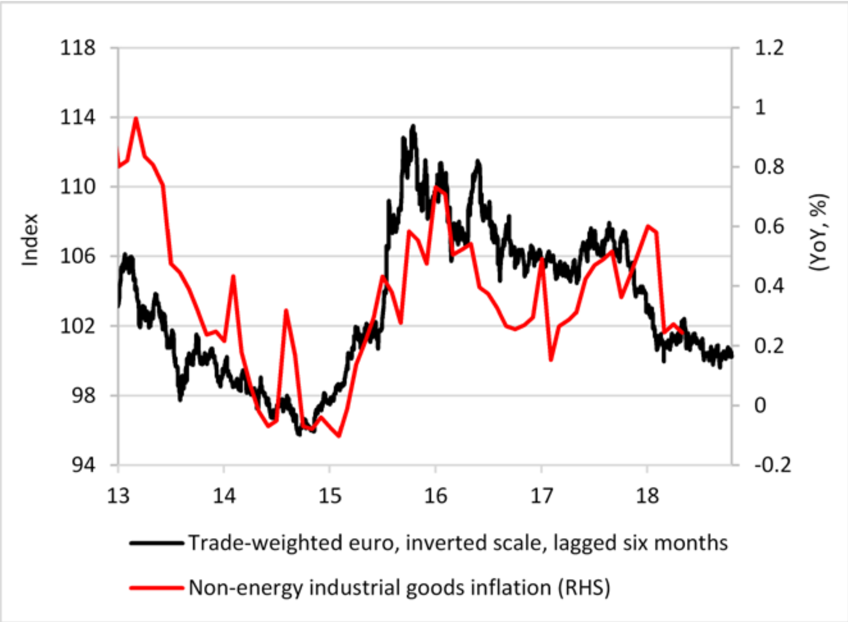
Source: HSBC Global Research

Notes:
1. HSBC Research estimates based on an Error Correction Model. The chart shows the impact X number of quarters after the shock. The positive initial reaction for some countries might be due to the source of the shock; for example, positive demand shock could boost FX and intra Euro-area exports

Global macro

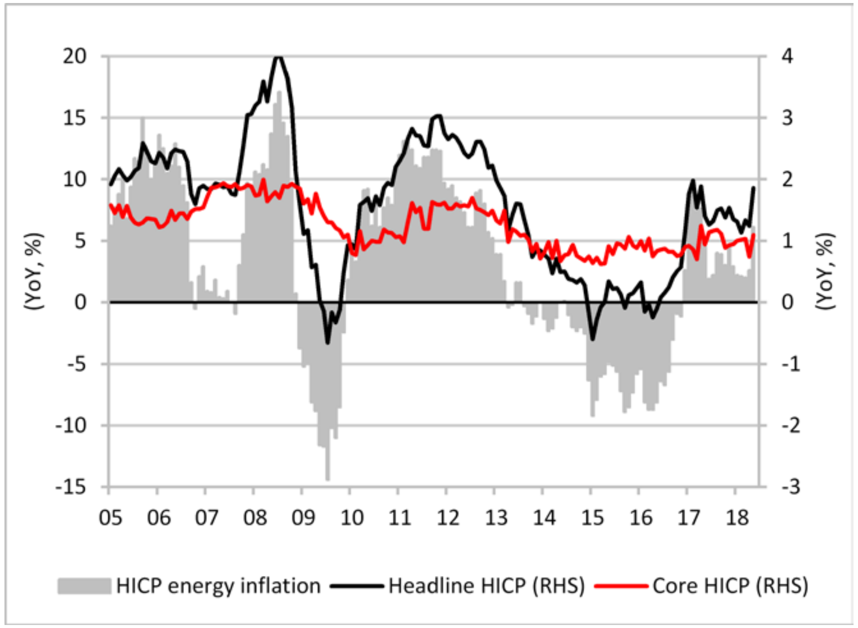
The effect of the currency on Euro-area inflation

Trade-weighted euro and non-energy industrial goods inflation



Source: HSBC Global Research calculations, Eurostat

Euro-area core inflation has barely moved since QE started



Source: HSBC, Eurostat

- Has the recent strength in the euro started to weigh on Euro-area inflation?
  - Lagged relationship is suggestive of a medium-term dampening effect on inflation in the Euro-area
- While headline inflation has moved higher during QE, core Euro-area has remained constant
  - The core inflation measure has in fact been hovering around close to the 1% level since 2014

Tariffs and trade wars

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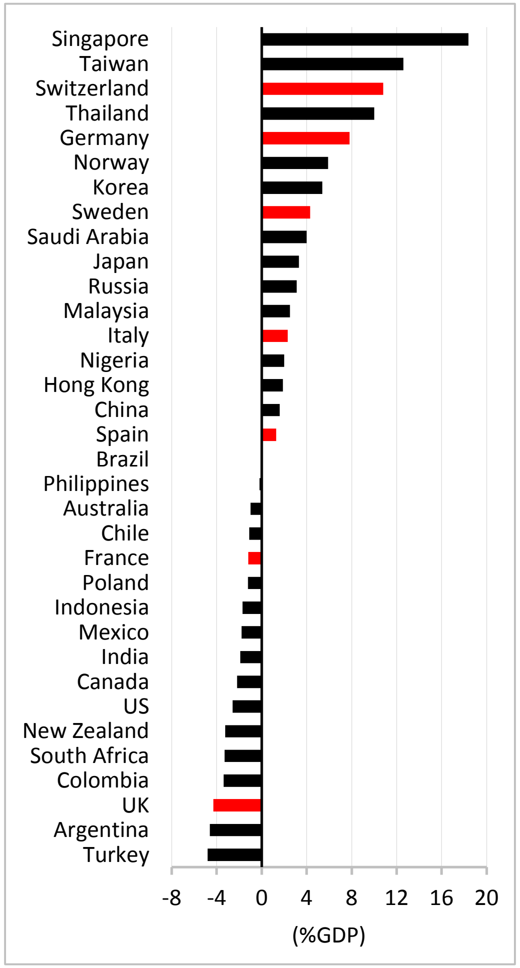
Tariffs and trade wars

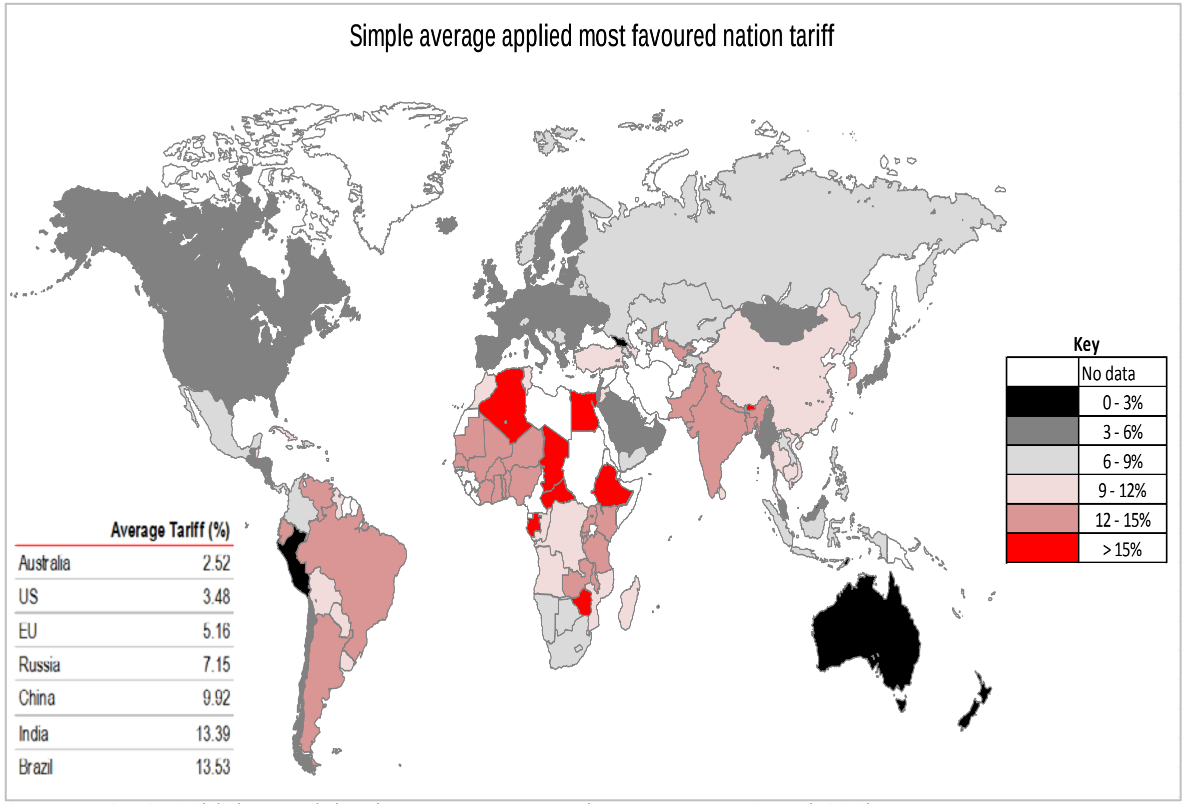
Countries with large external deficits are vulnerable to trade actions

Current account balance, 2018



Source: Thomson Reuters Datastream

US tariffs are low by global standards



	Average Tariff (%)
Australia	2.52
US	3.48
EU	5.16
Russia	7.15
China	9.92
India	13.39
Brazil	13.53

Source: WTO, HSBC Global Research ('Trade Wars', Janet Henry and James Pomeroy, 13 March 2018)

ECB APP and PSPP dynamics: past and future

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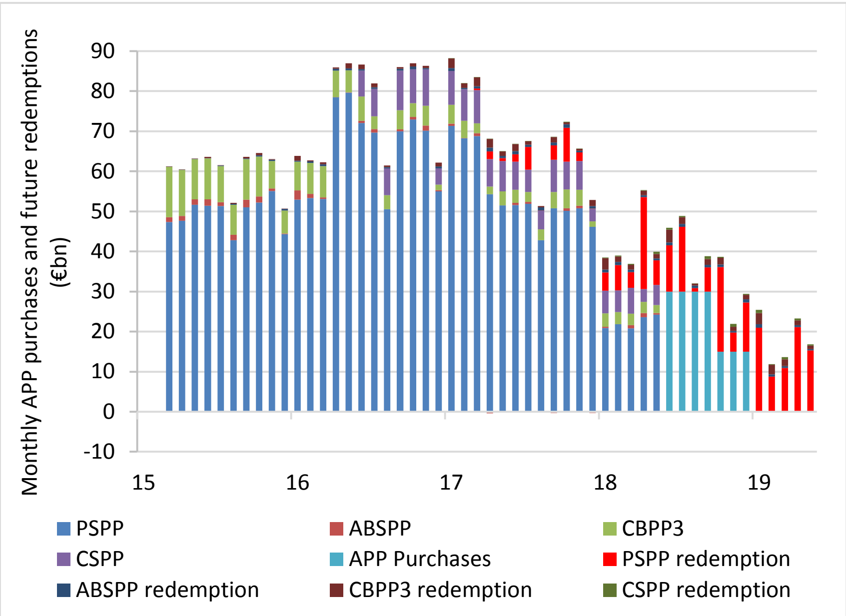
ECB APP and PSPP dynamics: past and future

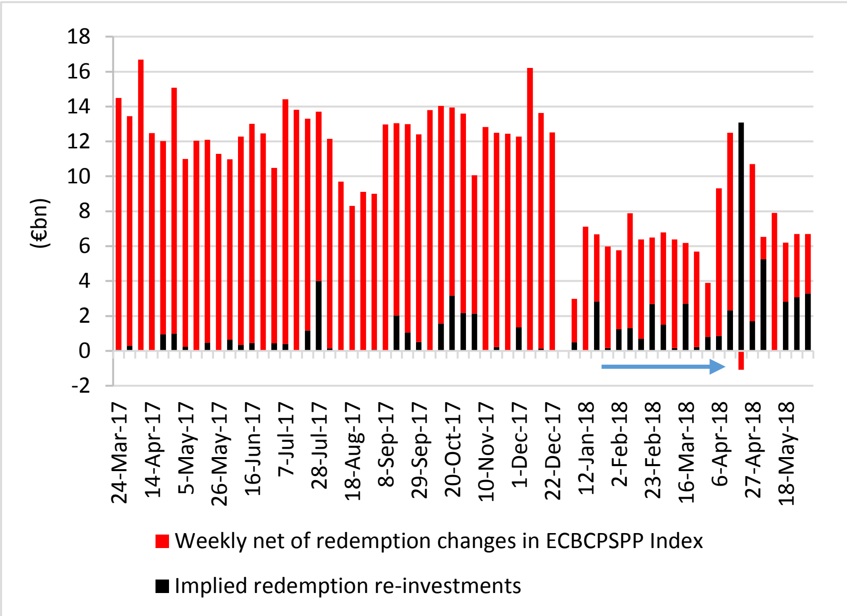
Evolution and the increasing importance of redemptions

History of ECB APP programmes, with redemption amounts



Source: HSBC, ECB (incl. redemption forecasts), Bloomberg

Breakdown of ECB APP purchases and impact of redemptions



Source: HSBC (incl. redemption estimates[2]), ECB, Bloomberg

- While the ECB QE programme has been reduced, redemptions are increasing
  - ECB's APP programme is currently at €30bn per month to September, and €15bn thereafter till December 2018
  - However, an issue of growing importance is the redemptions, especially within the PSPP…
  - …in fact, the week of 20 April 2018 saw purchases be entirely a function of re-investment (indeed net purchases were negative)

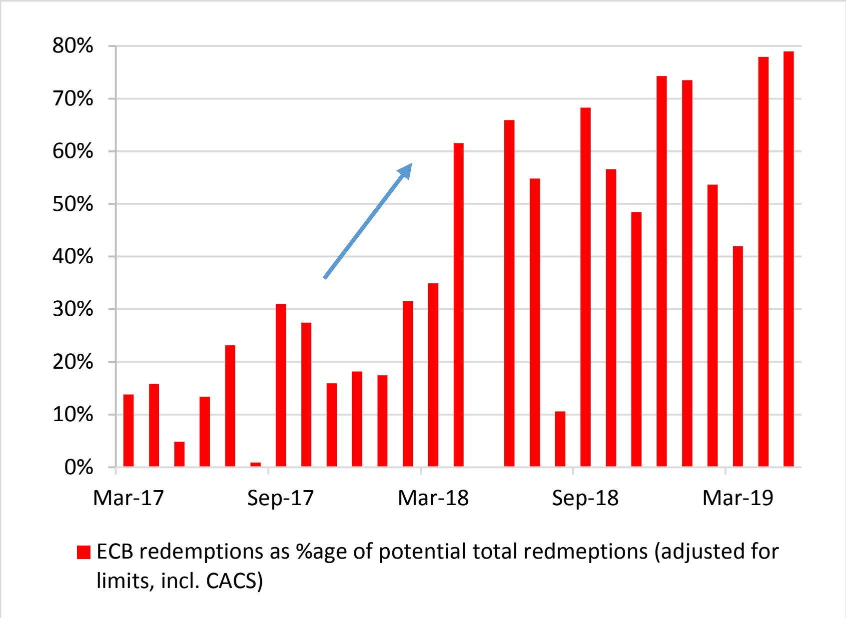
Notes:

2. By cross-referencing the monthly data on PSPP flow, with the ECB's weekly financial statement and the list of lending ISINs provided by the ECB and NCBs, it is possible to confirm relatively accurately around 13.8% of the actual redemptions; whereas for the latter some arbitrary assumption are made to 'distribute' the published redemption amounts to each maturing ISIN

ECB APP and PSPP dynamics: past and future

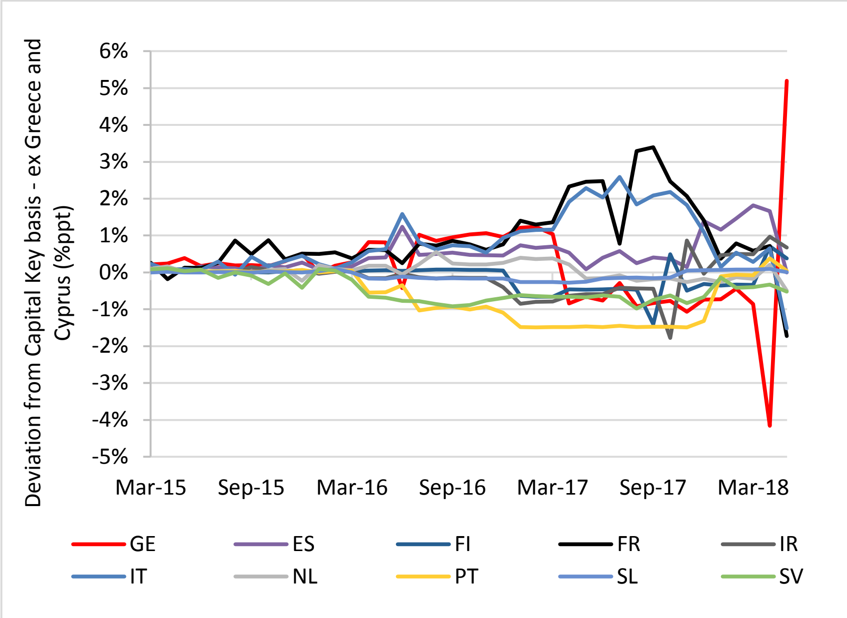
PSPP redemptions are sizeable to potential; Capital key deviations

Redemptions have moved to around 50+% of potential



Source: HSBC, ECB, Bloomberg

Redemptions also likely to cause deviations from key



Source: HSBC (incl. redemption estimates[3]), ECB, Bloomberg

- For most months, PSPP redemption amounts have become over 50% of potential holdings
  - Comparing ECB's PSPP redemption path with a calculation of the maximum allowable purchase per maturing security…
  - …based on ECB/NCB lending ISINs and PSPP purchasing limits, shows that the redemptions have climbed to 50+% of potential
  - This is especially from March 2018, predominantly due to the ECB's APP rule changes introduced in January 2017
  - Redemptions also driver for monthly deviation from Capital Key
  - Large re-investment in German bond caused 'miss' on March/April 2018 net PSPP German purchases

Notes:

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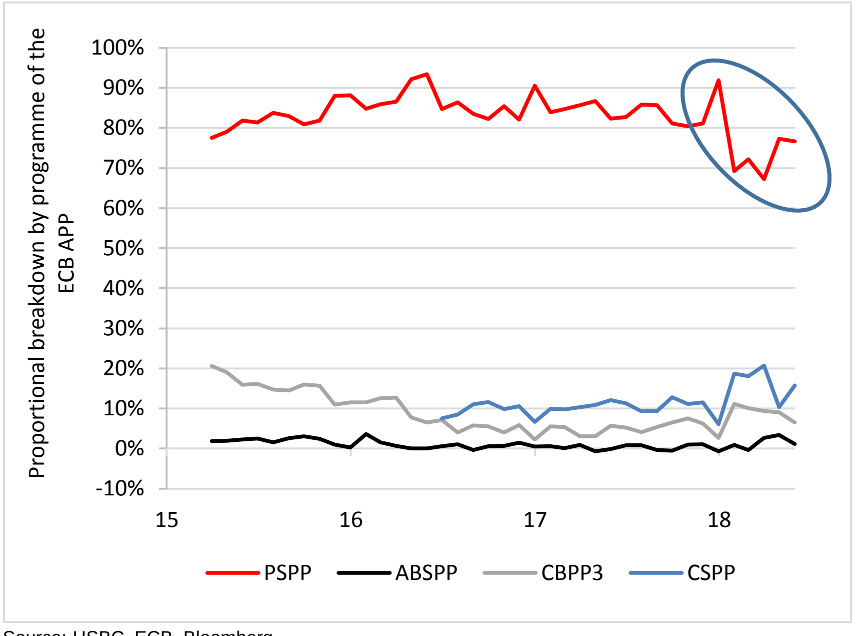
ECB APP and PSPP dynamics: past and future

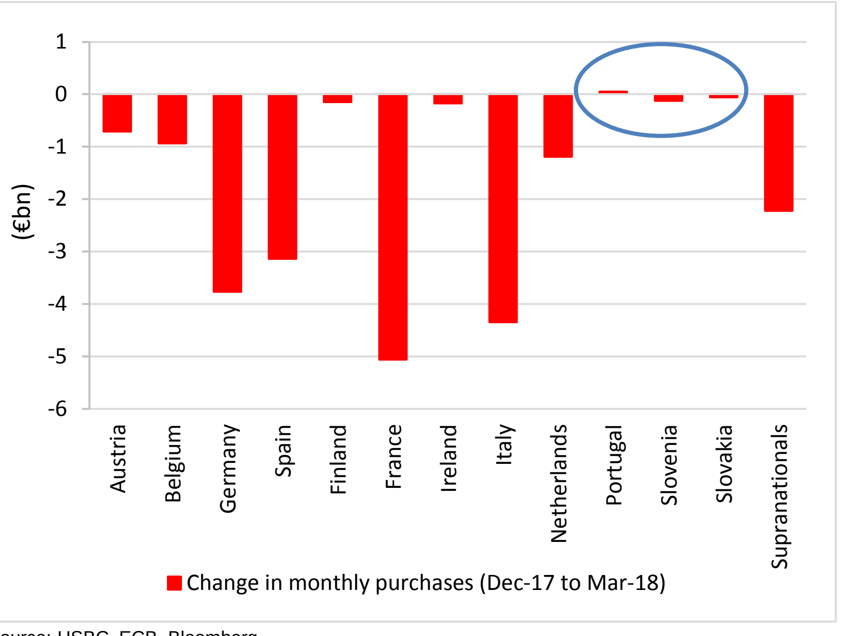
Reduced monthly APP purchases allow for broadening of buys

PSPP proportion of monthly APP purchase is now below 80%



Source: HSBC, ECB, Bloomberg

Reduction in PSPP monthly purchases has not been consistent



Source: HSBC, ECB, Bloomberg

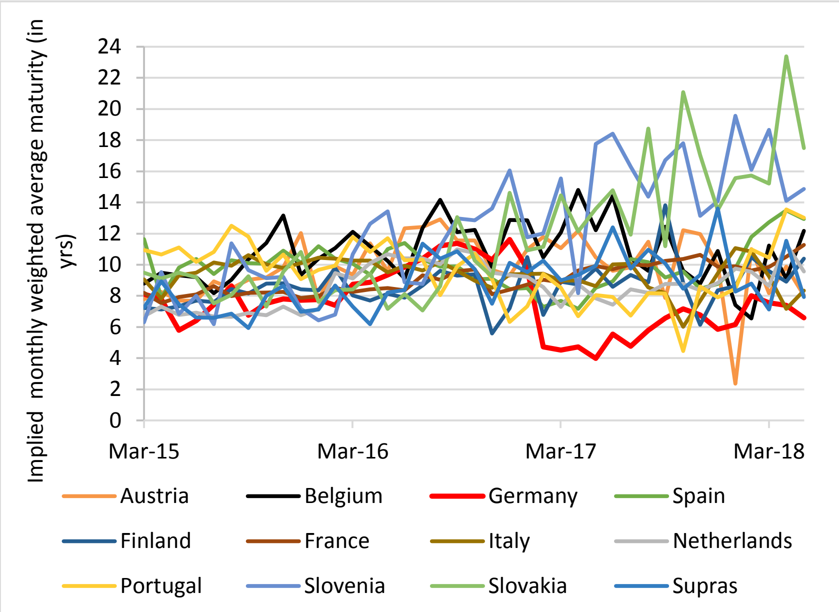
- Reduction in monthly APP to €30bn has seen a decline in PSPP to now less than 80%
  - Monthly PSPP purchases have been in €20.7-23.6bn range in 2018, roughly 70-80% of monthly APP
  - Less liquid markets than Sovereigns or Supras provides only a finite amount of flow that can be purchased…
  - …the lower overall APP purchase amount allows for a continuation of that purchase rate, and hence a greater decrease for PSPP
  - A similar narrative can be seen for smaller sovereign markets, such as Portugal, Slovenia, Slovakia, as well as Finland and Ireland
- Quarter-end adjustments up to €7bn
  - Adjustments to PSPP at quarter-end, due to amortisation impact, have become sizeable

The importance of PSPP purchases on the curve

The importance of PSPP purchases on the curve

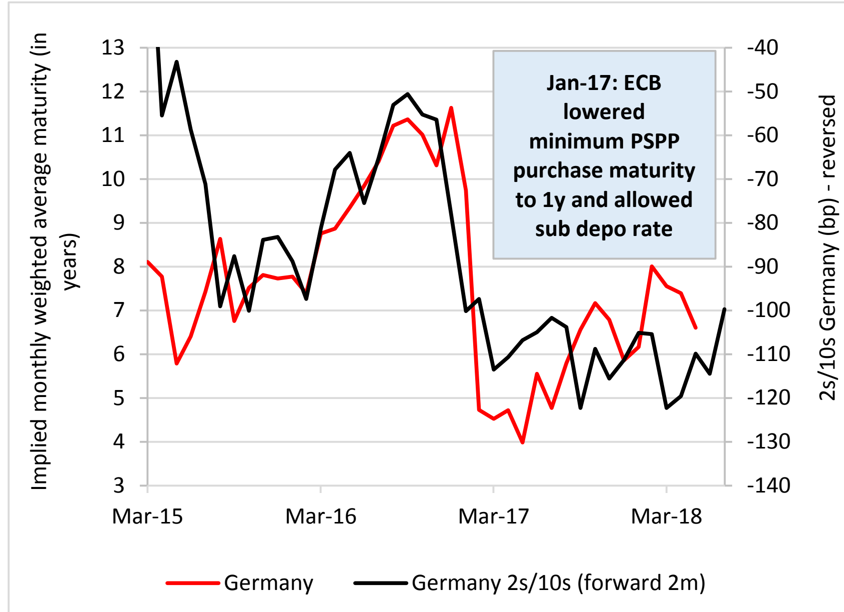
Implied monthly weighted average maturity of PSPP has been critical

Evolution of implied[4] monthly WAM for PSPP



Source: HSBC, ECB, Bloomberg

Shift in German PSPP monthly implied[4] WAM key for curve



Source: HSBC, ECB, Bloomberg

- The implied weighted average maturity for each PSPP sector has diverged since 2017
  - Capacity constraints, especially for the smaller markets, has been the primary reason for divergent paths
- German PSPP purchases are key to the shape of the bond yield curve in Euro-area
  - The ECB changes in January 2017, opening the front-end of the curve, allowed for a sharp steepening of 2s/10s
  - This could be key when redemption are preeminent

Notes:

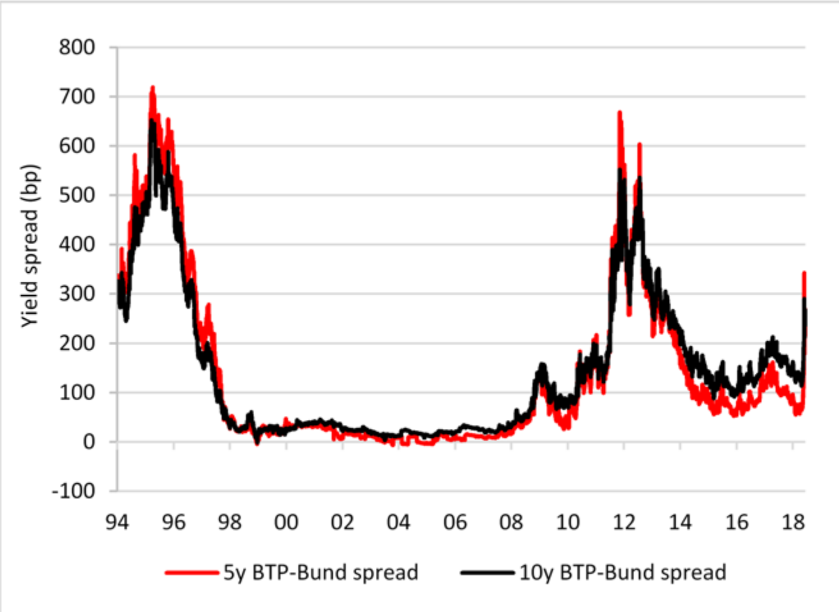
4. By cross-referencing the monthly data on PSPP flow, with the ECB's weekly financial statement and the list of lending ISINs provided by the ECB and NCBs, it is possible to confirm relatively accurately around 13.8% of the actual redemptions; whereas for the latter some arbitrary assumption are made to 'distribute' the published redemption amounts to each maturing ISIN

Italy developments

Italy developments

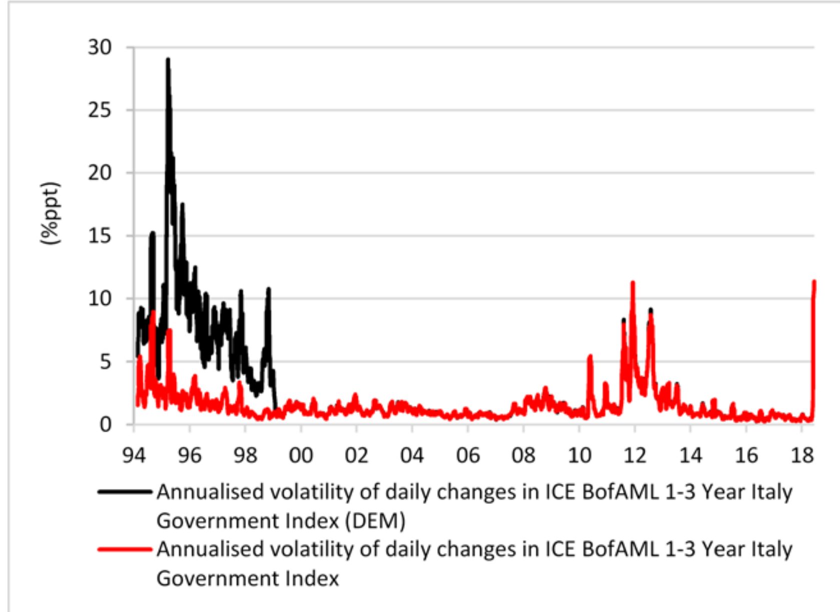
Volatility of Italian government bond market, in a historical context

5y and 10y BTP-Bund yield spreads



Source: HSBC, Bloomberg

Volatility of returns for 1-3y Italy index and including FX



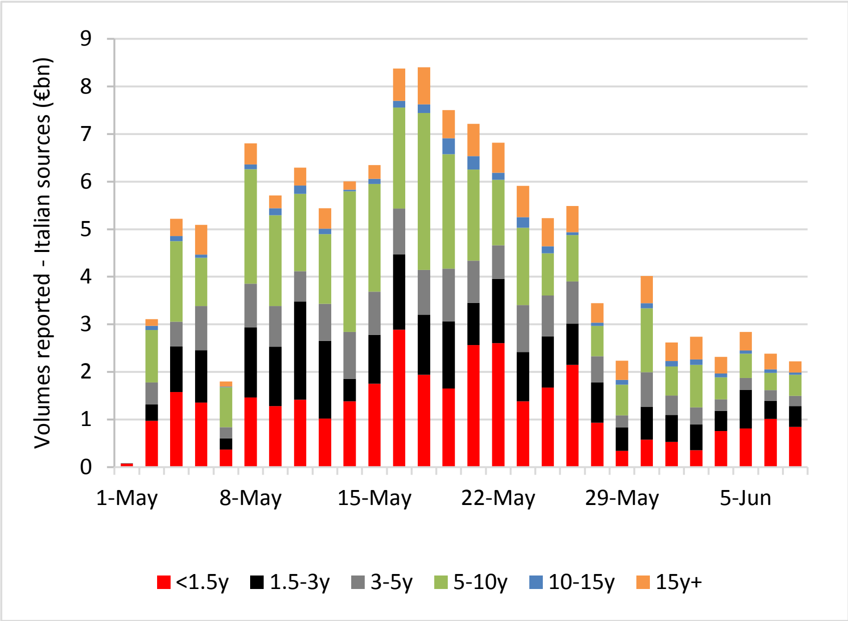
Source: HSBC, Bloomberg

- Most recent pick-up in volatility is small by historical standards
  - Widening of 5y and 10y BTP-Bund yield spread has been greater than 2017 episode, but remain less than in Euro-zone crisis
  - Increase in annualised volatility for Italian government bonds has been consistent with what occurred during Euro-zone crisis…
  - …however substantially lower than volatility seen during 1990s, if historical ITL-DEM FX rates included
  - One way of thinking about the evolution of historical volatility from the pre-Euro period is to consider…
  - …the transition of FX volatility into the credit spread (i.e. BTP-Bunds)

Italy developments

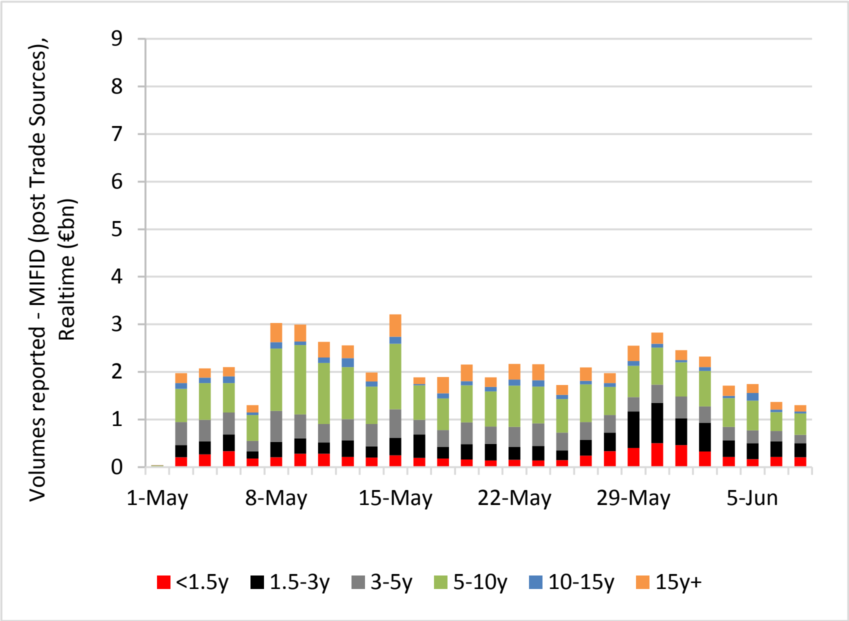
Italian government bonds volumes declined significantly over May

Daily volumes: Italian sources (MIFID)[5]



Source: HSBC, Bloomberg

MIFID (post-trade) daily volumes (real-time only)[5]



Source: HSBC, Bloomberg

- Daily volume declined significantly during May, especially on a domestic basis
  - Using merely non-delayed data, daily volumes for the BTP, CCT and CTZ markets fell from a €6-8bn range, down to €2-3bn
  - Meanwhile the other MIFID trade source (i.e. non-domestically focused) have seen a decline as well…
  - …however, the absolute amount of reduction has been less

Notes:
5. Italian government bonds used: BTPS, CCTs and ICTZ, extracted using the MOSB Bloomberg function on 7 June 2018. Italian sources on Bloomberg output include MTS Italia; whereas the MIFID (post-trade) includes MTS BondVision, Bloomberg and TradeWeb

Italy developments

Italy's sovereign ratings under pressure

Sovereign credit ratings for Italy

Italy	Fitch	Moody's	S&P	Total
Rating	BBB	Baa2 (–ve)	BBB	BBB
Score	9	9	9	9

Source: HSBC, Bloomberg, Credit Rating Agencies, media websites

Calendar schedule for assessments of ratings

Italy	Fitch	Moody's	S&P
Last	16-Mar-18	16-Mar-18[6]	27-Apr-18
Next	31-Aug-18	7-Sep-18	26-Oct-18

Source: HSBC, Bloomberg and various media websites

Example of rating score for bond index inclusion (Markit iBoxx)

Fitch	Moody's	S&P	Score
AAA	Aaa	AAA	1
AA+	Aa1	AA+	2
AA	Aa2	AA	3
AA-	Aa3	AA-	4
A+	A1	A+	5
A	A2	A	6
A-	A3	A-	7
BBB+	Baa1	BBB+	8
BBB	Baa2	BBB	9
BBB-	Baa3	BBB-	10
BB+	Ba1	BB+	11
BB	Ba2	BB	12
BB-	Ba3	BB-	13
B+	B1	B+	14
B	B2	B	15
B-	B3	B-	16
CCC+	Caa1	CCC+	17
CCC	Caa2	CCC	18
CCC-	Caa3	CCC-	19
CC	Ca	CC	20
C	C	C	21
D/RD		D	22

Score	iBoxx Rating
1	AAA
2	AA
3	
4	
5	A
6	
7	
8	BBB
9	
10	
11	BB
12	
13	
14	B
15	
16	
17	CCC
18	
19	
20	CC
21	C
22	D

Source: HSBC, Markit iBoxx website

- Rules for inclusion to Bond Indices
  - Most of the main globally used benchmark bond indices, such as Markit iBoxx, Bloomberg Barclays, etc. use an investment grade threshold for inclusion, on a sovereign credit ratings basis
  - Most use an average or 'two out of three' approach, where the sovereign requires an investment rating from at least two of the three main credit rating agencies (S&P, Moody's and Fitch)
  - Some utilise a main index, for example the S&P, with Moody's substituted in the event of no ratings from the former
  - Domestic bond indices, such as the FTSE MTS series, for Italian government bonds, do not have a ratings threshold
- Italy has a 2-notch buffer
  - Currently Italy has the same level of rating from all three agencies

Notes:
6. Moody's put Italy's sovereign rating on watch-list negative on 25 May 2018

Rates market

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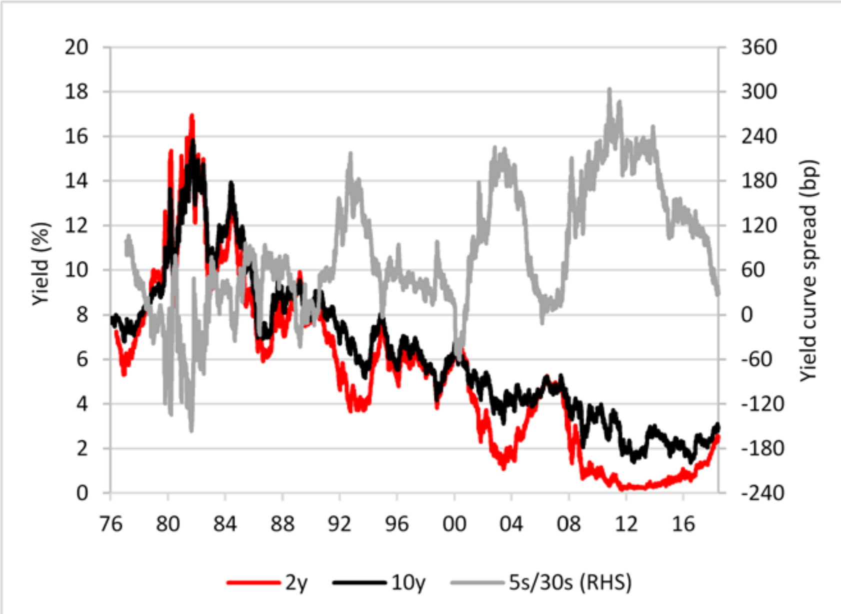
Rates market

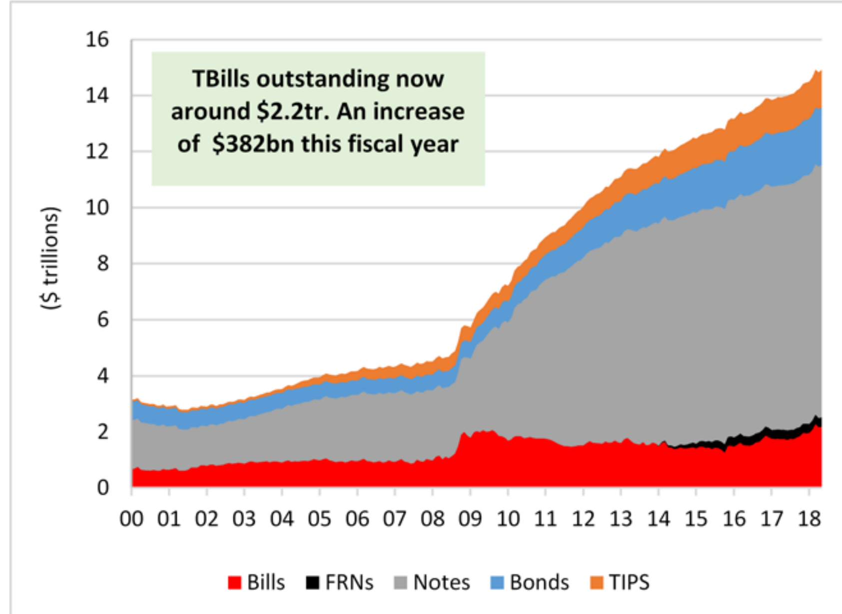
US Treasury yields and curves

2y and 10y UST yields and 5s/30s curve



Source: HSBC, Bloomberg

UST issuance: this fiscal year focus has been on TBills



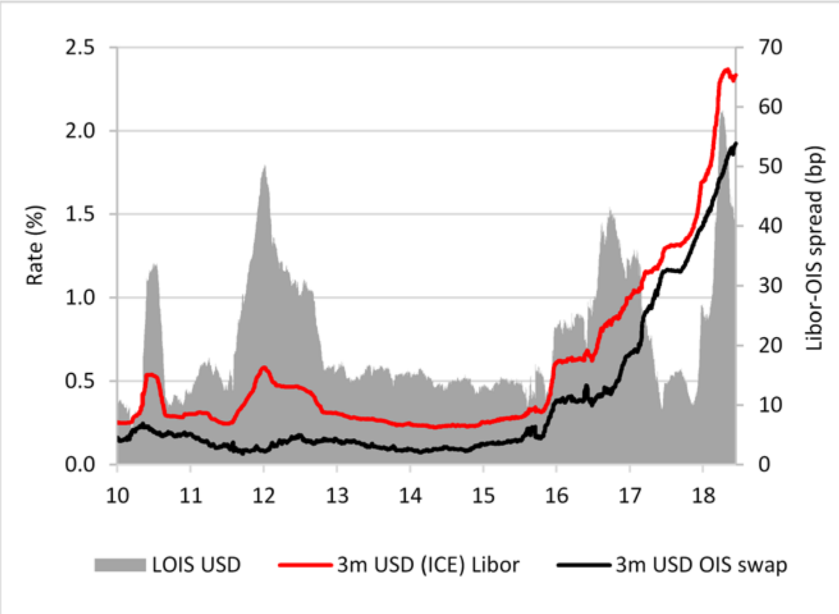
Source: HSBC, Bloomberg

- Continuation of the trend seen for the past couple of years: higher yields, flatter curves
  - Combination of healthy underlying US economy has allowed the Fed to continue its hiking cycle
  - Fiscal trajectory, issuance projections and Fed balance sheet run-down assisting monetary policy in pushing yields higher
  - However, with the near-term focus being an increase in at the front-end (i.e. TBills), the curve has continued to bear-flatten

Rates market

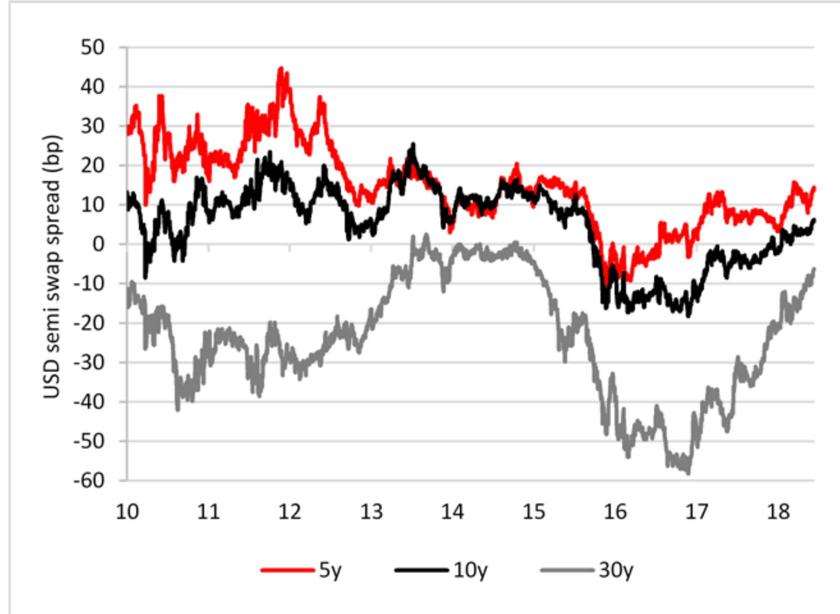
Libor-OIS and US swap spreads

3m USD Libor-OIS widened aggressively this year



Source: HSBC, Bloomberg

US swap spread have moved higher; 10y now positive



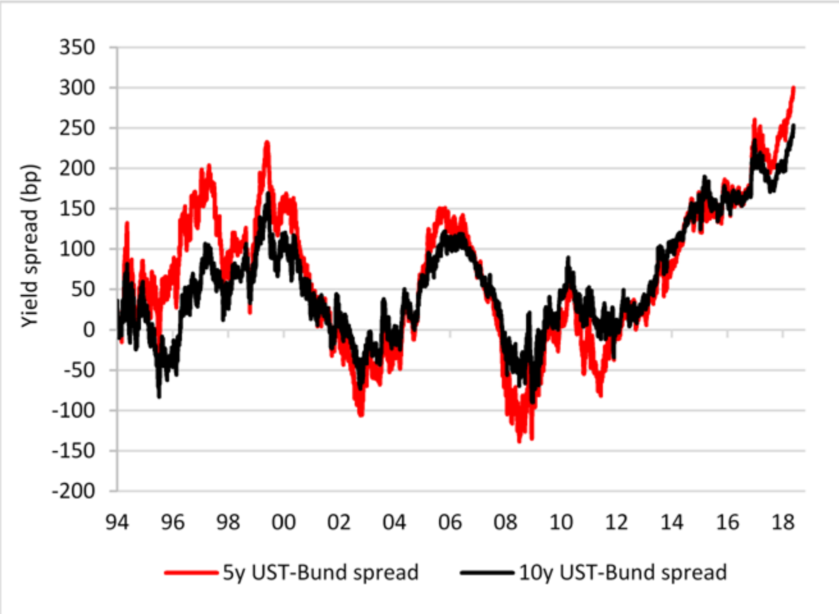
Source: HSBC, Bloomberg

- Theme of US swap spread widening has continued in 2018
  - At short-end, various factors including increased TBill issuance and effects of reforms has been catalyst for widening Libor-OIS
  - Along the curve, combination of fiscal expansion and bearish yield environment have allowed swap spreads to move positive
  - 30y swap spreads look likely to test the flat level last seen in 2014

Rates market

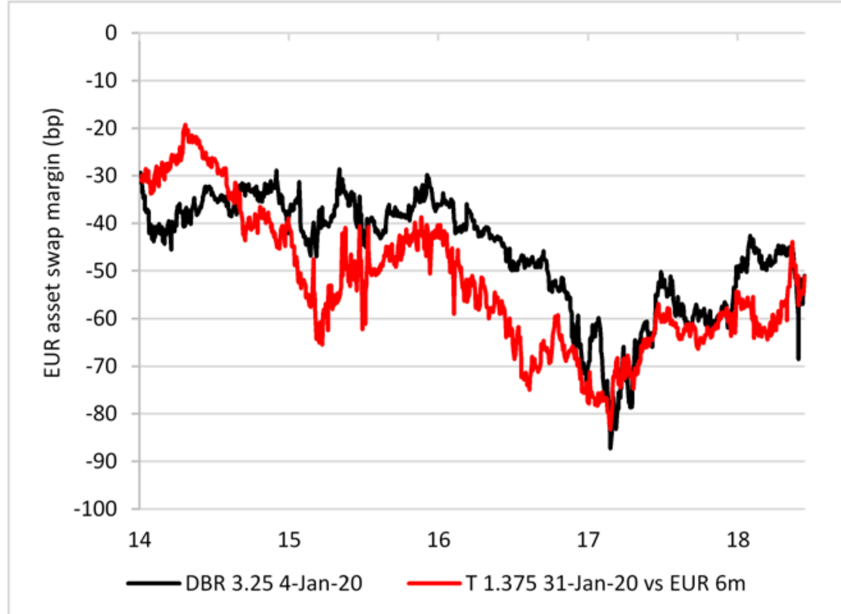
Bunds and USTs

History of 5y and 10y UST-Bund yield spread



Source: HSBC, Bloomberg

Bund and UST asset swap, in 6m EUR[7]



Source: HSBC, Bloomberg

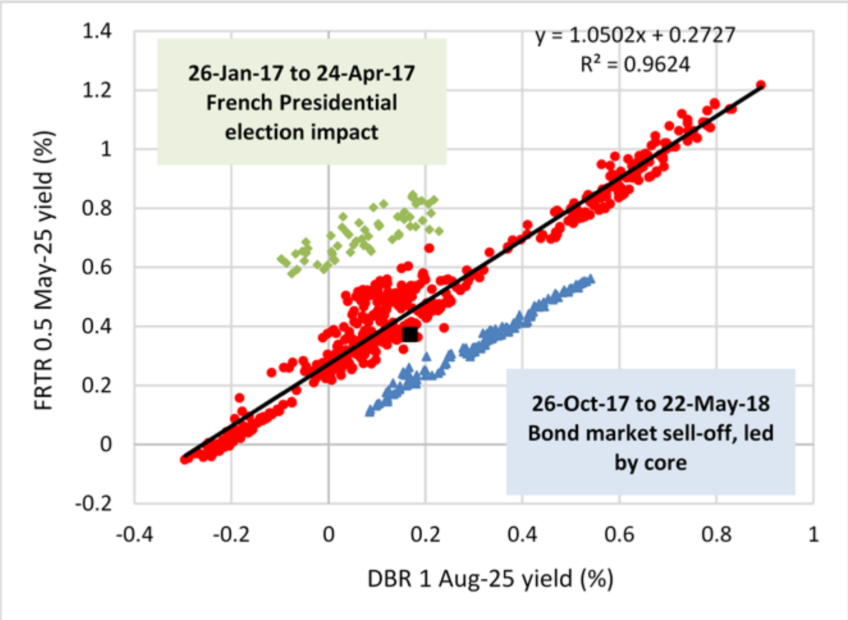
- UST-Bund 5y and 10y spread has moved to widest levels seen in past few decades
  - On-going Fed tightening, while the ECB has remained in relative easing mode, has allowed for a substantial increase in the spread
  - However, viewed through the prism of a Euro-based investor and the 6m EUR asset swap margin…
  - …for most of the Fed's rate hiking move it has been the Bund that has held more relative value

Notes:
7. UST asset swap into 6m EUR does not include adjustment for FX reset

Rates market

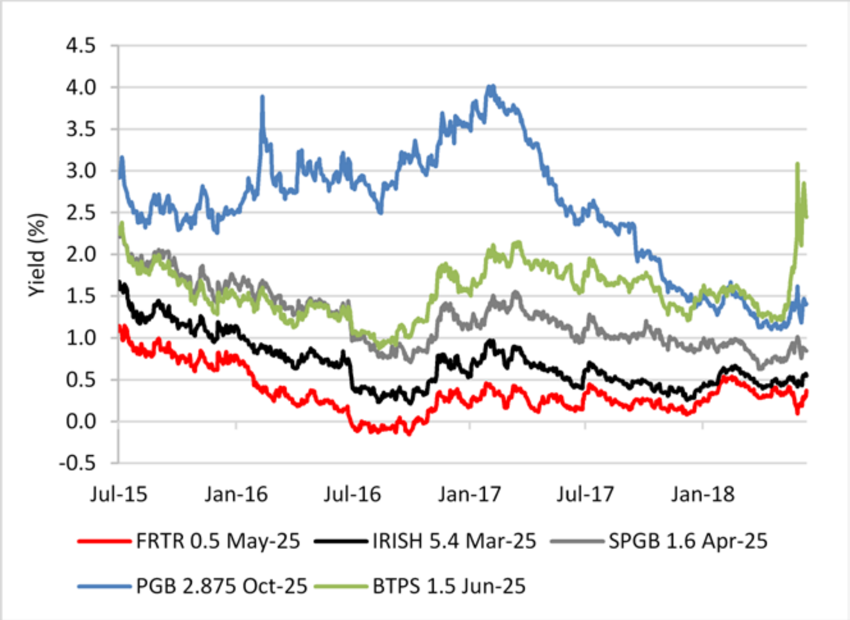
Intra Euro-area

Since Jul-15, two phases of divergence to Bunds vs OATs



Source: HSBC, Bloomberg

Shifts between semi-core and peripheral bond yield in Euro-area



Source: HSBC, Bloomberg

- The phases of Bund-OATs, reflecting market pressures
  - The relationship between 10y OAT and Bunds has been an interesting barometer of intra Euro-area bond market pressures
  - Two periods stand-out: French Presidential campaign and its two elections, the bond market sell-off into 2018
- Structural shift in the peripheral sector?
  - Ireland has completed its move into the semi-core; Spain almost there (albeit more correlated to BTPs in recent sell-off)
  - Portugal now not the outlier anymore. Italy yield now more than 10y SPGB plus 10y PGB

Outlook

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Outlook

Into the second half of 2018

- Geo-politics and global trade interactions: where does the Euro-area go?
- Will the Fed continue to be hawkish in its interpretation?
- US politics: mid-terms
- Are emerging markets something to be concerned about?
- Focus growing on Brexit end date and impact

- Will the euro currency continue to weaken and assist with export led growth?
- Euro-zone economic momentum enough to sustain a move higher in yields…
- …aided by end of QE purchases and prospects for ECB tightening
- Euro-area bond market adjusts to discrete APP redemption flows, as purchase are either tapered or ended
- Periphery loses assistance of PSPP…wider core-periphery spreads

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