ECB BMCG, BOND MARKET OUTLOOK

Group Economic and Macro Strategy,

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AGENDA

1. **Developments Since Last BMCG Meeting**
2. **Market Prospects**
   - 2.a 3 Risks and 1 Strong Uncertainty
   - 2.b Market Perspective
3. **Discussion Points**
   - 3.a What if EUR Strength/USD weakness is Structural?
   - 3.b Few More Issues for Discussion

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Developments Since Last BMCG Meeting

Section 1

2 MAJOR STRUCTURAL CHANGES AND CARES EXPIRY (1/2)

Developments Since Last BMCG Meeting **Section 1**

Next Generation EU (18 May - 21 July)

- The process begins with the Franco-German proposal on May the 18th. It ends on July 21st
- Main features
  - **EUR 390bn grants** allow targeted and one-off fiscal transfers among member states
  - **A Supra national European bond issuer becomes market-material**
  - Not clear if there is a "joint and several guarantee" of members states

CARES [1] Expiry (25 July)

- CARES starts on March the 27th and ends on July 25th
- Main features
  - **USD 2tr grants** capacity
  - **Extremely granular program**
  - **Households disposable income rose significantly** (by USD 1tr from Feb to Jul) despite a **large wage drop** (by USD 445bn from Feb to Jul)

Flexible Average Inflation Targeting (27 August)

- Main features
  - It allows for **time limited inflation target overshoots following below target spells.**
  - Fed shifts **from proactive to reactive**
  - It (only) **incentivizes the market to price above target future inflation**
  - **No change in FED's toolbox**

US Disp. Income (white); Wages (gold); USD bn

PIDSDI Index (US Disposable Personal Income Nominal Dollars SAAR) Monthly 31JUL Copyright© 2020 Bloomberg Finance L.P. 16-Sep-2020 09:33:36

(1) CARES (= Coronavirus Aid, Relief, and Economic Security) is centered on up to USD 1.2k per adult making less than USD 99k/Y and USD 500 per child under 17 + USD 1.2k to no-2018-2019-tax filers Social Security recipients

2 Major Structural Changes and CARES Expiry (2/2)

Developments Since Last BMCG Meeting **Section 1**

Eurostoxx (white), SPX (green), EUR (gold)

10Y IT Spread (white, rhs), 10Y FR Spread (gold, lhs)

10–2 IT BOX (1) (white), 10–2 FR BOX (gold)

- The process that saw **Next Generation EU** born **boosted confidence in the EU project** =>
  - stronger EUR (and weaker USD from multi year strength),
  - US equity outperforms EU equities
  - synchronized credit spread contraction both in periphery and core countries in Euro area
  - credit risk term structure broad brush unchanged over the period
- **CARES expiry and AIT are so far mkt-irrelevant**

Note: White shaded Spell is May 18 (Franco-German recovery fund proposal) to Jul 21 (Next Generation EU approved), red vertical is Jul 25 (end of CARES), green vertical line is Aug 27 (AIT speech by Mr. Powell)
1) 10-2 IT BOX = 10Y (IT – GER) - 2Y (IT – GER); 10-2 FR BOX = 10Y (FR – GER) - 2Y (FR – GER)

Market Prospects

Section 2

3 Risks and 1 Strong Uncertainty

Subsection 2.a

3 Risks: Fiscal Stimulus, Election Day, UK-EU Trade Deal

US Financial Stimulus Renewal: global relevant

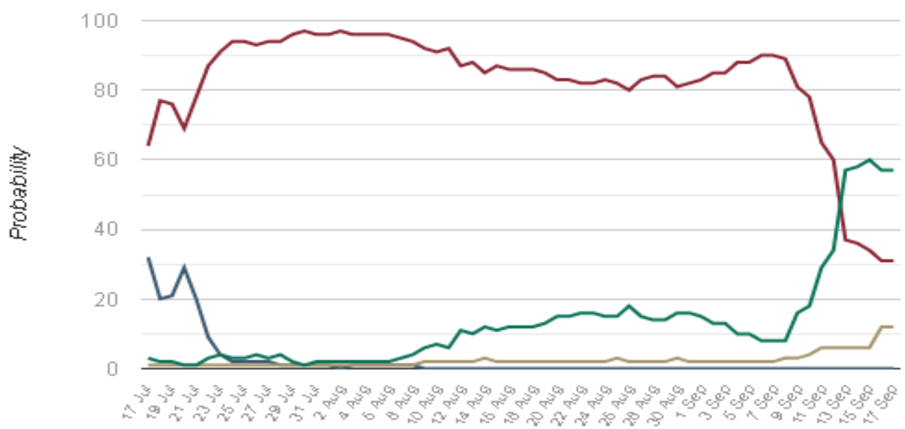
- **To Reps**, households making more money via subsidies than jobs is unconceivable => **USD 0.5tr stimulus proposal**
- **To Dems**, inefficiencies are worth paying to sustain households income =>**USD 2.2tr stimulus proposal**
- The latest attempt to bridge the differences is a bipartisan caucus proposal worth some USD 1.5tr
- The information set on this issue is stable => **solution pops in a short time or after the elections**

US Presidential elections: global relevant

- Mr. Trump has proclaimed his discontent with mailed ballots
- **He will not concede if mail-ballots are deemed crucial for Mr. Biden's victory**
  - By Dec 8th States votes disputes need to be solved; electors cast their vote on Dec 14th. Congress counts the votes on Jan 6th.. If disagreement persists to Jan 20 the speaker of the House would act as caretaker
- **The stalemate after the last contested election result lived up to mid Dec**

When a USD 750 billion or more of fiscal stimulus?

Red:1 Aug to 31 Oct; yellow 1 Nov to 31 Dec; green: Later



EU-UK Trade deal: "regional" relevant

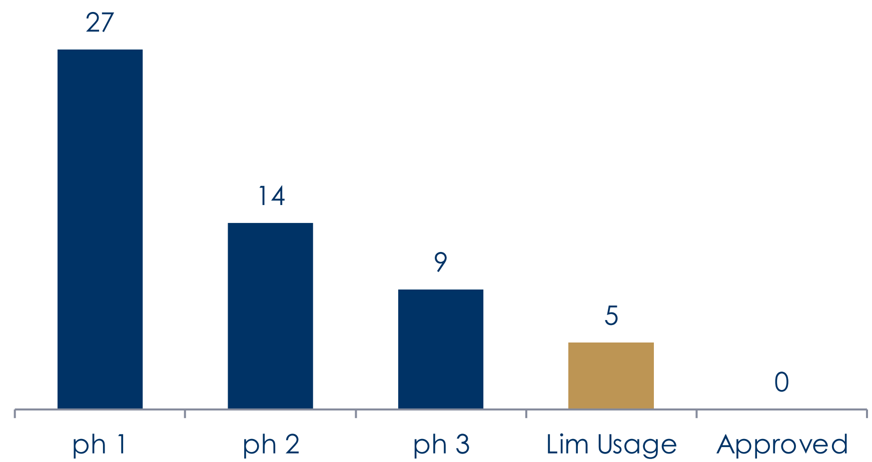
- The UK seeks ways to access the EU single market, tax/subsidize domestic economic sectors at will, and preserve the Good Friday agreement
- The EU would allow access to the single market only if the UK commits not to subsidize some industries and apply EU regulation (for this would disrupt market competition)
- **No-deal Brexit is becoming the "bad equilibrium"**

Source: Good Judgement. As of Sep 17, 2020 1 Aug to 31 Oct = 31%; 1 Nov to 31 Dec = 12%; Later = 57%

1 Strong Uncertainty: COVID-19 Vaccine

C19 Vaccine: global relevant

- Grand total of **55 candidate vaccines are being developed**
- 9 in pre-approval phase, 5 are being utilized without approval
- **Strong uncertainty about whether/when a candidate vaccine will be approved**
- Possible production hurdles
  - How many doses to each individual? Guesstimates for deployment in 1st quarter past approval are in 2 to 4bn doses range
  - Storage capacity
  - Adjuvant (a vaccine booster) production
  - Vials production capacity, as pre-stocking is not viable before knowing the vaccine properties
  - Syringes production



- Bottom line
  - **A vaccine may or may not be developed**: strong uncertainty
  - It's entirely **plausible, but not sure, a vaccine will be ready by year end**
  - Vaccine **approval will flare market sentiment**
  - Past approval, effective medical treatment will take a few quarters to spread globally

Source: NY Times and Bloomberg
Note, ph 1 = vaccine tested in small numbers, it checks safety and doss; ph 2 = 100s of people tested, it checks for vaccine's stability among sub-groups; ph 3 = 1,000s tested, placebo introduced, it checks vaccine's protection (defined by the public health authority); Lim Usage = emergency use; approval = vaccine is approved by the competent authority, monitoring for safety continues

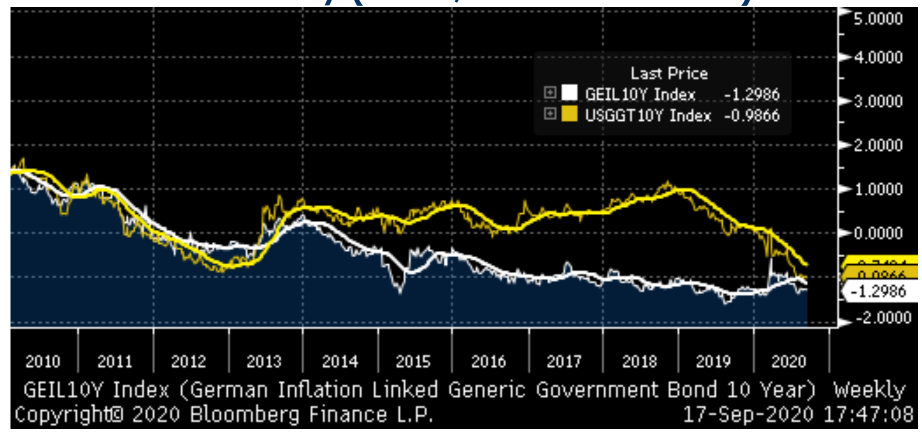
Market Perspective

Subsection 2.b

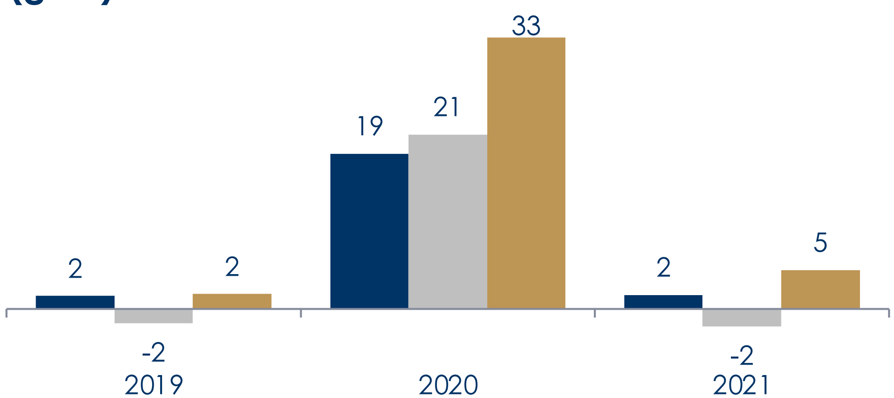
Real Economy Needs Low Rates

10Y Nom US (yellow, 22d Mav is bold), 10Y Nom Germany (white, 22d MAv is bold)

10Y Real US (yellow, 22d Mav is bold), 10Y Real Germany (white, 22d MAv is bold)



Delta Debt/GDP (%): World (blue); EA (grey); US (gold)

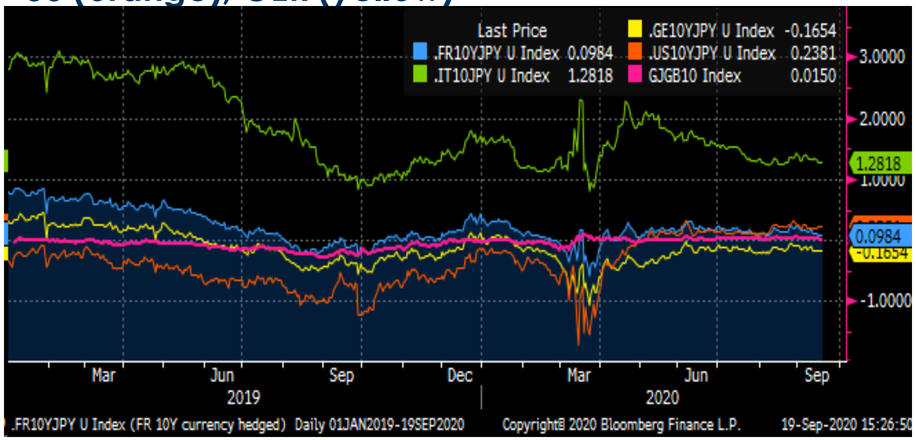


- **Government debt jumped** due to C19 policy response
- **Low nominal yields** are needed to **keep cost of funding in check**
- **Low real yields** are needed to **pinpoint fixed capital formation and future growth**

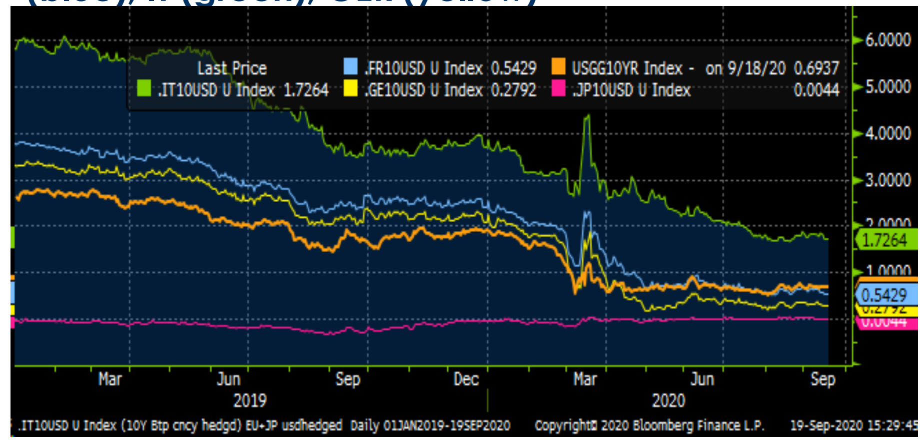
Source IMF, WEO

Financial Markets Need High(er) Rates

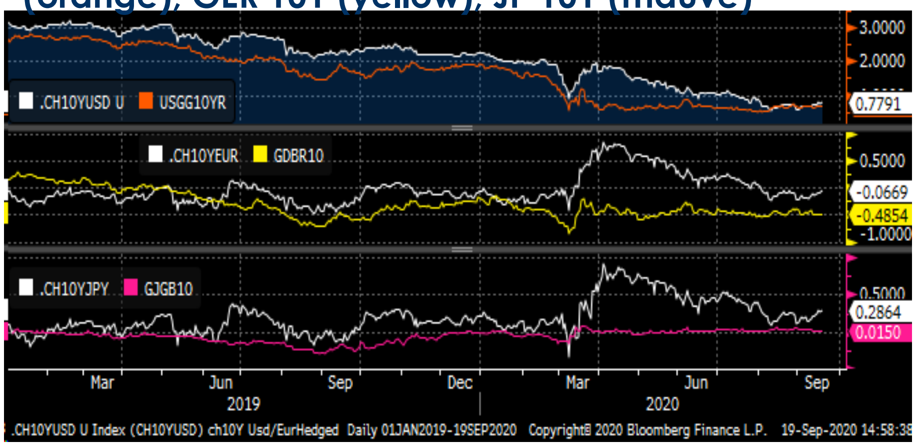
10Y JPY-hedged: JP (mauve), FR (blue), IT (green), US (orange), GER (yellow)



10Y USD-hedged: US (orange), JP (mauve), FR (blue), IT (green), GER (yellow)



10Y CH USD,EUR,JPY-hedged (white), US 10Y (orange), GER 10Y (yellow), JP 10Y (mauve)



- **Currency hedged yields generally offer no effective alternative to domestic bonds**
- **Exception: Euro Area periphery** (e.g. Italy and Spain) yields stand out from different jurisdictions
- Barring risk-off flares, **yield hunting is likely to lure investors towards Euro Area periphery**

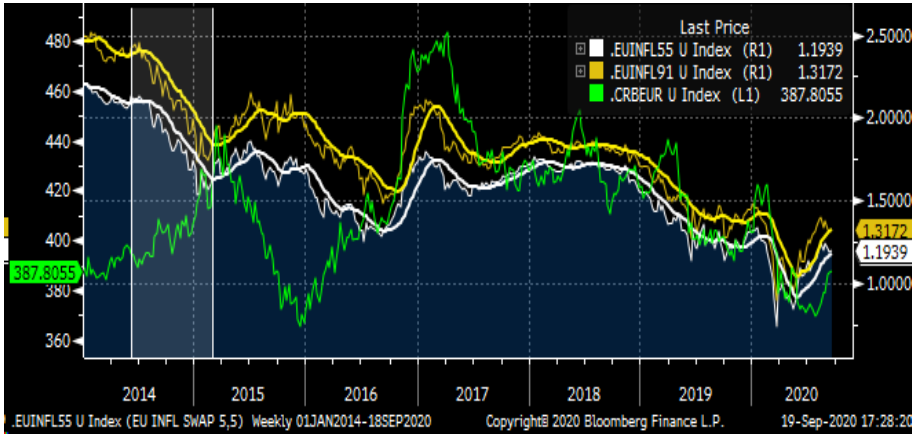
Note, currency hedged yield is proxied by the relevant foreign yield minus the cost of borrowing the foreign denominated cash via 12 months forex forward points

DISCUSSION POINTS

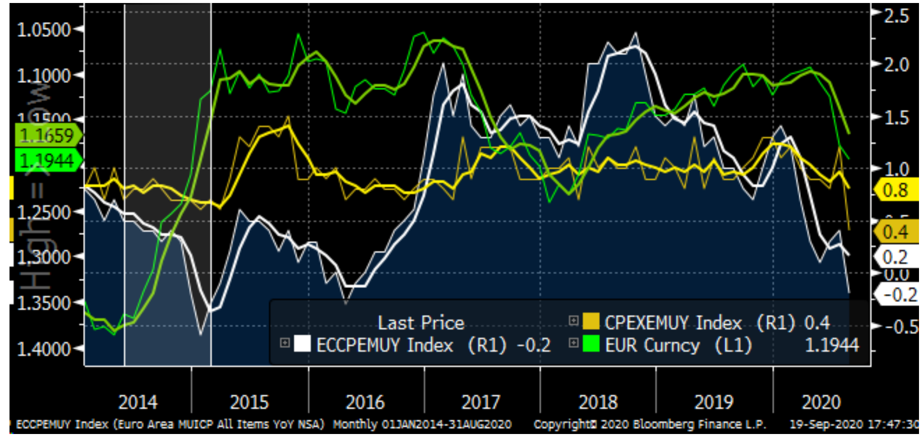
Section 3

WHAT IF EUR STRENGTH/USD WEAKNESS IS STRUCTURAL?

EU Infl 5Y,5Y (white[1]), Infl 9Y,1Y (gold[1]), CRB RIND (green, EUR, lhs)



EU infl (white[2], y/y,%), Core Infl (gold[2], y/y, %), EUR (green[2], inv. scale, lhs)



- Shaded area = from ECB announces "preparatory work" on QE (Jun14) to ECB starts QE (Mar15) =>
  - EUR weakens by some 18% to 1.11
  - Inflation expectations decrease
  - Core and headline inflation decrease
- Rule of thumb[3]: 1% EUR appreciation => slightly less than 0.1% lower EU inflation
- Sep 2020 ECB Staff Projections assume EUR at 1.18 in 2021 and 2022 and see inflation at 1.0% in 2021 and 1.3% in 2022

- **What if EUR is in for structural appreciation?**
  - USD reserve currency status is challenged (e.g. Ch diversifies away from it by selling treasuries and buying commodities)
  - EU deeper integration (e.g. Next Generation EU)
- EUR could reach 1.25 (5% appreciation) and then 1.4 (18%) => roughly 0.5% off inflation or outright deflation respectively
- **What's the right response? Lower short term rates or further QE?**

(1) 12w Mav is bold; (2) 3M Mav is bold;
(3) Money matters? Perspectives on Monetary Policy, Sep 14, 2020 blog post, and "Exchange rate pass-through in the euro area and EU countries", ECB, April 2020

Few More Issues for Discussion

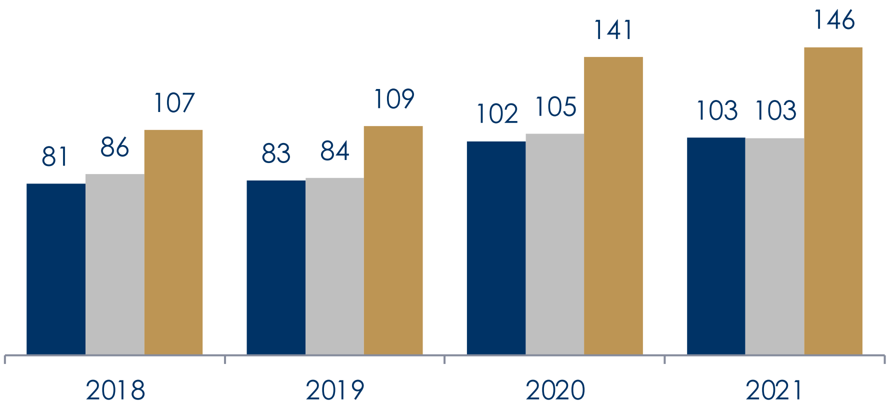
Discussion Points **Section 3**

- **Is the fiscal dominance issue not market-relevant?**
  - **Debt will rise significantly in 2020 and 2021**. Higher cost of debt weaken financial stability. Weakened financial stability impedes the transmission of monetary policy impulses.
  - Conclusion: Central banks are bound to buy government bonds to strengthen financial stability and tame debt costs
  - Excerpt from Mrs. Schnabel recent speech(1) "Fiscal expansion is indispensable at the current juncture to sustain demand [..]. Monetary policy can complement these efforts. But by itself, it may not be sufficient to stabilise the economy." **From a market perspective**, this translates in **1) more fiscal stimulus is needed and 2) fiscal dominance is ok-sh**

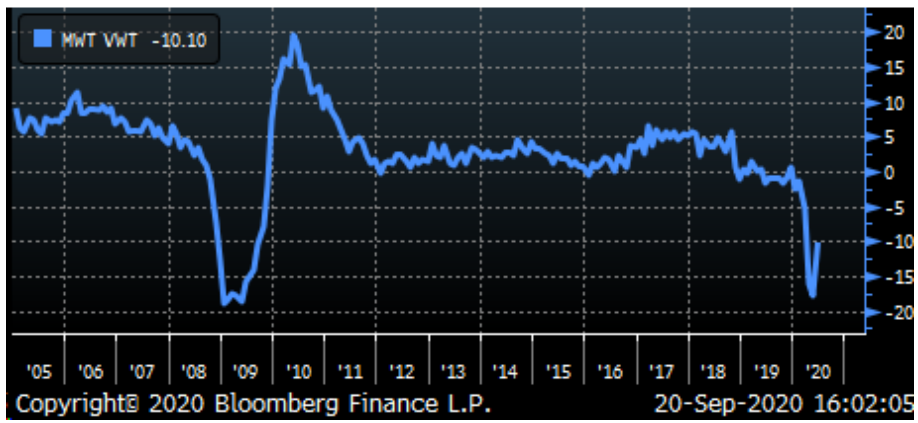
- Deglobalization incentivizes trade barriers**. Is free movement of financial capital compatible with trade barriers?** Are we entering a world where financial flows become, willingly or unwillingly, a policy issue? (e.g. EUR at 1.4, CHF at 1.00)

- **The FED** did change its reaction function but it **did not change its toolbox**. What other tool could the Fed/other CBs introduce to induce inflation ana not just wait for inflation to happen?

Debt/GDP (%): World (blue); EA (grey); US (gold)



Trade Volume (y/y, %)



(1) "The shadow of fiscal dominance: Misconceptions, perceptions and perspectives", September, 2020

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