



ECB Bond Market Contact Group

# Bond Market Outlook

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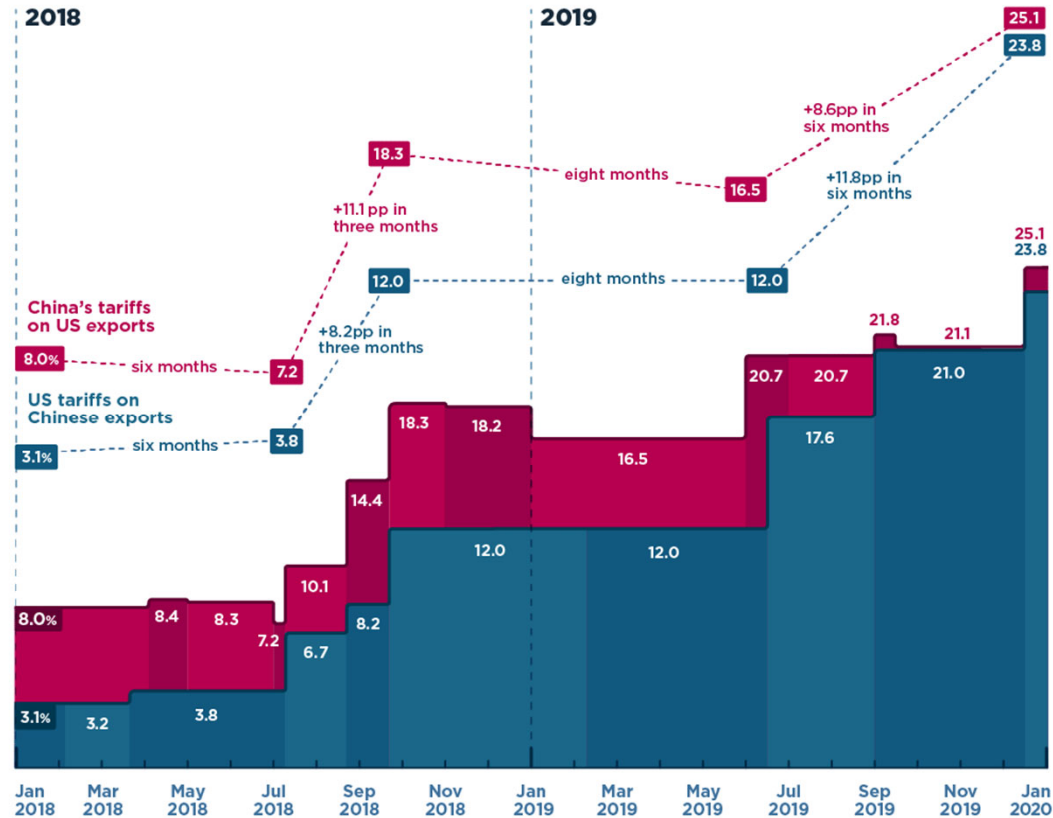
20 November 2019

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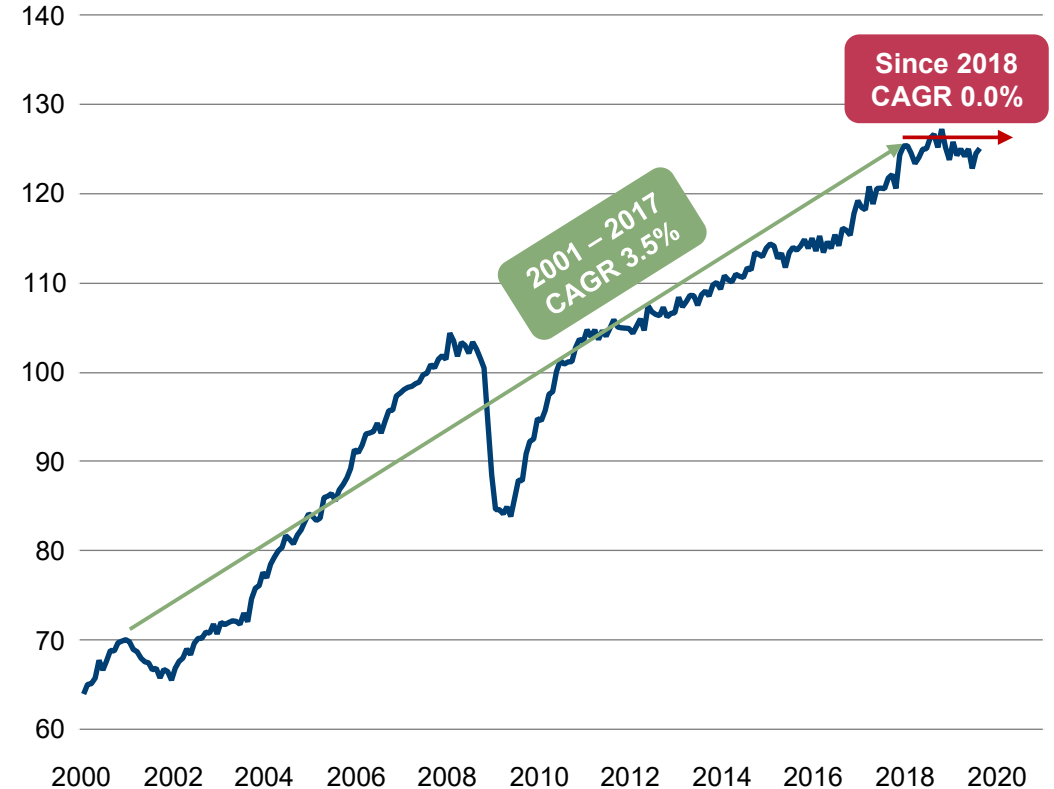
## Macroeconomic outlook

# US-China tensions have stopped the growth in global trade

## Average tariff rates in US-China bilateral trade



## Merchandise world trade volume, index



Sources: Peterson Institute. CBP. Macrobond, Union Investment

# Direct effects: Economic slowdown

## Estimated impact of a slowdown in global trade

	Estimated output elasticity to global trade		Cumulative output effect of trade tensions	
	Year 1	Year 2	Baseline	Escalation
<b>EMU</b>	0.0%	0.3%	-0.3%	-0.9%
<b>Germany</b>	0.3%	0.2%	-0.5%	-1.5%
<b>France</b>	0.0%	0.2%	-0.2%	-0.6%
<b>USA</b>	0.1%	0.05%	-0.15%	-0.5%
<b>Japan</b>	0.3%	0.0%	-0.45%	-0.9%

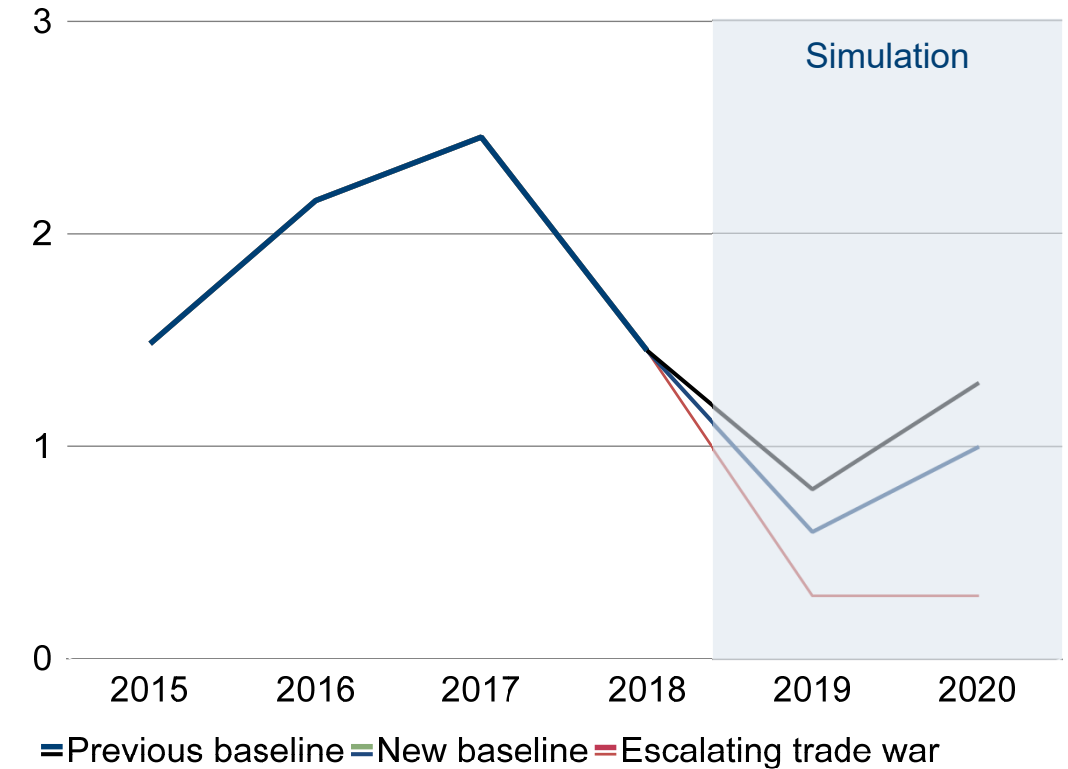
Baseline scenario: Annual world trade volume growth of 1.5%

Escalation scenario: Annual world trade volume contraction by 1.0%

Source: Union Investment

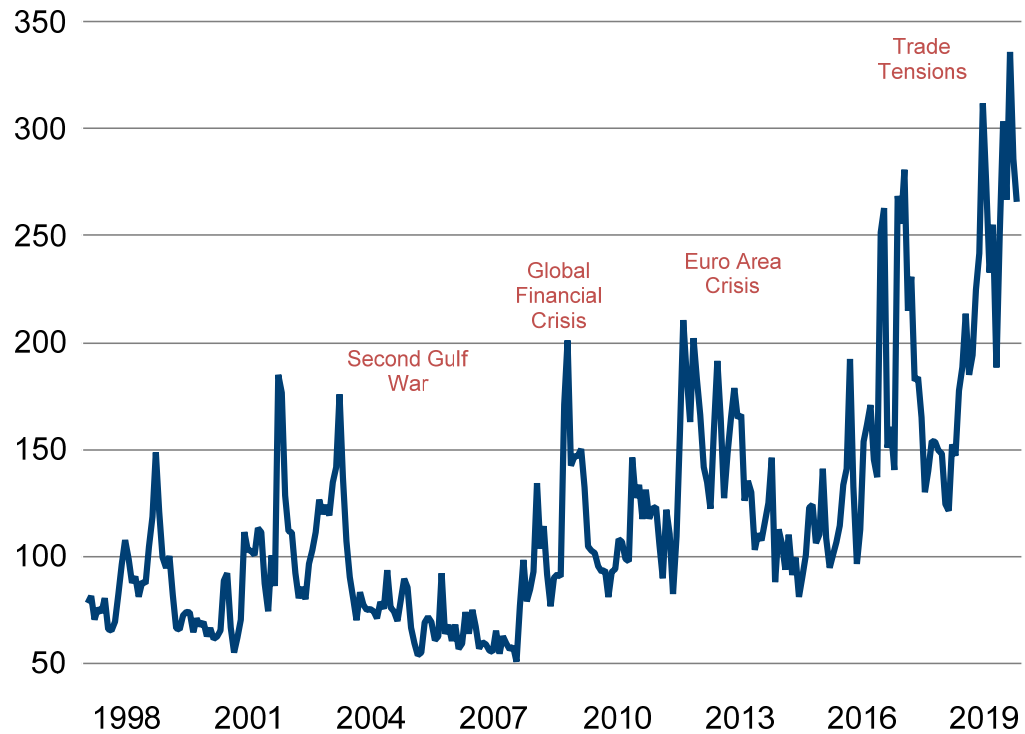
## Effect of trade tensions on EMU economic output

Real GDP, annual change in percent

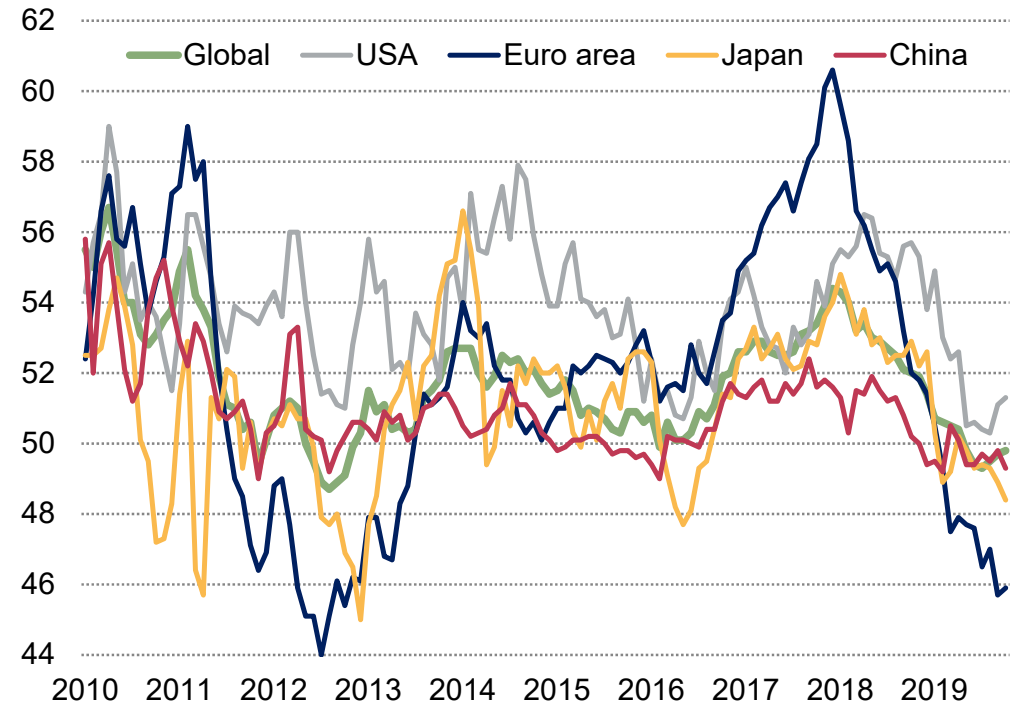


# Indirect effects: A dent on confidence

## Global Economic Policy Uncertainty Index



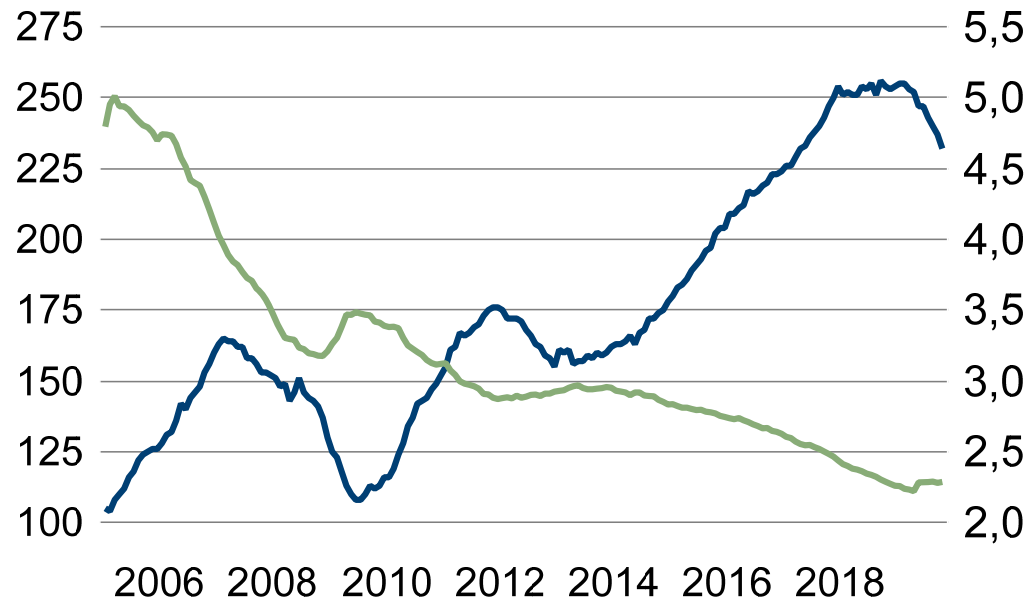
## Manufacturing Purchasing Manager Indices



Sources: PolicyUncertainty.com, Markit, Macrobond, Union Investment

# Germany: The labour market has turned

## National labour market

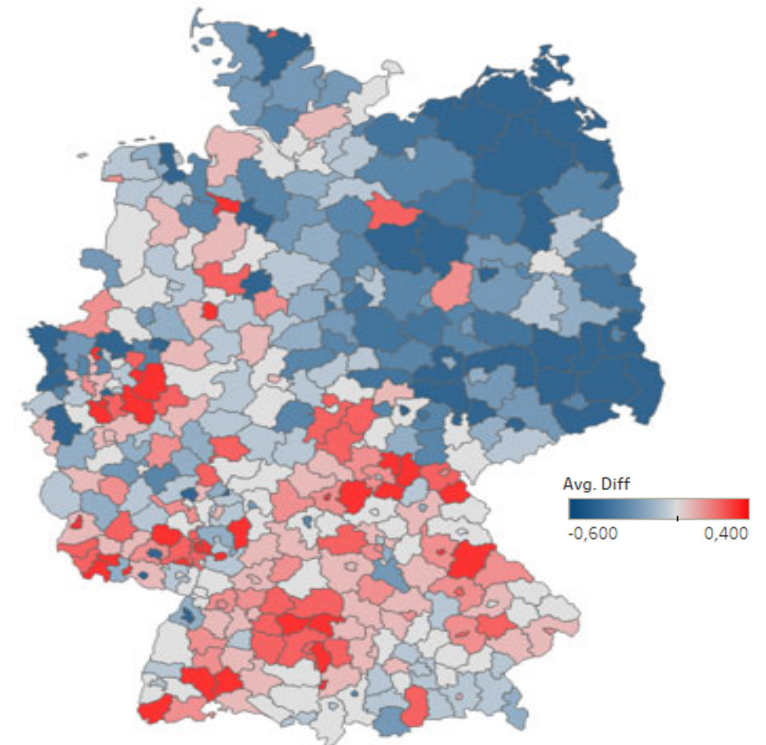


— Unemployed workers, in million (rhs)  
 — Unfilled vacancies, index (lhs)

Sources: BfA, Macrobond, Union Investment

## Rising unemployment in the industrial core

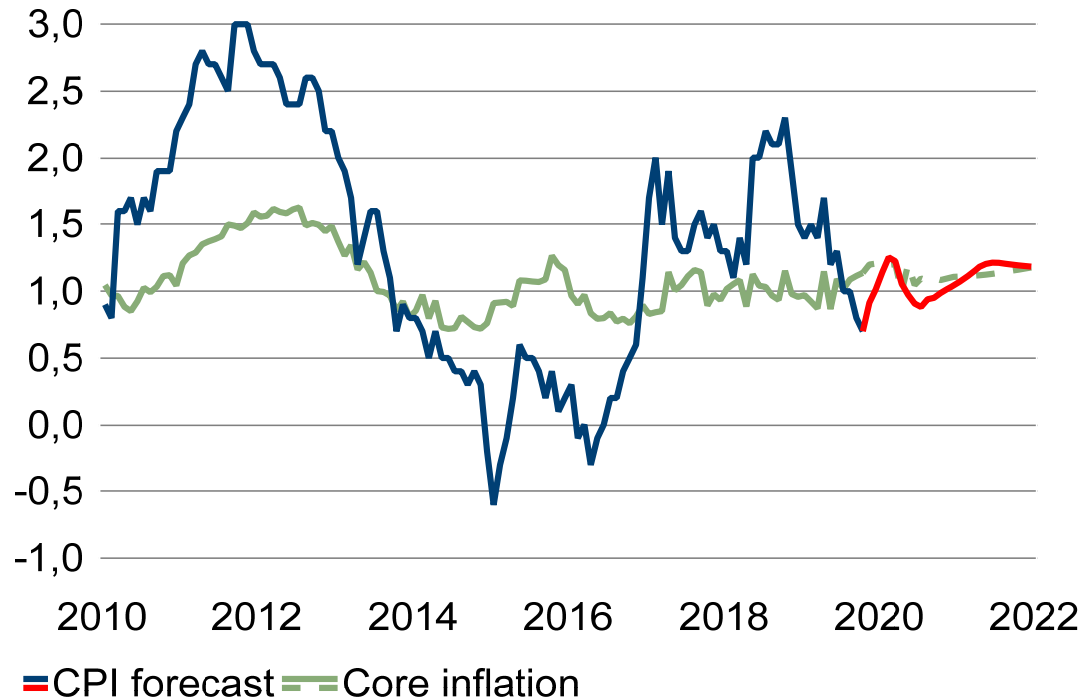
Annual change in the unemployment rate, in percent



# Euro area: Subdued inflation

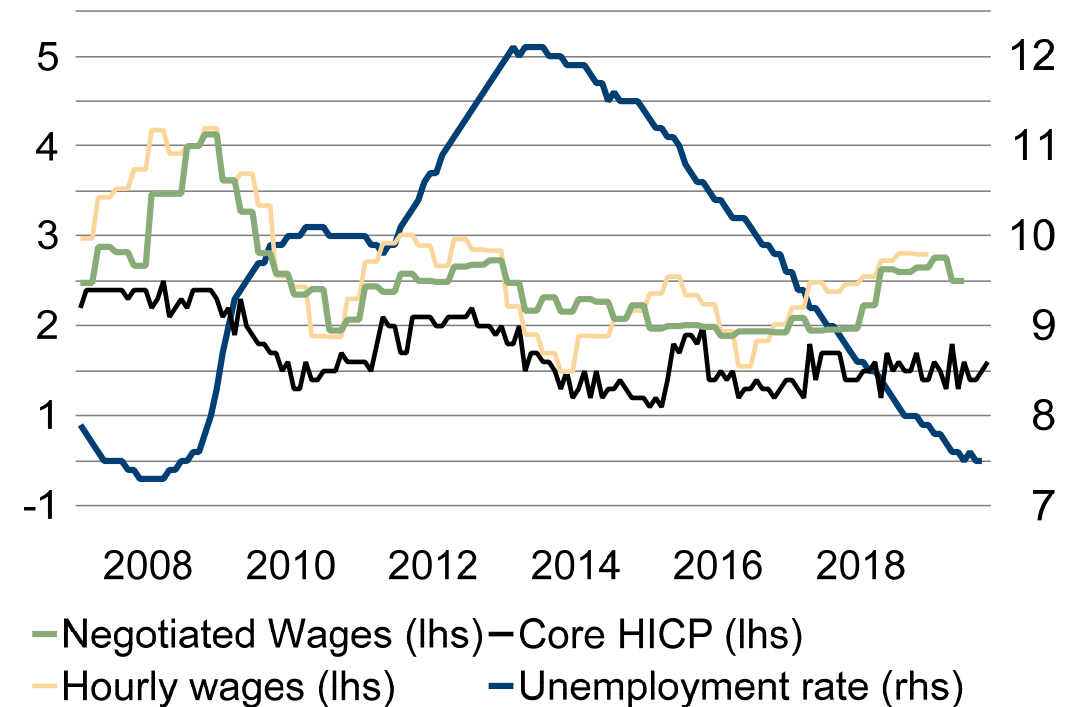
## Euro area consumer price inflation

Annual change in percent



## Core inflation fails to react to tight labour market

Seasonally-adjusted annual change in percent

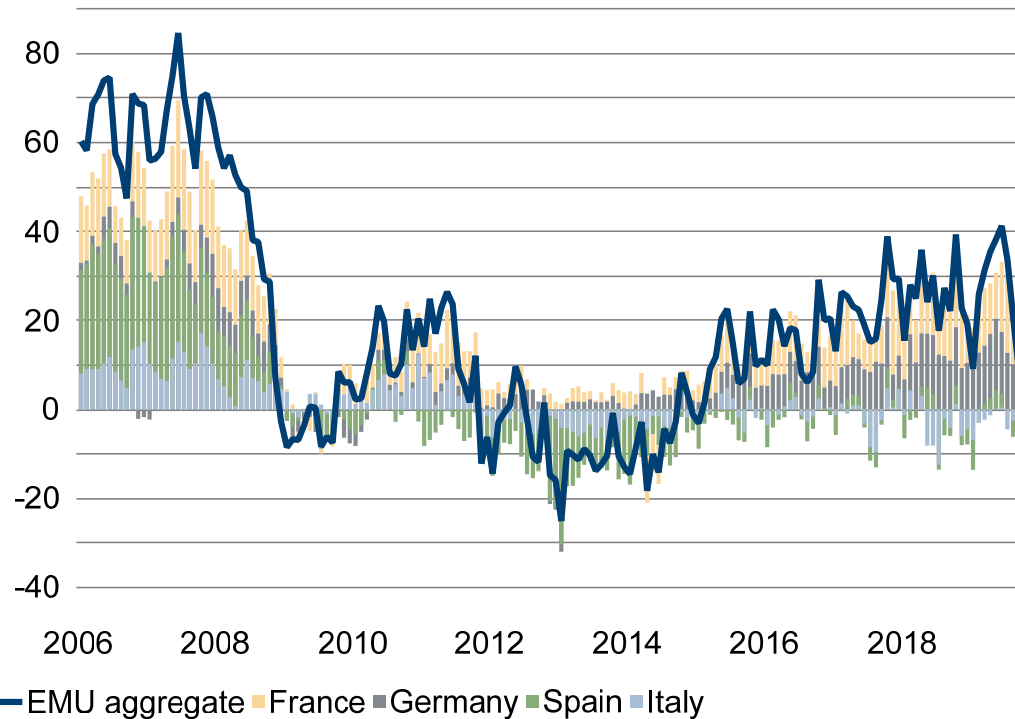


Source: Union Investment, Macrobond

# Euro area: Changing composition of lending to the private sector

## Bank lending to the private sector

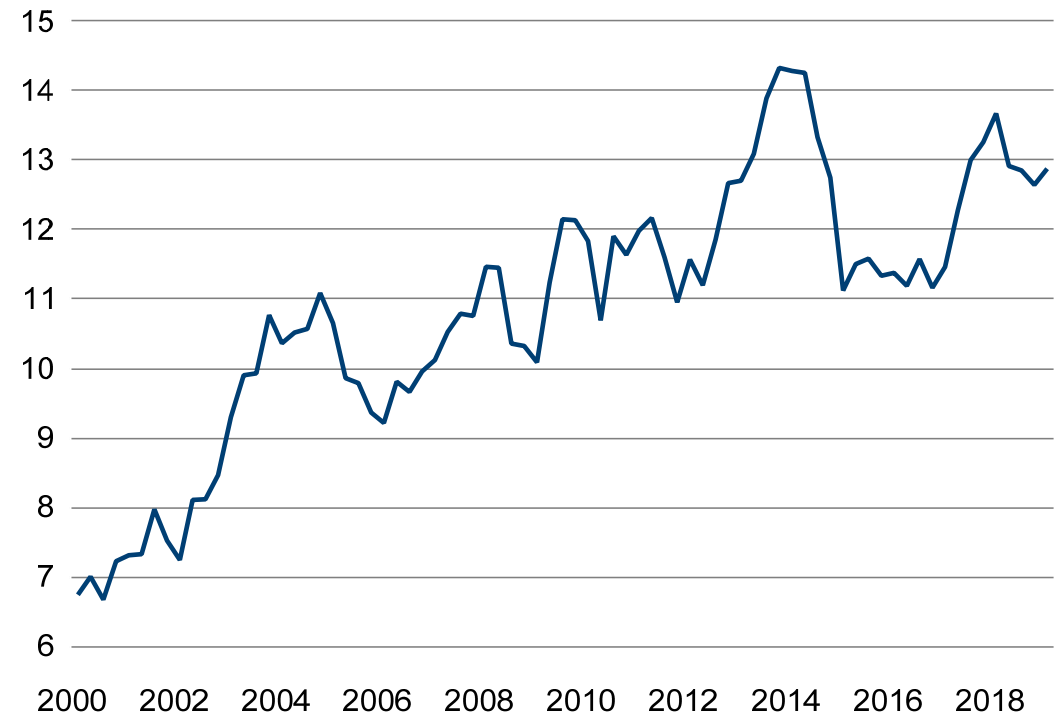
€ billion, 3 month moving average



Source: Union Investment, ECB, BIS, Macrobond

## Capital market funding to non-financial corporates

Percentage of total debt funding





# Euro area: Baseline economic projections

		2018				2019				2020				2018	2019	2020
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
Real GDP	% y-o-y	0.3	0.4	0.2	0.3	0.4	0.2	0.1	0.2	0.2	0.2	0.2	0.3	1.9	1.1	0.8
Private Consumption	% y-o-y	0.5	0.1	0.2	0.4	0.4	0.2	0.4	0.4	0.4	0.4	0.4	0.4	1.4	1.2	1.4
Government Spending	% y-o-y	0.1	0.3	0.2	0.4	0.4	0.3	0.5	0.6	0.6	0.6	0.6	0.6	1.1	1.5	2.3
Private Investment	% y-o-y	0.2	1.7	0.5	1.5	0.2	0.5	0.4	0.6	0.6	0.6	0.6	0.4	2.3	2.8	2.2
Exports	% y-o-y	-0.5	1.1	0.4	1.0	0.9	0.0	0.4	0.4	0.3	0.3	0.5	0.6	3.5	2.5	1.4
Imports	% y-o-y	-0.1	1.4	0.9	1.0	0.4	0.2	1.1	1.0	0.8	0.8	1.0	1.0	2.7	2.9	3.6
Net Exports	EUR bn	136	133	127	128	136	134	126	118	112	106	100	95	524	525	414
Industrial Production		-0.9	0.1	0.0	-1.2	0.6	0.1	0.1	0.2	0.3	0.3	0.3	0.3	0.9	-0.2	0.9
Unemployment	%	8.5	8.3	8.0	7.9	7.8	7.6	7.5	7.5	7.5	7.5	7.5	7.5	8.2	7.6	7.5
HICP	% y-o-y	1.3	1.7	2.1	1.9	1.4	1.4	1.2	1.0	1.2	0.9	1.0	1.6	1.8	1.3	1.2
HICP (core)	% y-o-y	1.0	1.0	1.0	1.0	1.0	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.0	1.1	1.1
M3	% y-o-y	3.6	3.8	3.7	4.0	4.8	5.1	5.6	5.5	5.4	5.0	4.8	4.4	3.8	5.3	4.9
Nominal GDP	% y-o-y	3.4	4.3	3.8	3.1	2.8	2.6	2.2	1.9	1.9	1.6	1.9	2.5	3.7	2.4	2.0
Current Account	EUR bn	102	92	79	86	94	91	83	76	70	64	58	53	359	344	244
	% GDP	3.6	3.2	2.7	2.9	3.2	3.1	2.8	2.5	2.3	2.1	1.9	1.7	3.1	2.9	2.0
Fiscal Balance	% GDP													-0.5	-0.8	-1.2

Source: Union Investment

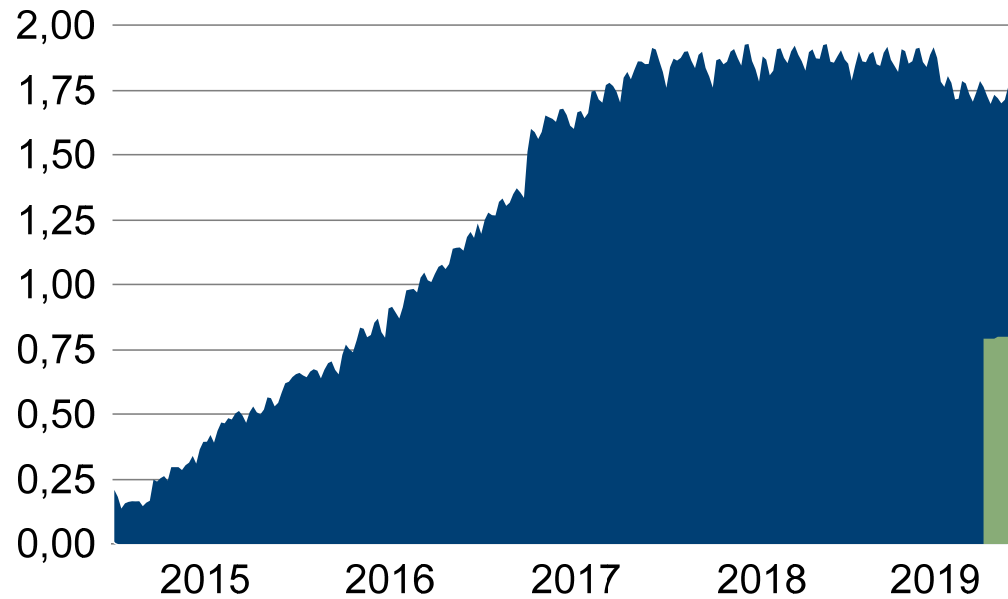
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## Bond market developments since June 2019

# The ECB's monetary policy decisions on 12 September 2019

## Tiering of central bank deposit rates

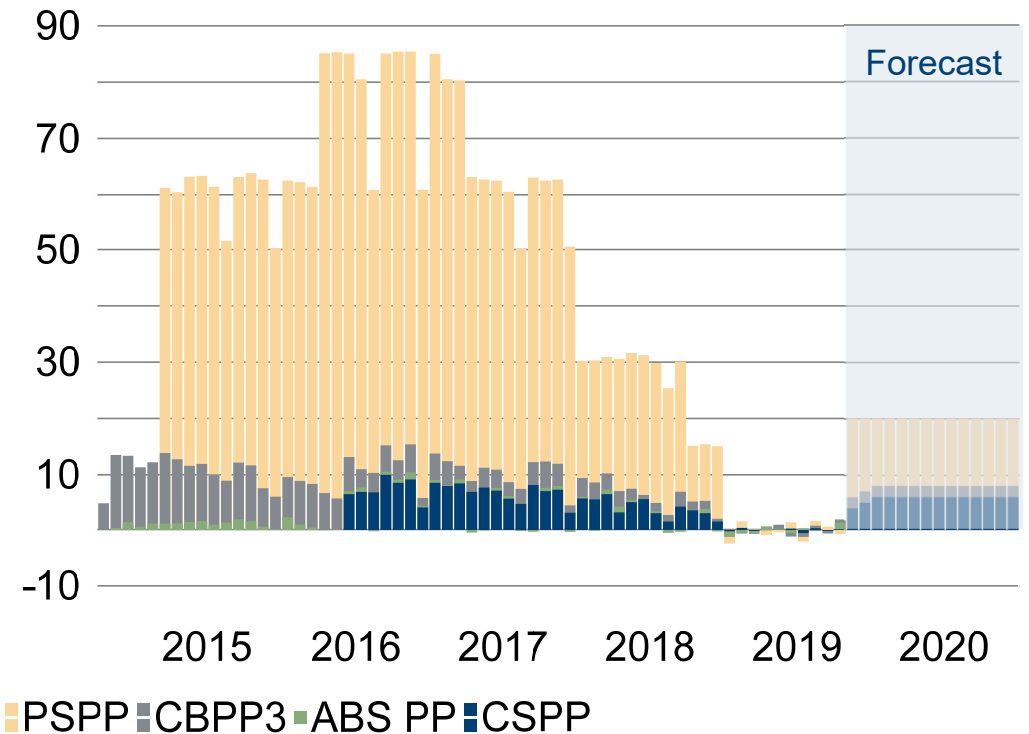
Stock of excess reserves held at the Eurosystem, in € billion



- Reserves exempt from the negative deposit facility rate
- Total excess reserves

## Resumption of large-scale asset purchases

Monthly asset purchases, in € billion

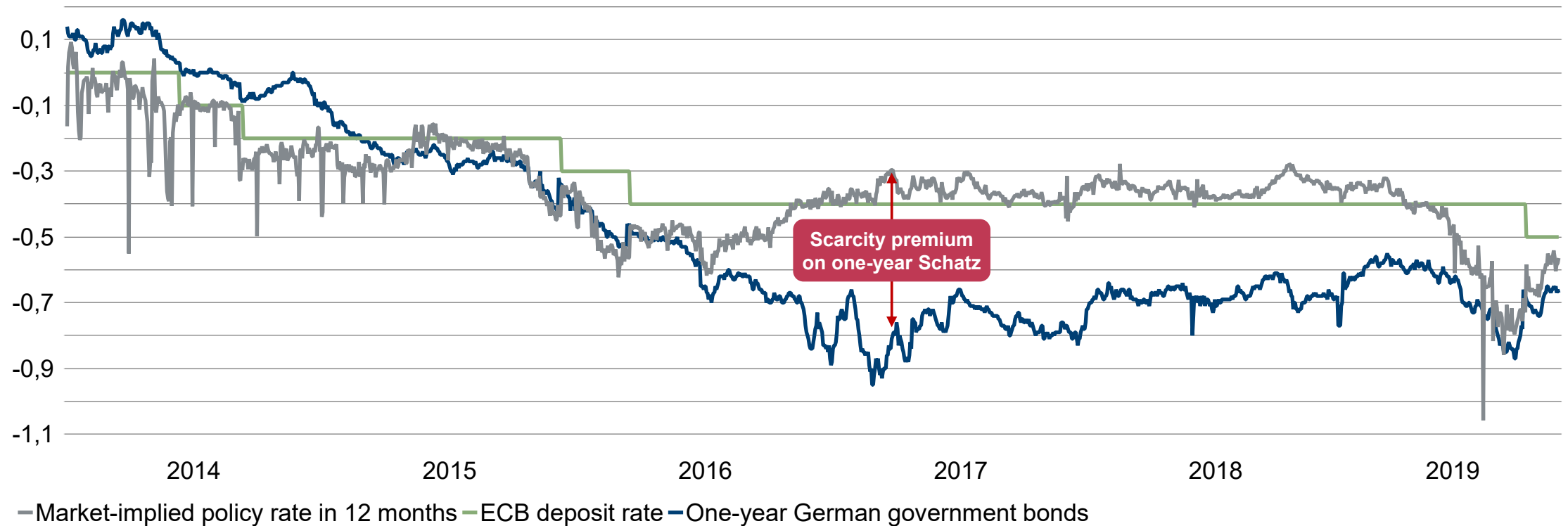


- PSPP
- CBPP3
- ABS PP
- CSPP

Source: Union Investment, ECB, Macrobond

# The market has priced out further ECB deposit rate cuts and the scarcity premium on German government bonds has all but disappeared

## Short-term euro area interest rates, in percent

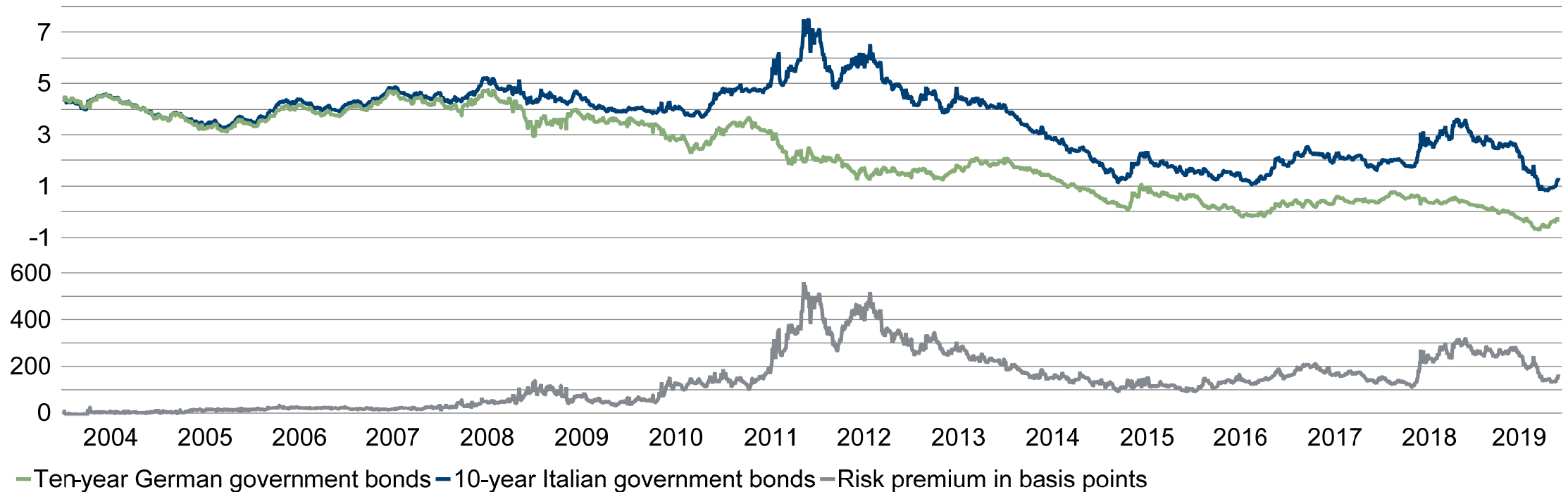


Source: Macrobond

# Declining yields and risk premia on Italian government bonds

## Yield spread between Germany and Italy

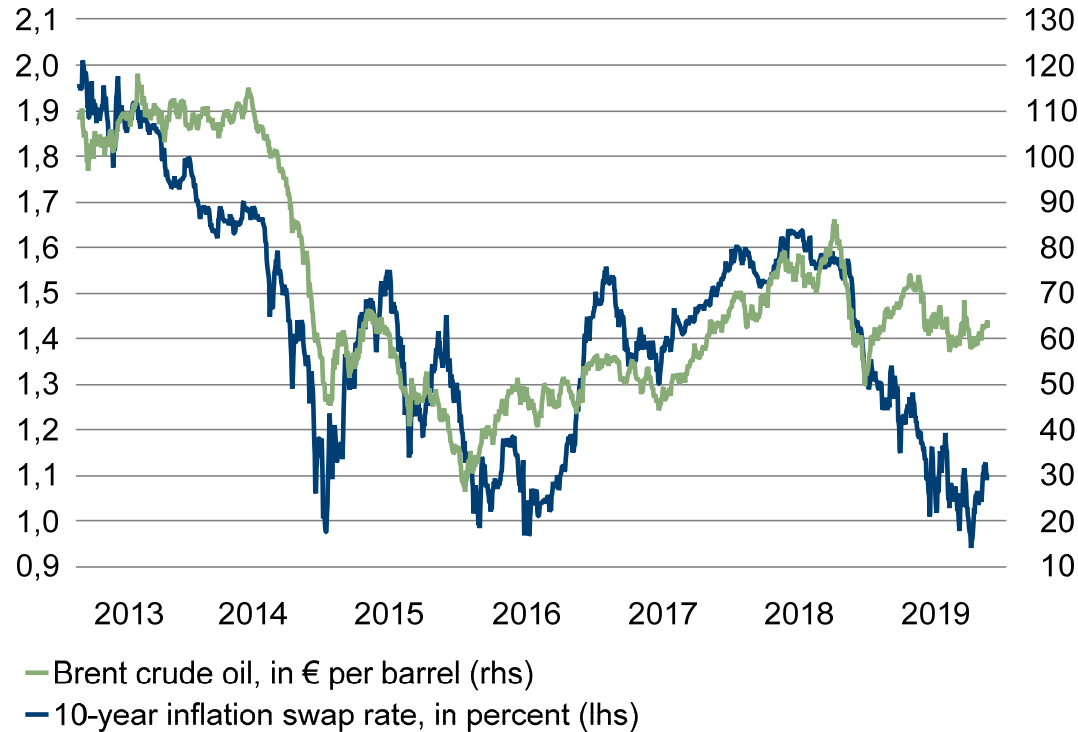
Ten-year government bonds



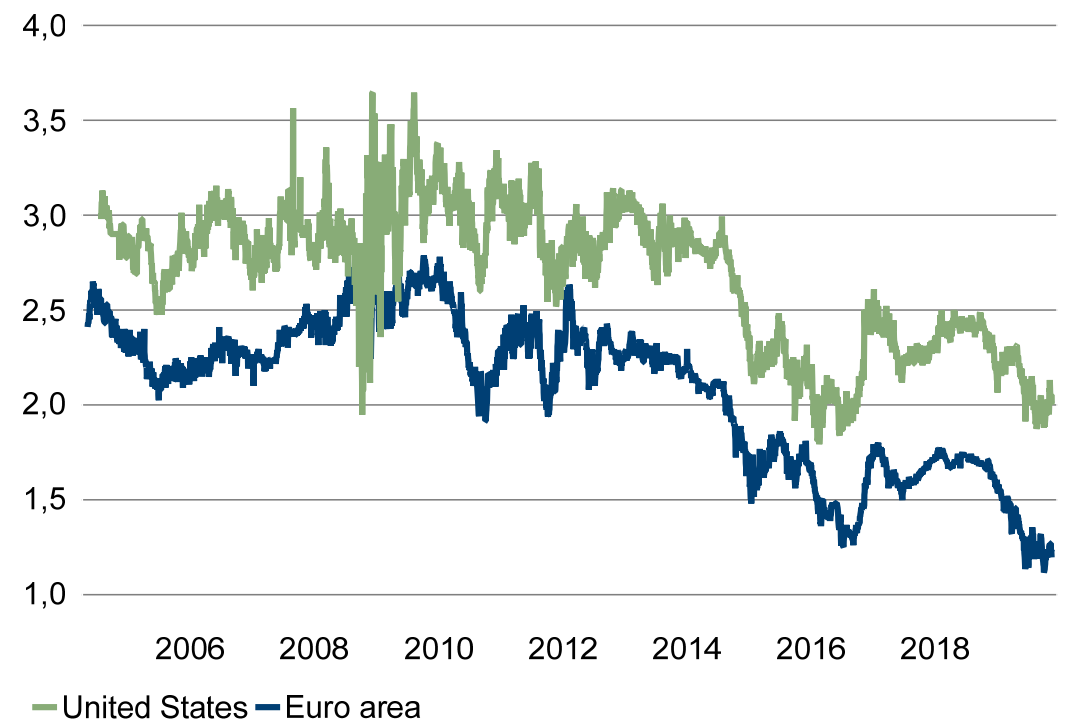
Source: Macrobond

# Market-based inflation expectations have stabilised at a very low level

## Euro area inflation expectations and crude oil



## 5-year 5-year forward break-even inflation

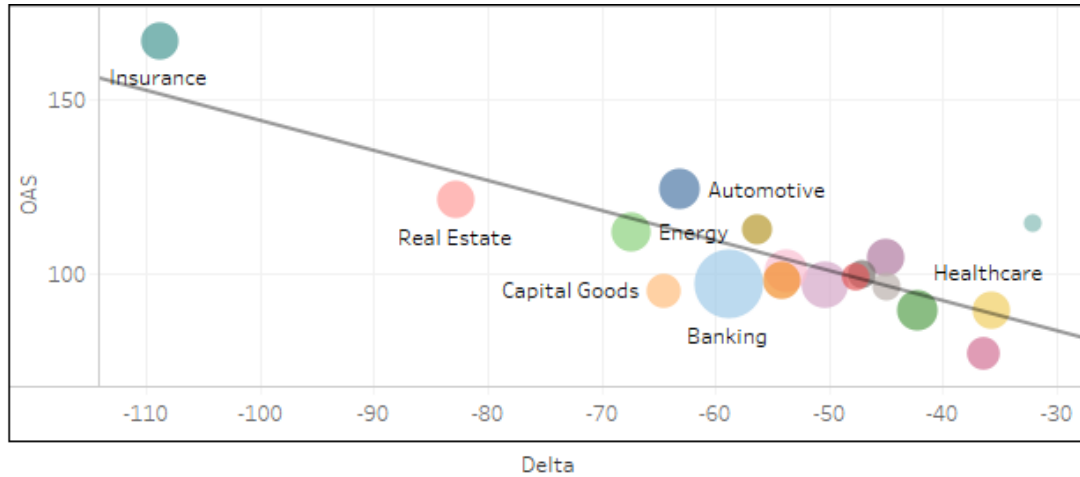


Source: Macrobond

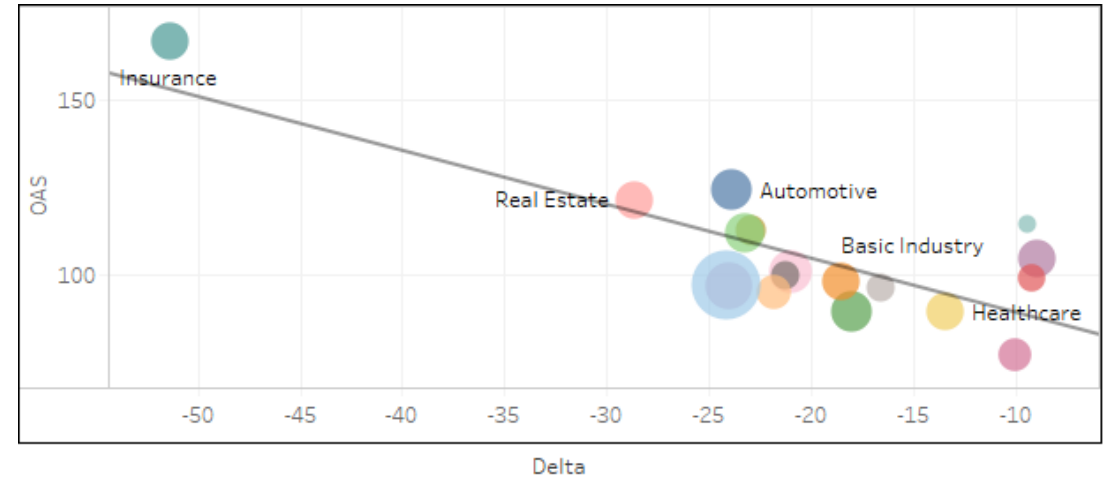
# Corporate bonds: Outperformance of interest rate sensitive sectors ...

## Sector performance in the European corporate bond market

Spread changes from 31 Dec 2018 to 15 Nov 2019, in basis points



Spread changes from 12 Jun 2019 to 15 Nov 2019, in basis points

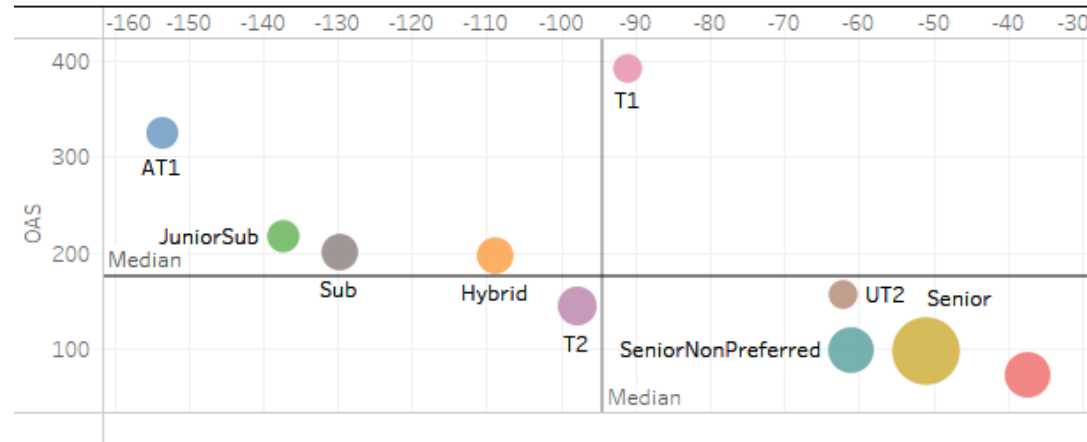


Source: Union Investment

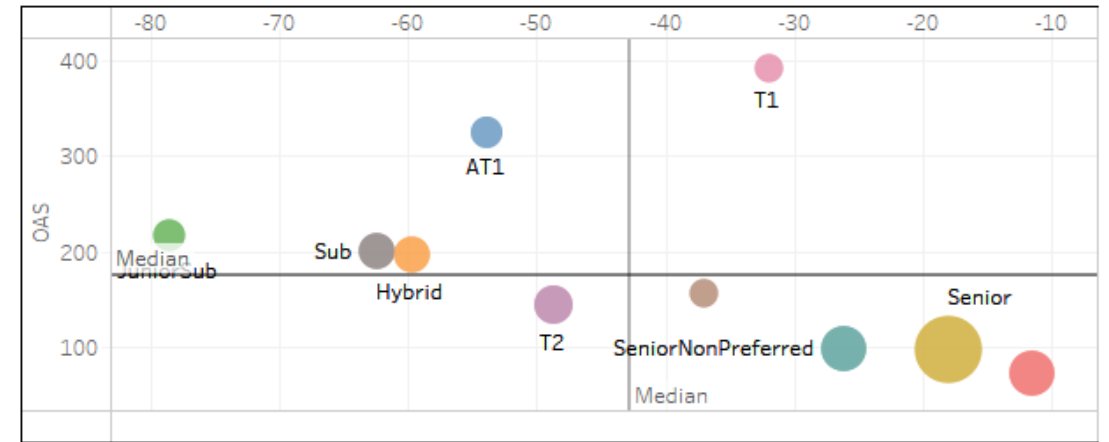
# ... and of risky market segments

## Instrument category performance in the European corporate bond market

Spread changes from 31 Dec 2018 to 15 Nov 2019, in basis points



Spread changes from 12 Jun 2019 to 15 Nov 2019, in basis points



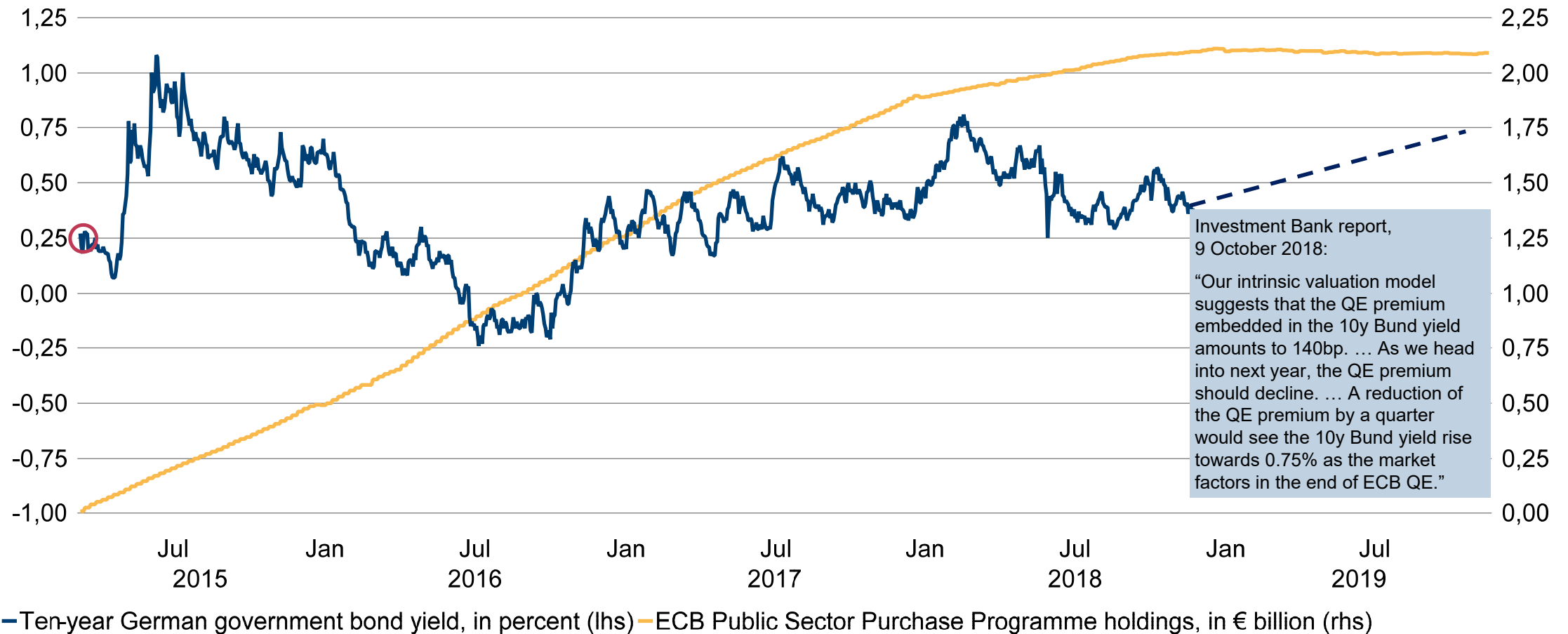
Source: Union Investment



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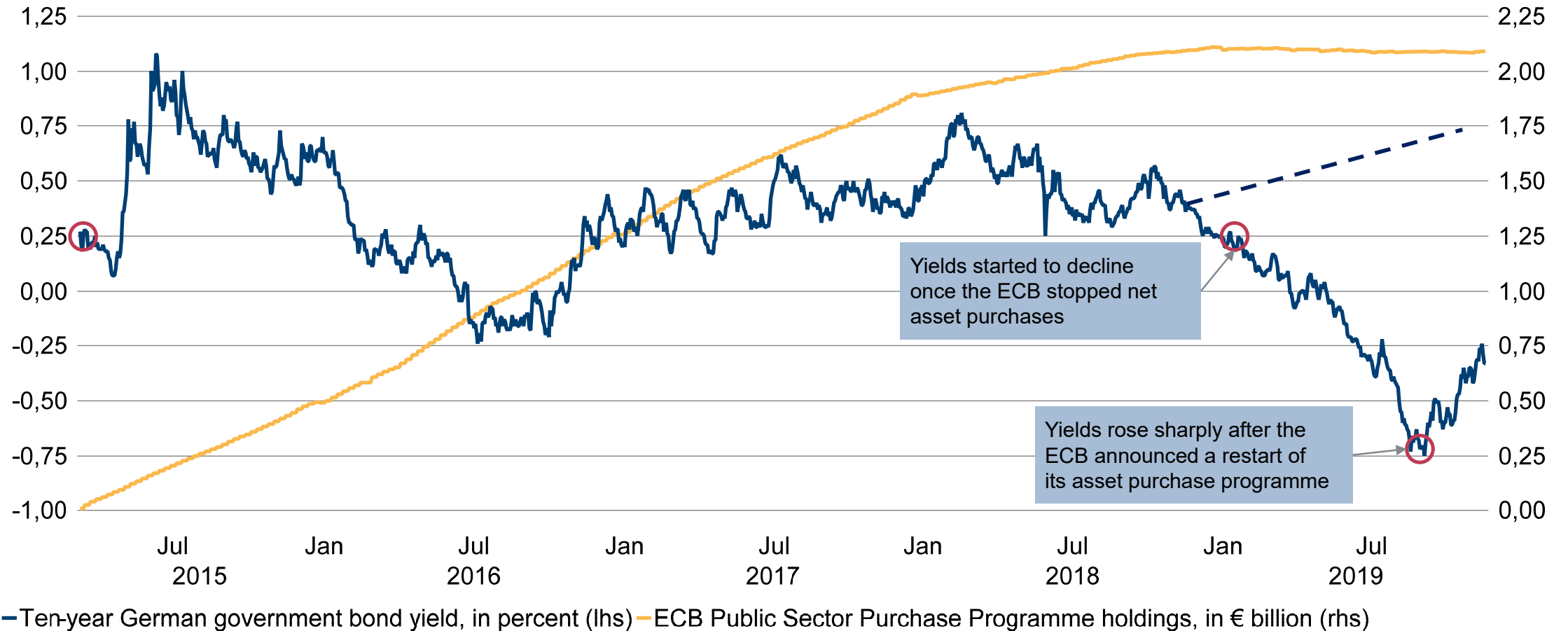
## Bond market outlook

# The impact of asset purchases on Bund yields: expectations ...



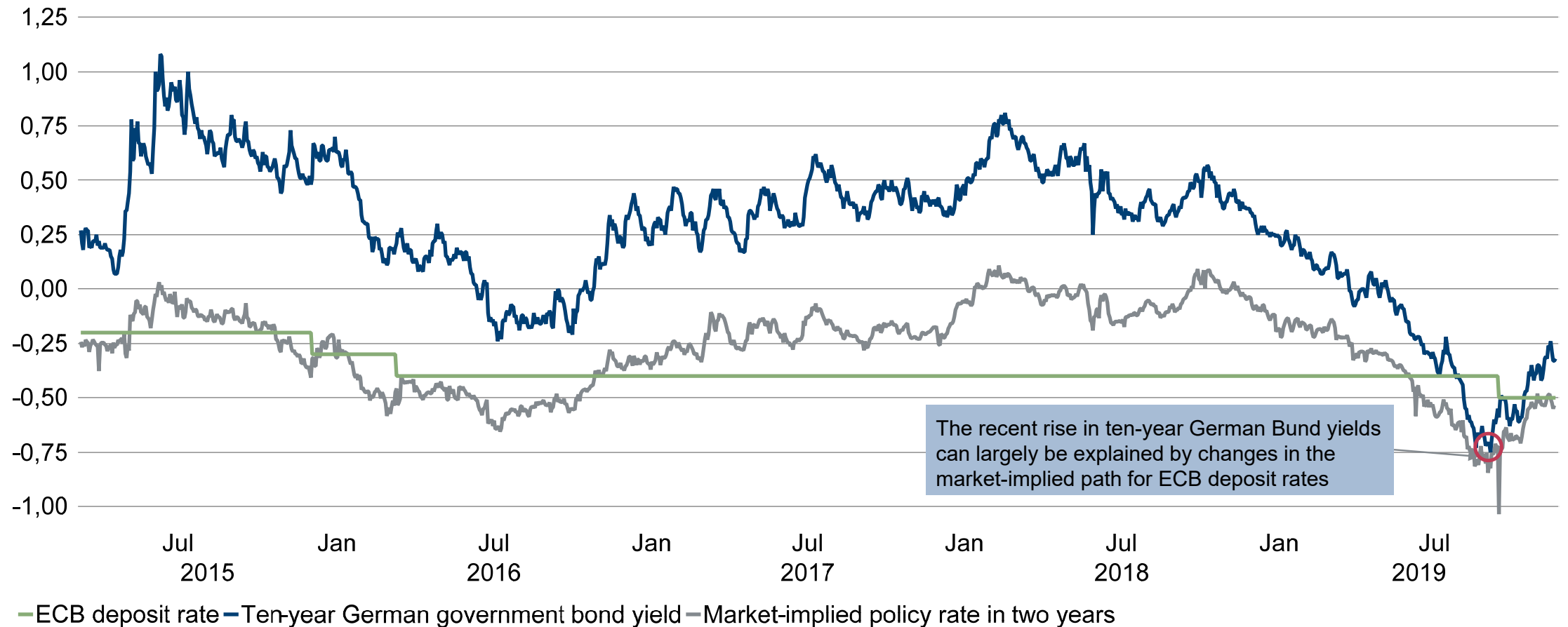
Source: Union Investment, Macrobond

## ... and empirical observations



Source: Union Investment, Macrobond

# Long-term yields seem to be largely driven by expected short-term yields, while asset purchases have a very limited impact only



Source: Macrobond

# Bond market forecasts

	18 November 2019	March 2020	June 2020	September 2020	December 2020
2-year US Treasury	1.59%	1.50%	1.40%	1.20%	1.10%
10-year US Treasury	1.81%	1.90%	1.70%	1.60%	1.50%
2-year German Schatz	-0.64%	-0.70%	-0.70%	-0.70%	-0.70%
10-year German Bund	-0.34%	-0.30%	-0.40%	-0.50%	-0.50%

- We expect the US economy to slow down into 2020, which should prompt two further Fed rate cuts. This should be sufficient to avoid a recession and allow for a modest steepening of the US yield curve.
- We have revised up our Schatz yield forecast as the ECB cut its deposit rate by 10 basis points only in September 2019. Further rate cuts seem unlikely due to financial stability concerns (cf. October 2019 GFSR).
- Persistently weak growth and low inflation coupled with downward pressure on global yields stemming from further Fed rate cuts should lead to somewhat lower long-term German government bond yields next year and an even flatter Bund yield curve.
- Peripheral government bonds and corporate bond markets remain well-supported.

Source: Union Investment

# Bond market forecasts

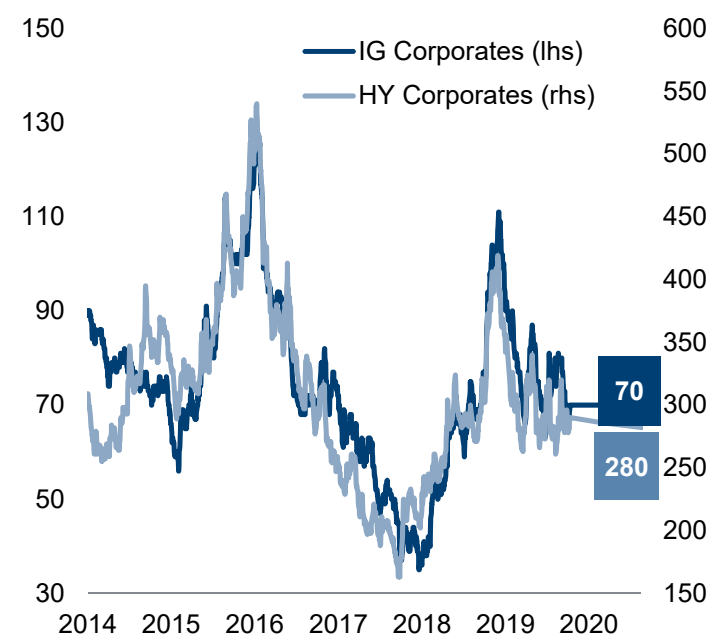
## Euro area government bonds

Yield to maturity, in percent



## Corporate bonds

Asset swap spreads, in basis points



## Emerging Markets bonds

Spreads over US Treasuries, in basis points



Sources: ICE BofAML Euro Periphery Index (EGLR), Euro Corporate Index (ER00), BB-B Euro High Yield Non-Financial Index (HEAG), JP Morgan EMBI Global Diversified Index (JPGCSOSD)

# Key points

- 1 Trade tensions have led to a sharp slowdown of the global economy, but the euro area should be able to avoid a recession in 2020 due to resilient domestic demand.
- 2 Inflation remains subdued and inflation expectations have declined in most advanced economies, likely due to global factors which are not in the control of central banks.
- 3 The ECB's asset purchases have a minor effect on long-term government bond yields only, but a rising impact on the funding to non-financial corporates and on corporate bond spreads.
- 4 Further ECB deposit rate cuts appear unlikely, since their marginal economic benefit would be dwarfed by mounting risks to financial stability (rising solvency risk for banks and non-bank financials, corporate debt build-up, asset bubbles, excess investment in lower quality and illiquid alternative assets).
- 5 Long-term yields in the euro area should gradually converge towards the current ECB deposit rate.

## Topics for discussion

- What has driven the recent rise in euro area government bond yields?
- Why has the restart of the asset purchase programme not led to a decline in yields?
- Do the ECB's large scale asset purchases result in scarcity premia in euro area bond markets?
- What are the main risks to euro area bond markets going into 2020?



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