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Outbreak

China coronavirus restrains the rise in euro zone bond yields

Banca Promos
Investment Banking Desk

Alessandro Sica
Analyst

+39 081 01 70 622
alessandro.sica@bancapromos.it
investment.banking@bancapromos.it

Paolo Cozzolino
Managing Supervisor

+39 081 01 70 617
paolo.cozzolino@bancapromos.it
pcozzolino2@bloomberg.net

The risk-on stance that has characterized the European bond market since the end of summer 2019 abruptly stopped in the first month of 2020, when fears about the economic consequences of a new Chinese coronavirus have turned off the optimism of market participants.

In the current market environment, one of the most effective gauges of international investors' sentiment is arguably the Bloomberg-Barclays index that tracks the global volume of negative-yielding bonds.

Once crossed the €15tn threshold in August 2019, the index walked along a descending path that led it, in about four and a half months, to lose more than 1/3 of its value. Then, **since mid-January, the volume of bonds with sub-zero yields began to rise dramatically again**, surging from below €10tn to over €12tn.

This very pattern can be observed, over the same time horizon, with reference to the German Bund.

The long run of the Bund, that last summer has dragged the whole German yield curve below zero, gave its first sign of 'slack' on August 21, when the country's debt agency was unable to sell in full to investors a new 30-year bond carrying a negative yield (the first of its kind).

From that auction to mid-January, the 10-year Bund yield has risen by over 45bps to -0.20% area.

Timeline 2Q19-1Q20

April 10
UK and EU agree Brexit delay to October 31

May 10
US increases tariffs on $200bn of Chinese goods to 25%

June 1
Chinese tariffs on $60bn of imports are applied

August 2
Germany's yield curve slides entirely below zero

August 5
US labels China a currency manipulator

August 21
Germany's 30-year negative-yielding Bund issue is undersubscribed

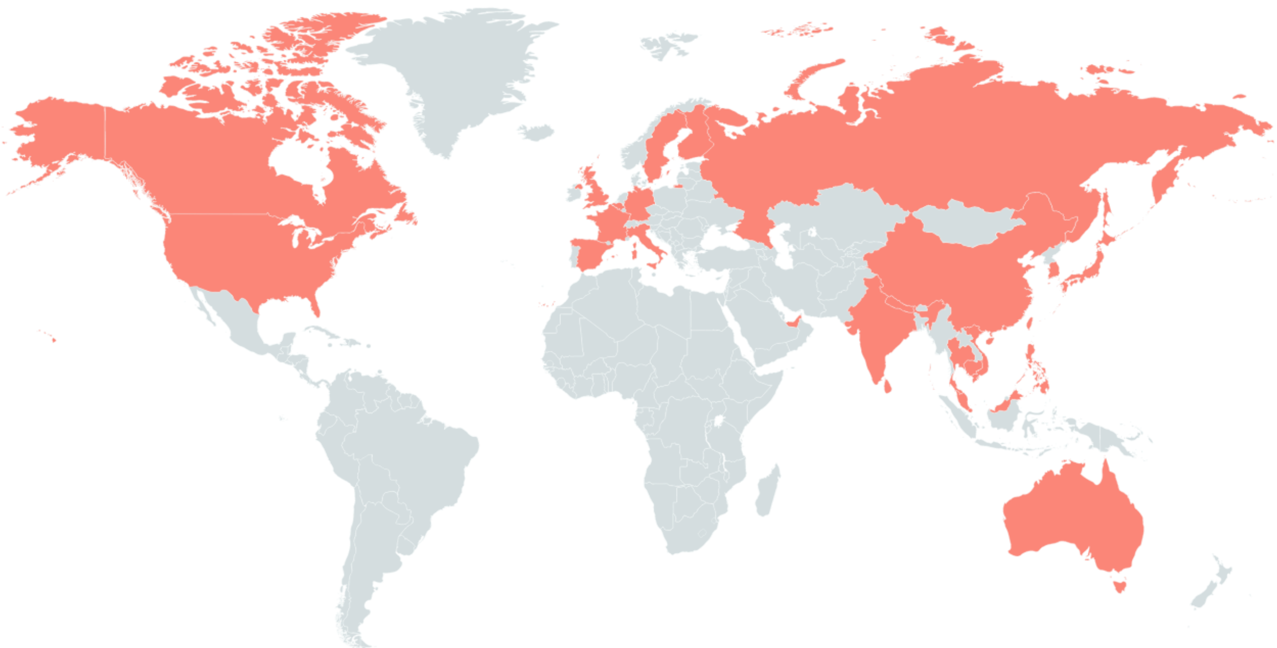
September 12
ECB cuts DFR to -0.50%, announces QE resumption

September 20
Germany announces €54bn climate package

October 11
US and China agree on the outline of a partial trade deal

(cont'd)

Coronavirus spread map



Source: The New York Times

Just as the market started pondering how quickly the yield on Germany's 10-year notes would return to express a positive value, the Chinese coronavirus made its appearance on the international stage, forcing analysts and investors to revise their forecasts.

Bloomberg Barclays Global Negative Yielding Debt Index (EUR tn)

Source: Bloomberg

Germany Bund 10 Year Yield (%)

Source: Bloomberg

October 15
Germany submits its 2020 draft budgetary plan

October 28
Brexit is delayed until January 31

November 14
Germany avoids recession with +0.1% GDP growth in 3Q19

November 30
Walter-Borjans, Esken are elected leaders of Germany's SPD

December 13
Johnson's Tories win majority in UK election

January 15
US and China sign phase one deal, German growth falls to 6-year low

January 31
UK formally leaves the EU

February 6
565 deaths and 28,276 confirmed cases worldwide due to 2019-nCoV coronavirus

1. Yields up

The rise in euro area bond yields since late summer 2019 **has been driven by a wave of optimism about** the health and **the outlook of the European and global economy.**

The drivers behind the upward shift were mainly three: softening of geopolitical risks, acknowledgment of the limits of monetary policy, potential launch of expansionary fiscal policies.

Geopolitics

As tensions between the United States and China faded -- allowing US President Donald Trump and Chinese Vice President Liu He to sign a phase 1 trade agreement on January 15 -- **a risk-on attitude has emerged among market participants**.

In the last two months of the year, Brexit gave portfolio managers further incentive to move from fixed income to riskier asset classes, generating an increasingly favorable news flow, peaked with Boris Johnson's Conservative Party landslide victory in December's general elections.

Central banks

Stances against ECB's unconventional monetary policies gained momentum as a consequence of the unprecedented increase in the volume of negative-yielding bonds in the eurozone and globally.

Firstly, there's the idea that **costs associated with negative rates** (especially those weighting on the banking sector) **have exceeded benefits**. Secondly, there's the opinion that the European Central Bank's monetary policy headroom is about to be fully depleted.

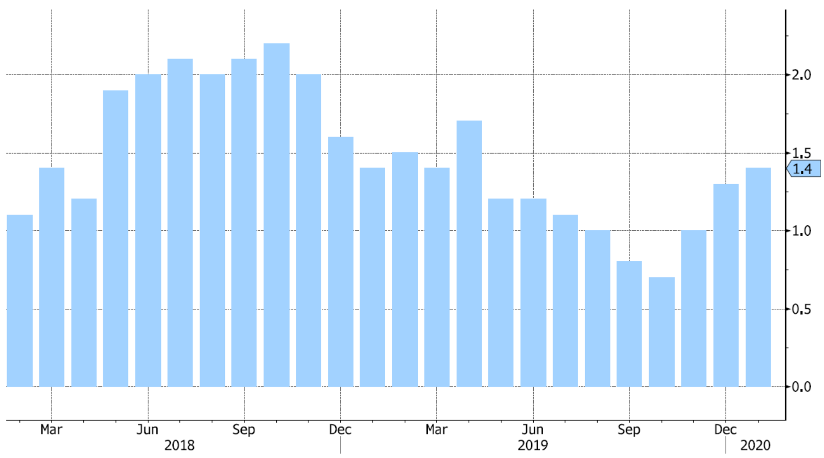
Therefore, **the ECB may find it hard to push rates below their current levels**, the most skeptical commentators argue. Hence the decision by the Frankfurt-based institution to launch a strategic review aimed at redefining its inflation target, instead of further lowering its policy rates.

Christine Lagarde
ECB President

"While the threat of a trade war between the United States and China appears to have receded, the coronavirus adds a new layer of uncertainty."

February 5, 2020

Eurostat Eurozone MUICP All Items YoY Flash Estimate NSA (%)



Source: Bloomberg

Fiscal policy

The expectation that a growing number of appeals by members of Germany's political, industrial and academic world for a softening in budgetary rigor could finally persuade Angela Merkel's government coalition has been among the main drivers behind the fall in Bund's prices over the last four months of 2019.

The market has been hoping that, having **Germany** recorded in 2019 its lowest GDP growth rate in six years, the country's government **would decide to give up on the totem of Black Zero**. Were this scenario to materialize, the new flow of bonds on offer and the prospect of a revitalization of the German economy (with its impact on euro-area inflation and ECB policies) would pave the way for yields to rise in Germany and elsewhere in the eurozone.

This view was also reinforced by the victory of Norbert Walter-Borjans and Saskia Esken in the election for the leadership of the Social Democratic Party of Germany (SPD). Indeed, the two leftwing politicians won over the duo led by centrist Finance minister Olaf Scholz also thanks to their proposal for an ambitious €450bn program of public investments over the next decade.

2. Yields down

In the first weeks of the new year, the decline in bond yields has been triggered by -- mainly unexpected and seemingly not structural -- factors such as the military escalation between the United States and Iran, and (more importantly) the spread of the Chinese coronavirus on a global scale. Meanwhile, some longer-term underlying drivers are still in place: supply and demand of euro-denominated bonds, trade disputes, and Brexit.

Supply side

Despite a record amount of bonds has been issued at the beginning of 2020, **the net volume of new notes to be sold by eurozone issuers is expected to stay relatively low over the full year**. A weak supply of euro-denominated bonds during the year -- a consequence of the reluctance by some euro area governments to increase their levels of spending and debt -- could contribute yields to stay at low levels.

In Germany, the new leaders of the SPD toned down their demands pretty soon after late November's elections. As the SPD can only lose from early elections, should its requests lead to a clash with the CDU, the discussion between the two parties has soon focused on very limited spending concessions.

Germany Sell 3M & Buy 10Y Bond Yield Spread (bps)

Source: Bloomberg

Demand side

Even assuming that euro area member countries with more fiscal space will bow to calls for larger fiscal efforts, an increase in interest rates by the ECB would not be immediate, as the central bank would wait for the fiscal stimulus to produce its effects on price levels before taking action.

Moreover, net purchases under QE (at a tune of €20bn per month) have resurged little more than three months ago. Therefore, **in the short term, it's hard to imagine Christine Lagarde unwinding the policy measures announced in September** by her predecessor Mario Draghi.

As a consequence, Quantitative Easing would keep amplifying the scarcity of German notes and more broadly provide support to demand and prices of euro-denominated bonds for a long time.

Philip Lane
ECB Chief Economist

"The history [of past epidemics] has been that there could be a significant short-term effect of events like these, but no long-lasting effect."

February 5, 2020

Geopolitics

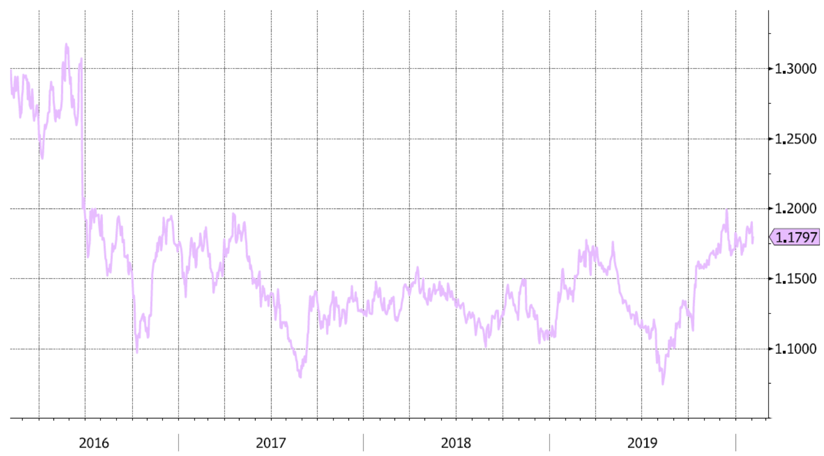
The phase 1 trade deal between the US and China is a sign of distension between the two largest economies in the world. However, **the trade war between the two countries cannot be considered over**, in particular because 25% tariffs on $250bn of Chinese goods as well as Chinese tariffs on over $100bn of US exports will remain in place.

Furthermore, a new European 'battlefront' could soon arise, as President **Trump has threatened to introduce tariffs on cars exported by European countries** if an agreement between the US and the EU is not reached within US elections in November. The EU has already been hit with $7.5bn in US tariffs following its illegal subsidies for Airbus and Trump has recently threatened 100% tariffs on $2.4bn in French products in response to the web tax introduced by Emmanuel Macron's government.

As for Brexit, a transition period has started on February 1. During the 11-month span -- when the United Kingdom will continue to be subject to European rules despite lacking representation in EU's institutions -- trade negotiations will take place between London and Brussels.

PM Johnson wants to achieve an agreement already by the end of 2020. But European Commission President **Ursula von der Leyen has stated that it will be 'impossible' to reach a full deal between the EU and the UK within December**, de facto confirming what several commentators already said: the UK-EU trade deal would take years (and not months) to be finalized.

GBP to EUR Exchange Rate



Source: Bloomberg

2019-nCoV

In many respects, the market reversal observed at the beginning of 2020 has been caused by two mainly unexpected factors: the US blitz that killed Iranian general Qassem Soleimani, with the fear of the outbreak of a military conflict in the Middle East, and the spread on a global scale of a new coronavirus, starting from the Chinese city of Wuhan.

The confrontation between the United States and Iran has scaled down rather quickly (although the clash is far from reaching its end), but **fears related to the impact of the Chinese virus on the global economy may prove more persistent**.

The repercussions of the virus on production, consumption, and financial markets may jeopardize the very commitments made by China in the context of its recent trade agreement with the United States, in particular for the part that requires China to increase its purchases of US goods and services for $200bn in the next 2 years.

Only time will tell whether the Chinese coronavirus will turn into a factor capable of slowing global growth over the longer term. As of now, it has had at least the effect to postpone (one more time) the long-awaited return of the bond market to its pre-crisis “normal”.

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