

## Can Eurozone yields experience another sharp setback?



**News:** Last spring, the 10Y Bund yield dipped to record low buoyed by an aggressive ECB. German 10Y rate fell as low as 0.07% prior bouncing back sharply close to 1% few weeks later. Similarly, in February 2016 the 5Y German yield dropped to -0.4%, an all-time low. How far can Eurozone government bonds rates fall? What are the drivers of sovereign yields?

### I- What are the drivers of sovereign yields?

Long term government bond yields are related to a broad spectrum of determinants, namely:

- short term interest rates;
- the expected real GDP growth;
- the expected rate of inflation;
- supply and demand dynamics;
- risk premiums.

Risk premiums capture the combination of: country-specific credit risk, liquidity risk, term premium for holding longer dated bonds [1] and the compensation for unexpected inflation. Interdependence with US interest rates is also a key driver of Eurozone yields as developed markets have become more integrated than ever.

## II- How far can Eurozone government bonds rates fall?

### 1- Short term rates

The ECB sets the key interest rates for the Eurozone banking systems [2]. It can directly influence money market interest rates and indirectly banks' lending and deposit rates. By controlling short-term interest rates, the Central Bank can also affect medium and long-term interest rates [3]. Since the ECB seems reluctant- for the time being - to cut rates further [4], the 2Y German bond should remain range-bound between -0.5% to -0.4%.

### 2- The expected real GDP growth

Latest Eurozone surveys are consistent with a steady GDP growth (circa. 0.4% q/q in Q1). The faster the economic growth is, the easier the country can pay back its debt. Indeed, all things being equal, a fast growing economy generates stronger public revenues (through higher VAT and corporate taxes) than a stagnant economy.

### 3- The expected rate of inflation

The 5Y5Y inflation swapforward is the key market-based indicator used by the ECB to gauge investors' inflation expectations [5]. Tumbling oil prices have dragged down inflation expectations significantly well below ECB's 2% target (see appendix). While oil prices may have bottomed out, they are not expected to soar materially in the coming months. Yet, Alan Greenspan highlighted that "we're going to watch the inflation issue coming back" [6] in the US. The resurgence of US inflation may add upward pressure to Eurozone inflation expectations. In fact, any significant rise in actual and expected US inflation could be perceived as a success of QE experiment.

### 4- Supply and demand dynamics

Net government supply (issuance minus redemptions and coupon payments) after QE purchases (net supply minus ECB's asset purchases) is projected to be extremely negative in April at around -€120bn taking into account the €20bn increase in asset purchases programme. Assuming coupons will be reinvested in sovereign bonds, supply and demand dynamics are very supportive for Eurozone government rates.

### 5- Risk premiums

Country-specific credit risk: No imminent threats despite some political noise (Spain, Portugal, Ireland). In addition, European institutions have sufficient tools (OMT, ESM...) to alleviate any sovereign debt crisis. Finally, the Greek case may resurface, but not in the short run (the government and its creditors are still negotiating conditions to unlock the new bailout programme) [7].

Position and liquidity risk: Positioning is hard to assess accurately, but one can reasonably think that thin liquidity and heavy positioning could easily exacerbate the rise in yields.

QE premium: Bonds are trading significantly well below fundamental valuation mainly due to ECB's expanded asset purchases. Last year, the pricing of the scarcity negative premium went too far and too rapidly. In fact, the sharp setback in yields was largely driven by repricing of QE premium. The newly announced measures by the ECB seem already priced in; hence the downward impact on yields may be limited.

Interdependence with US long term rates: Another Fed rate hike in June could put upward pressure on Eurozone sovereign bonds yields. This component is closely linked to the path of US inflation.

Components	Impact on rates
Short term rates	<i>neutral</i>
The expected real GDP growth	<i>neutral</i>
The expected rate of inflation	<i>modestly bearish in the mid term</i>
Supply and demand dynamics	<i>highly bullish in the short run</i>
Country-specific credit risk	<i>neutral</i>
Position and liquidity risk	<i>bearish in the mid term</i>
QE premium	<i>modestly bullish</i>
Interdependence with UST	<i>highly bearish in the mid term</i>

## Conclusion

All in all, another sharp setback is unlikely in the short term given supply dynamics and ECB’s additional set of policies. By contrast, the resurgence in US inflation could trigger a rapid bounce back in government bonds yields.

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## Notes

[1] Term premium: refers to the excess return required by investors to hold longer dated bond instead of buying in a series of shorter dated bonds. For instance, the lender can either buy a 10Y security or decide to invest a new 1Y bond each year. The term premium is usually positive.

[2] <https://www.ecb.europa.eu/stats/monetary/rates/html/index.en.html>

“The Governing Council of the ECB sets the key interest rates for the euro area:

- The interest rate on the main refinancing operations (MRO), which provide the bulk of liquidity to the banking system.
- The rate on the deposit facility, which banks may use to make overnight deposits with the Eurosystem.
- The rate on the marginal lending facility, which offers overnight credit to banks from the Eurosystem.”

[3] <https://www.ecb.europa.eu/mopo/intro/transmission/html/index.en.html>

“Expectations of future official interest-rate changes affect medium and long-term interest rates. In particular, longer-term interest rates depend in part on market expectations about the future course of short-term rates”

[4] Mario Draghi 10/03/2016: “Let me say that rates will stay low, very low, for a long period of time, and well past the horizon of our purchases. From today's perspective, and taking into account the

*support of our measures to growth and inflation, we don't anticipate that it will be necessary to reduce rates further. Of course, new facts can change the situation and the outlook."*

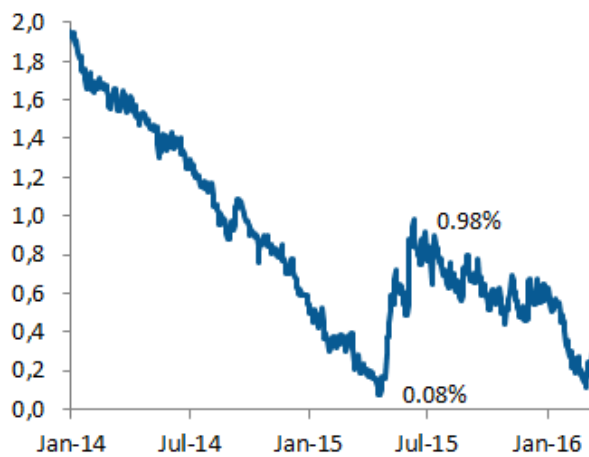
[5] 5Y5Y inflation swap forward: refers to an inflation swap starting in 5 year with a maturity of 5 years. One counterparty agrees to pay fixed while the other pays the cumulative increase in the inflation index. Hence in order to get a fair deal, the fixed rate is set to be the market expectation of the average inflation rate over the period, usually referred as the breakeven inflation rate.

[6]<http://www.bloomberg.com/news/articles/2016-03-17/greenspan-oil-slump-tied-to-demand-as-supply-is-building>

[7]<http://greece.greekreporter.com/2016/03/29/greece-needs-measures-worth-e5-5-billion-to-complete-bailout-review/>

**Appendix/Annexes**

1- 10Y German Bund



2- 5Y5Y Inflation swap



3- Inflation US: PCE core index



4- Crude oil

