



Bond Market Outlook

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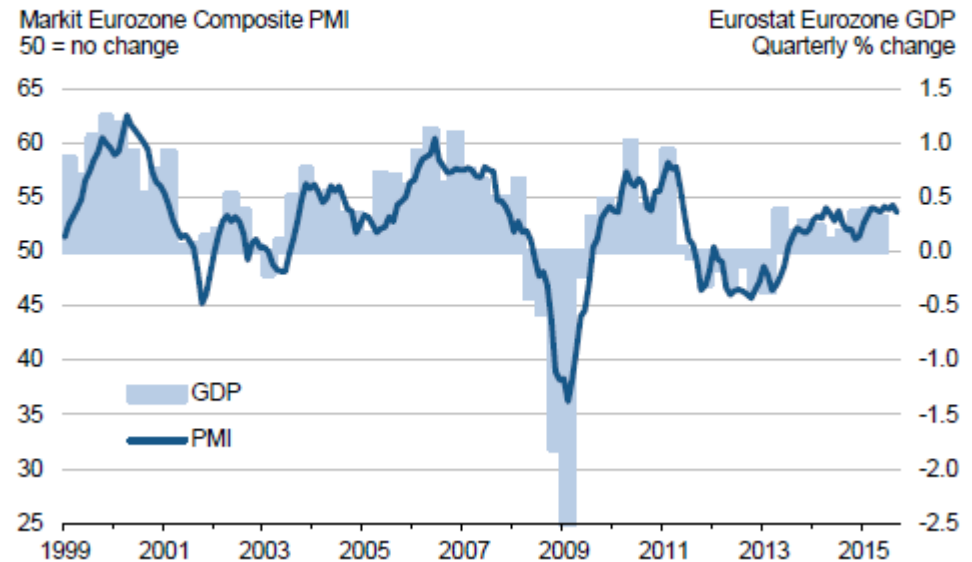
ECB BMCG meeting 13th October 2015

Eurozone economic data

Eurozone economic data has been relatively stable ...

- Eurozone PMI: data collected 11-25 September
- 18 September: U.S. EPA issued Notice of Violation of the Clean Air Act to Volkswagen Group
- Other headwinds: biotech, Brazil, Glencore
- Germany: volatility in August real data, consumer remains solid
- Overall moderate European data – Euro Rates most likely to be driven by events abroad?

Markit Eurozone PMI and GDP



Source: Markit, Eurostat

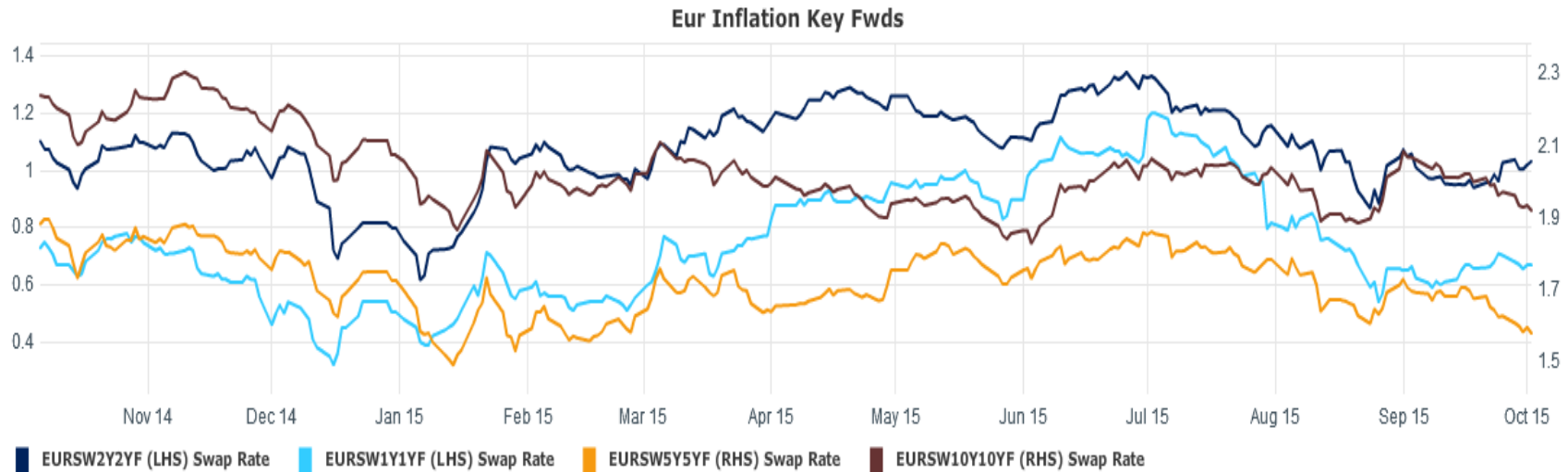
Eurozone economic data: Inflation

... Inflation still on the weak side

- Euro Area inflation back into negative territory in September, but core inflation was unchanged
- At non-core level, energy inflation fell to -8.9% y/y from -7.2% y/y previously.
- Food inflation led up by unprocessed food prices +2.7% y/y from +2.4% y/y.
- Core level developments were mixed. Too early to draw conclusions from data?

	Average Market HICP YoY	ECB September 2015 Staff projections	Market vs ECB	Barclays Trading Desk Forecast
2015	0.05%	0.10%	-0.05%	0.06%
2016	0.57%	1.10%	-0.53%	0.79%
2017	0.82%	1.70%	-0.88%	1.00%

Source: Barclays Research, Barclays Trading (Market Data from 5 Oct 2015)



U.S. Economics

U.S. Economic data points to slow-down – weakness in data not weather related

- Slowdown not related to bad weather
- Cyclical slowdown rather than the start of a recession
- Impact of US economic slow-down: currency channel is likely channel of transmission
- Focus on Yellen comments from Sep FOMC and recent Fed speakers
- Fed hike still to be delivered in 2015?

Citi Economic Surprise Index (US)



Source: Bloomberg, Citi (data from 5 October 2015)

U.S. Economic labour data: weakening momentum sufficient to prevent hike?

- Weakening momentum in September Employment report
- Unemployment rate unrepresentative of labour market dynamics in an environment of falling participation rate?
- Participation rate at 62.4% in September, a new low for the cycle

Unemployment rate (U3)



Average weekly hours of all employees

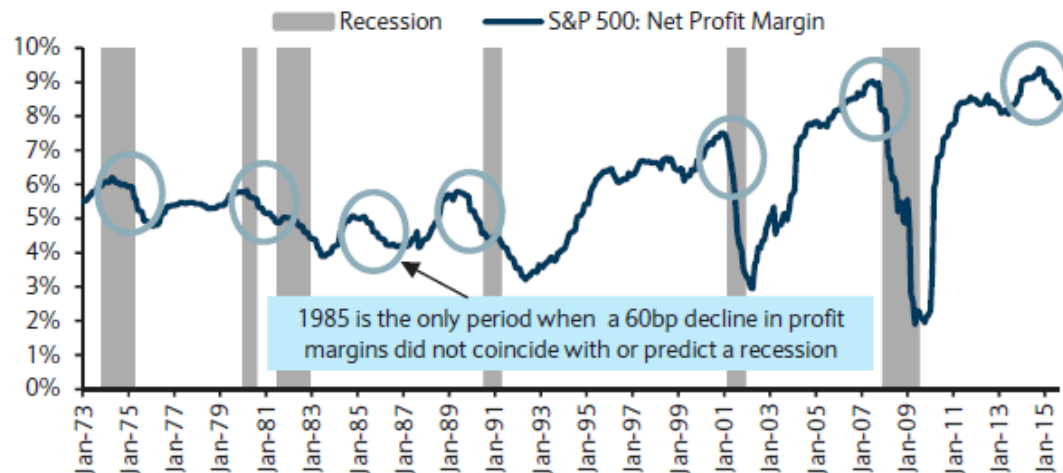


Source: BLS, Barclays Research

U.S. Equities

U.S. Equity profit margins – predicting a recession?

- U.S equity profit margins have declined 60bp from recent highs
- Declines of this magnitude are rare when the economy is not entering or in a recession (has only happened once previously in last 40 years, in 1985).



**“Profit margins – predicting a recession?
We do not expect a recession but we do
recommend increasing quality by focusing
on companies with high profit margins”**

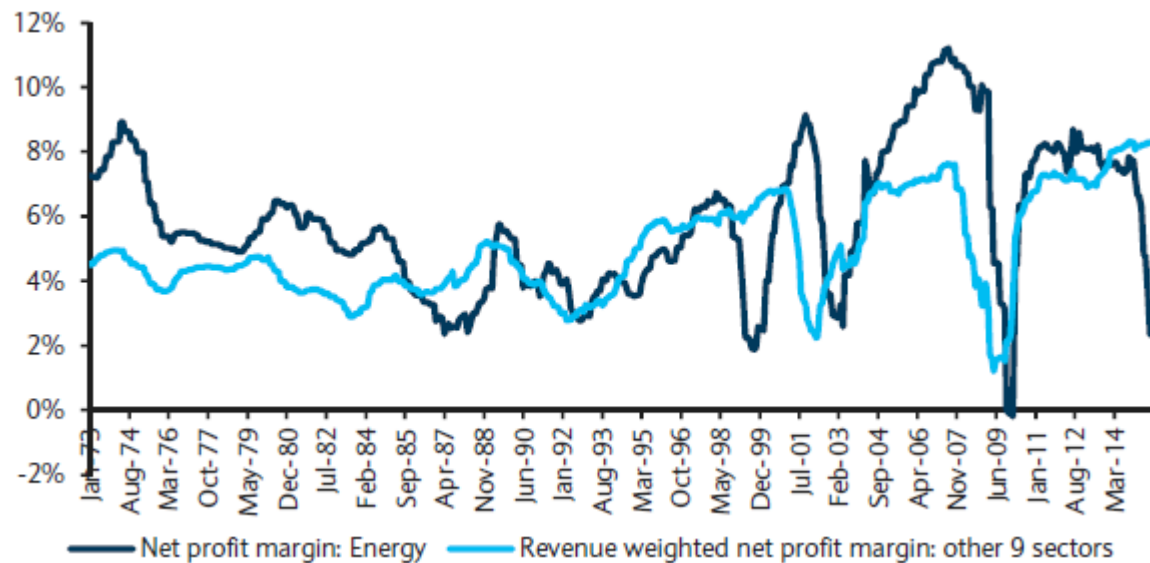
Jonathan Glionna
5 Oct 2015 | U.S. Equity Strategy: Profit margins –
predicting a recession.

Source: Thomson Reuters, Barclays Research

U.S. Equities

U.S. Equity profit margins – predicting a recession?

- In 1985, profit margins in the energy sector collapsed as oil prices began a 60% plunge

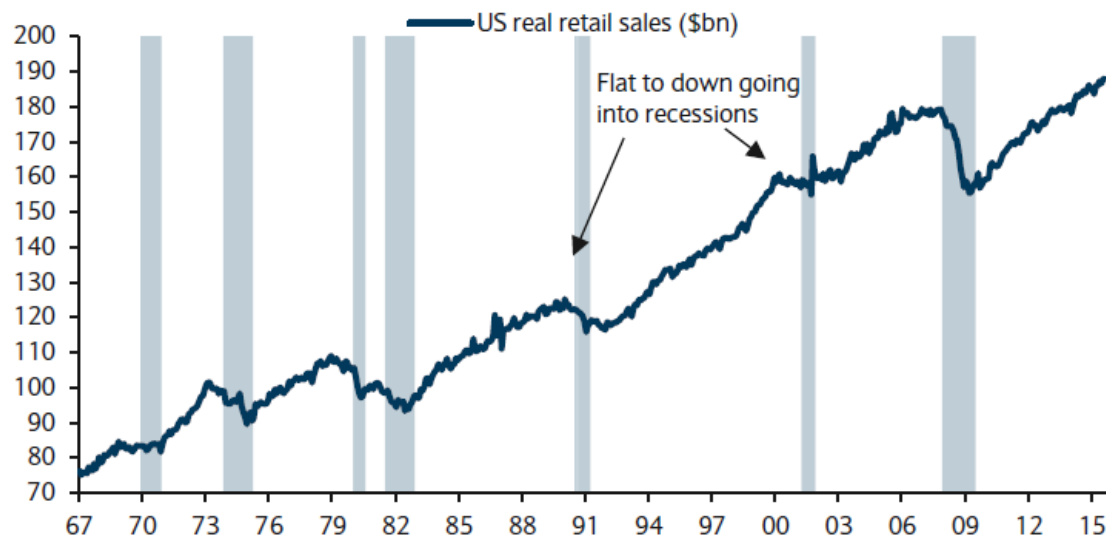


Source: Thomson Reuters, Barclays Research

Retail Sales resilience

- Solid consumption patterns suggest recession unlikely, even in an environment where a near term manufacturing rebound is not expected
- Risk factor: manufacturing data points to high inventory levels – risk of slowdown driven by destocking?

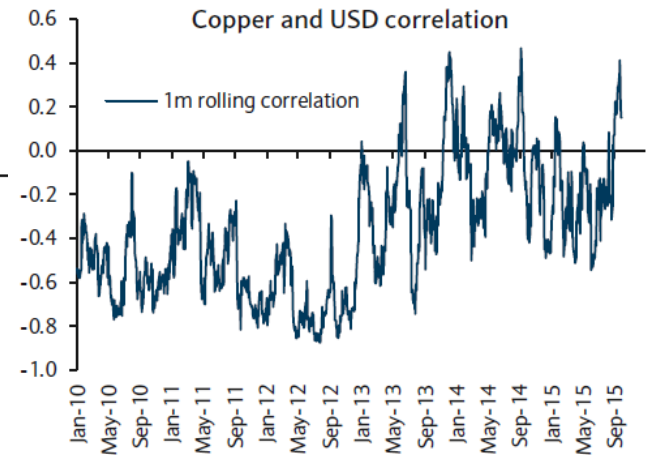
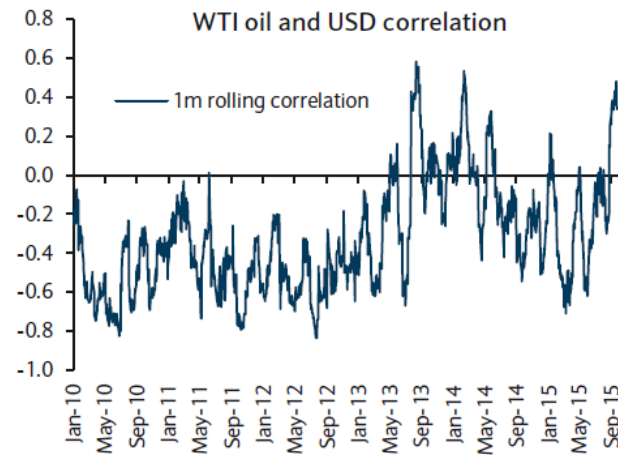
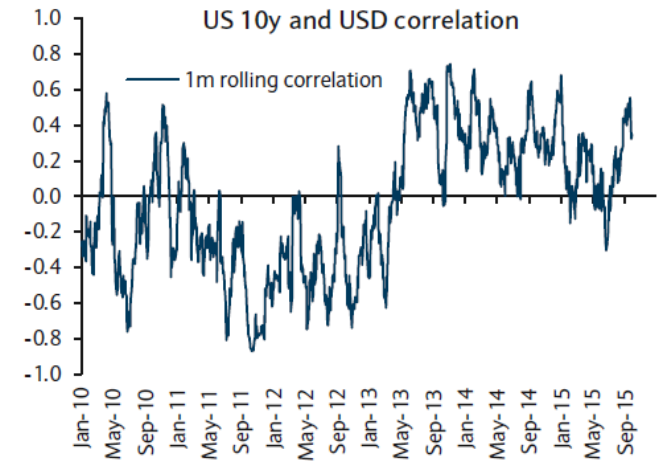
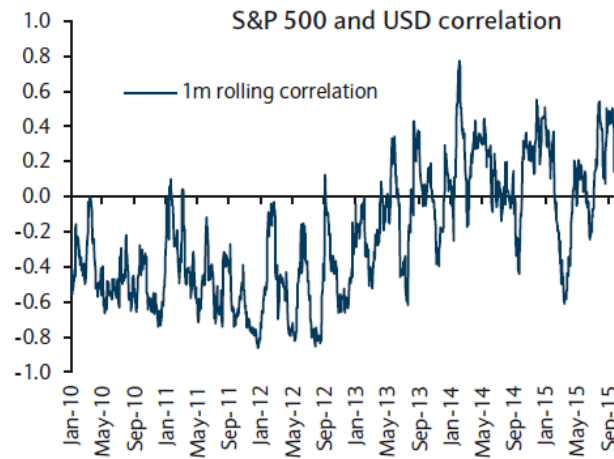
Real retail sales have weakened ahead of every recession, but have continued to grow recently



Source: St. Louis Fed, Haver Analytics, Barclays Research (5 October 2015)

Euro Rates focus on US economic data?

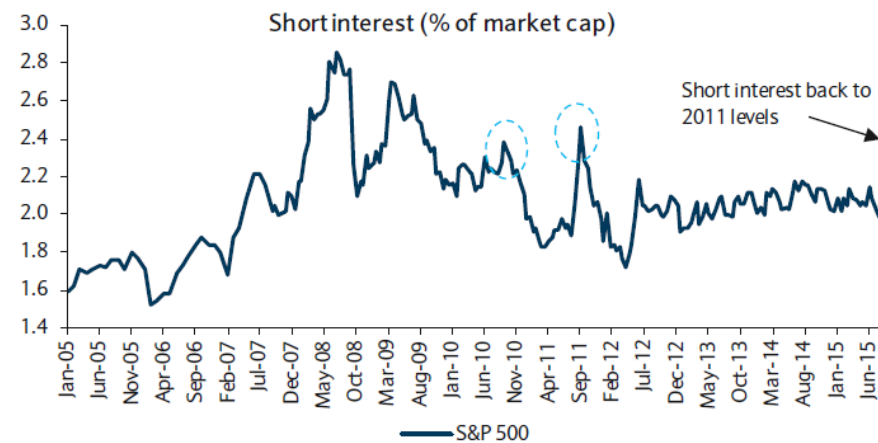
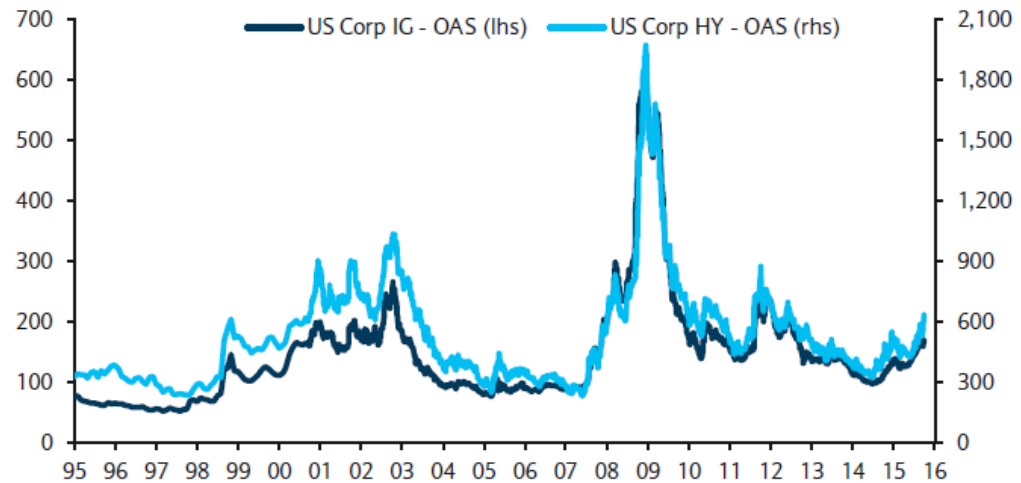
- Increasing correlations between USD and S&P, US 10yr yield, WTI oil, copper.
- WTI oil vs USD correlation turning positive in recent months
- Positive correlations vs USD suggest the strength of the US economy is seen as fundamental in the global economic recovery.



Source: Bloomberg, Barclays Research (5 October 2015)

Investor sentiment reflected in positioning, valuations?

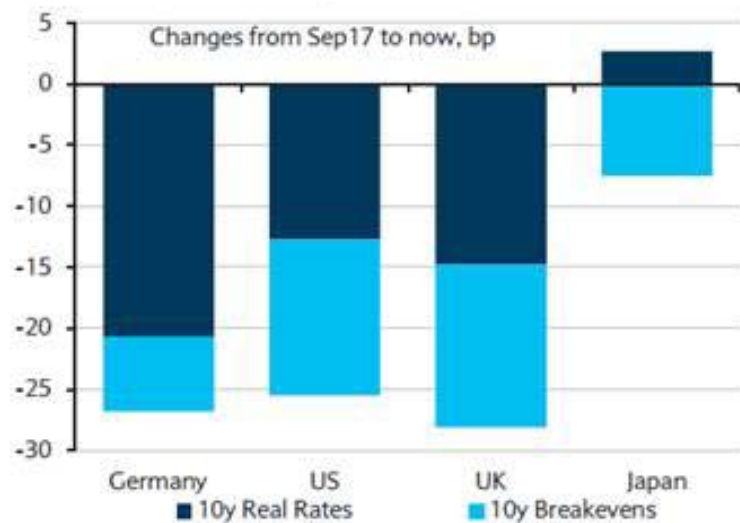
- Credit risk premia pricing in recession risk?
- US Investment Grade and High Yield spreads above peak of levels seen during 1998 EM crises.
- Short interest in S&P 500 has risen to multi-year highs
- Risk exposures generally defensive



Source: Factset, Barclays Research (5 October 2015)

Developed Market bond yield changes

10y yields have declined across sovereign markets since the September FOMC meeting

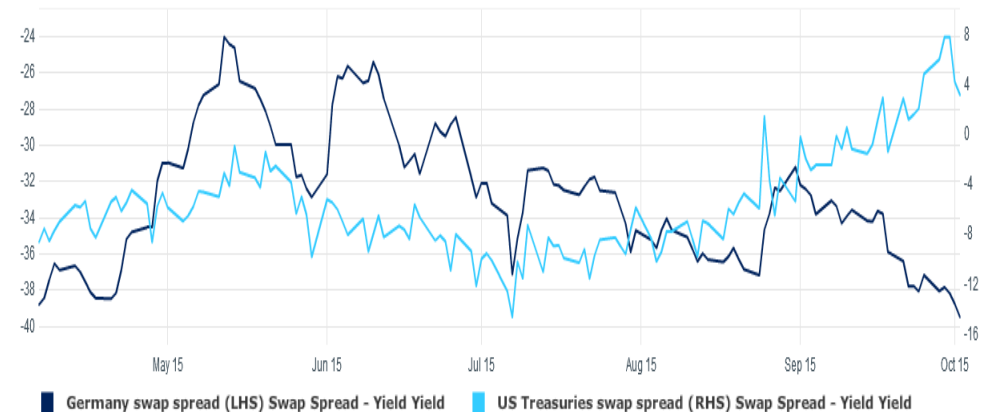


Source: Bloomberg, Barclays Research (market data based on 2 Oct 2015)

Euro Rates

Relative Value update

- Swap spread divergence between EUR and USD markets.
- Rate rally larger in Europe despite lower (yield) starting point - additional QE priced in in EUR?
- USD spreads driven tighter by VA hedging, swapped issuance, reversal of reserves accumulation?
 - Unlike the run up to “QE1”, 10s30s curve in EUR has steepened as more easing has been priced in.
- “Buy the rumour and sell the fact” reaction to asset purchases, more akin to reactions to US/UK asset purchase programs
- Credibility of policy response or “duration fatigue”?

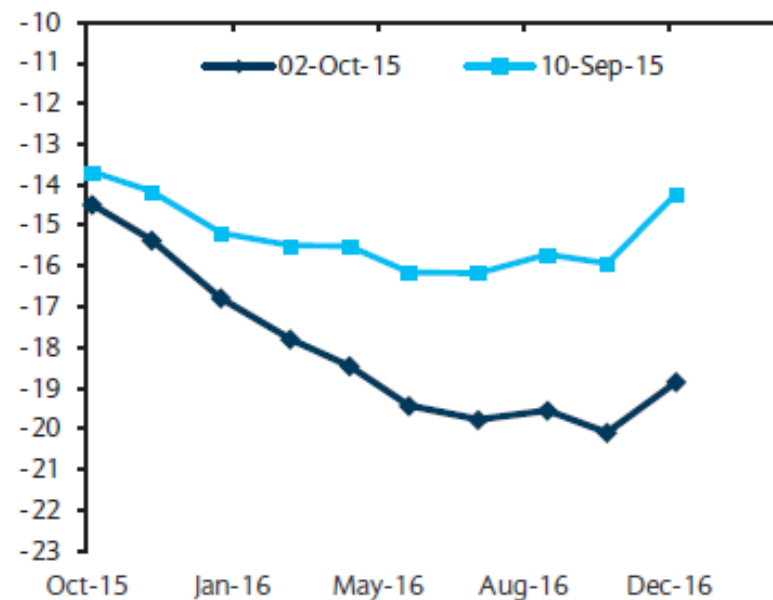


Source: Barclays Live Chart

Forward Eonia Rates evolution

- A non-negligible chance of a deposit rate cut also priced in
- Not straightforward to extract the likelihood of a deposit rate cut from market rates

ECB-dated Eonia forward curve (bp): sharp inversion since mid-September

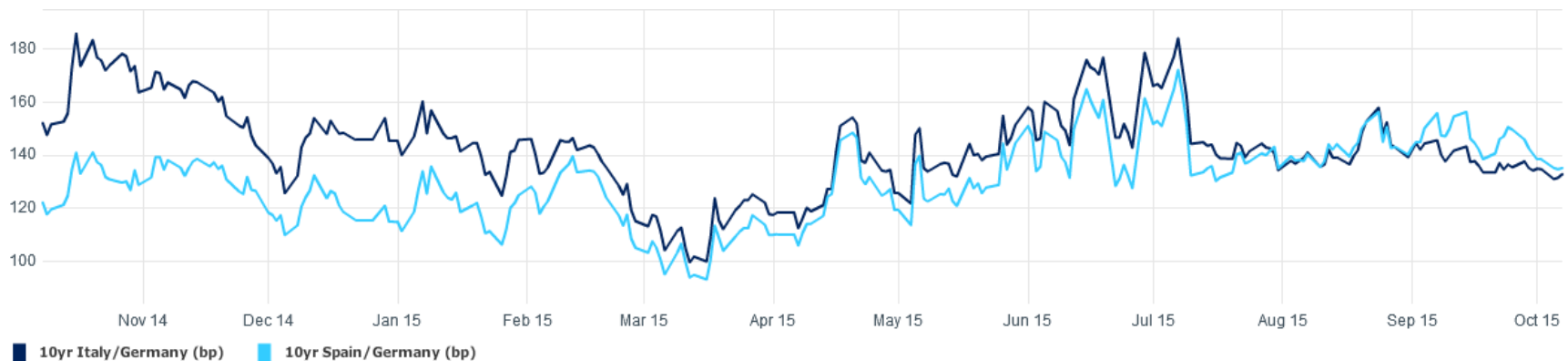
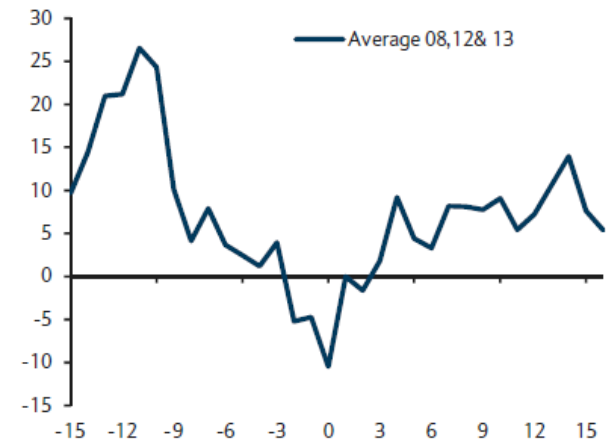


Source: Barclays Research

Periphery: seasonal factors are supportive, Iberia elections focus

- Catalonia regional elections and Portugal parliamentary elections behind, Spanish parliamentary elections ahead
- Moderate European data likely to support spread tightening. More ECB easing by year end?
- Spain cash flow profile supportive in October
- Spread tightening risk more compelling than outright duration views

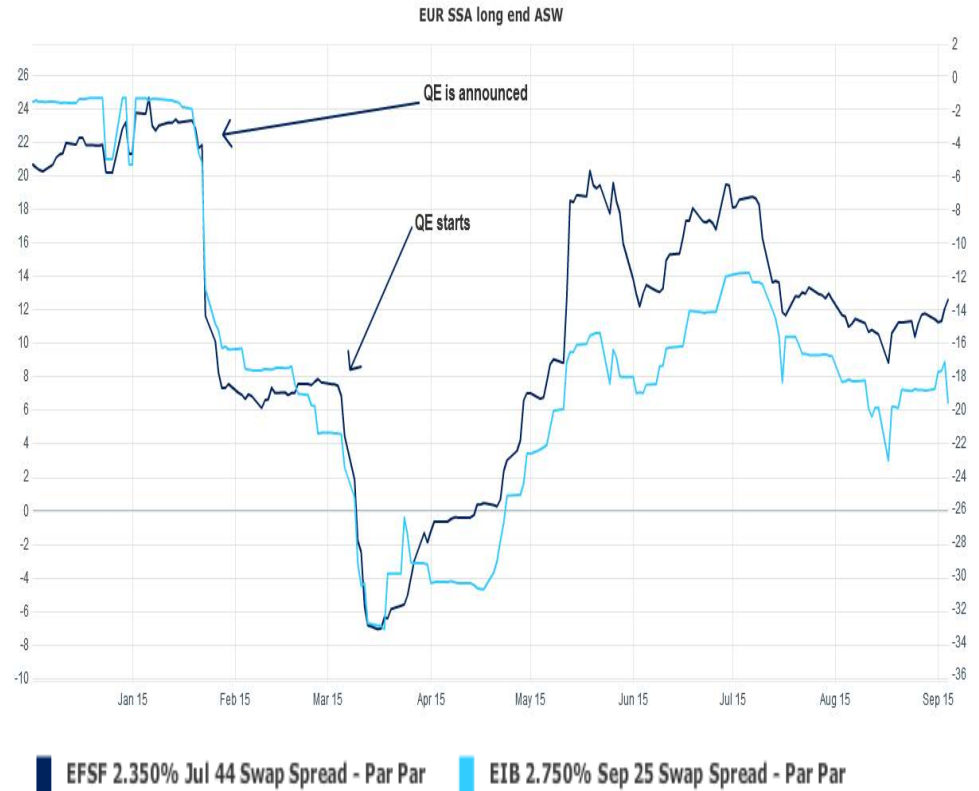
Spain 10y yield spread moves vs Italy around 31 October
Coupon/redemptions payments (bp)



Source: Barclays Research, Barclays Live

SSA update

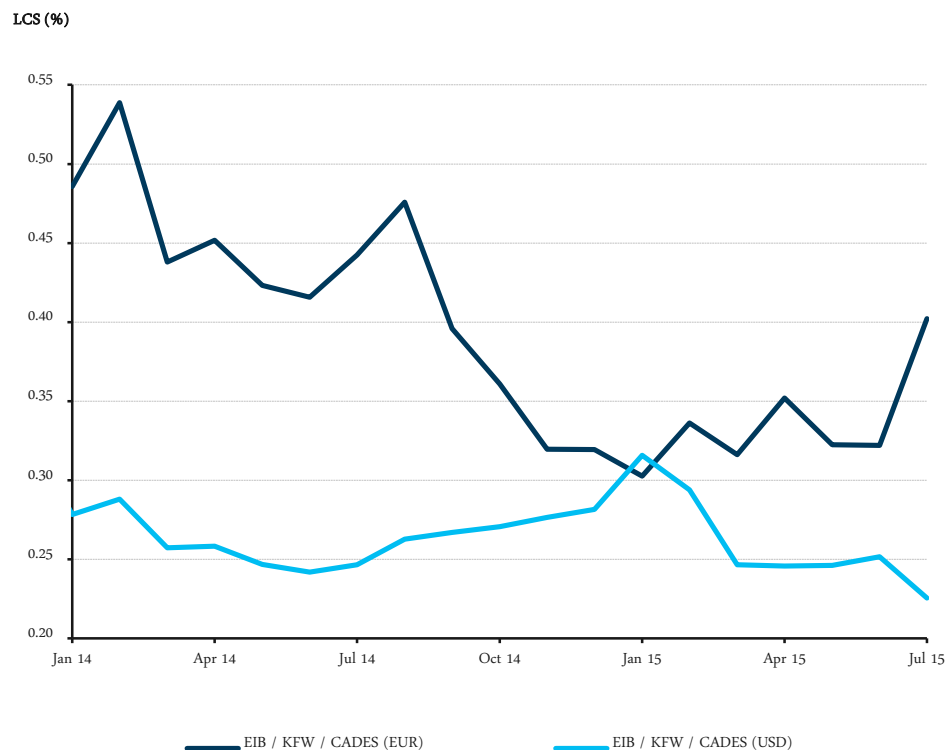
- Long end (10yr+ sector) of EUR SSA curve is now back to pre-QE levels
- On a relative basis, short end valuation volatility has been more muted



Source: Barclays Live Chart

SSA liquidity update

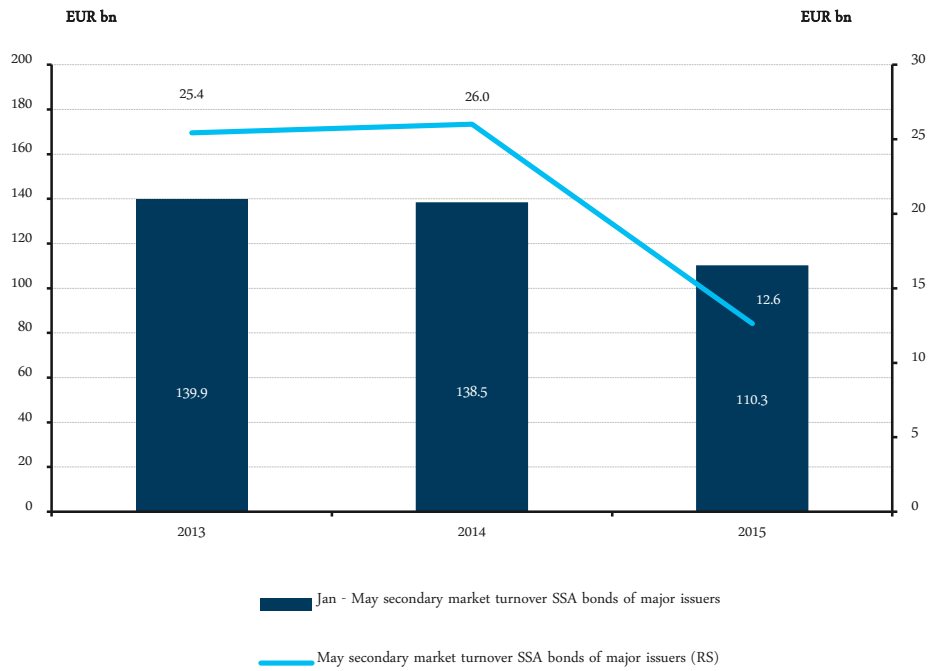
- Bid/offer spreads have widened in EUR SSA market
- Liquidity Cost Scores (LCS) increasing in EUR SSA market
- Bid/offer widening trend not apparent in USD SSA market
- Liquidity Cost Scores (LCS): cost of a standard institutional-size, round-trip transaction, expressed as a percentage of the bond's price



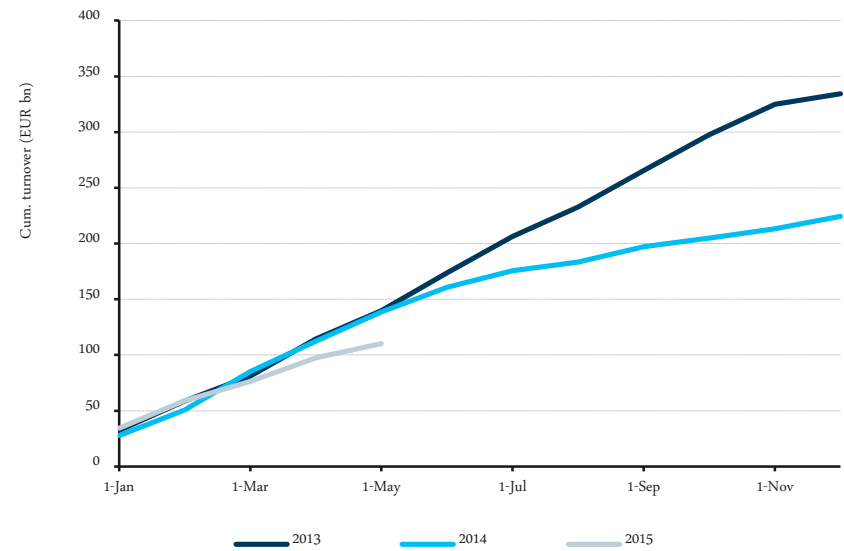
Source: Barclays Research

Reduction in turnover in EUR SSA markets

Development of the turnover in EUR SSA markets



Annual cumulative total SSA turnover (2013-15 YTD)

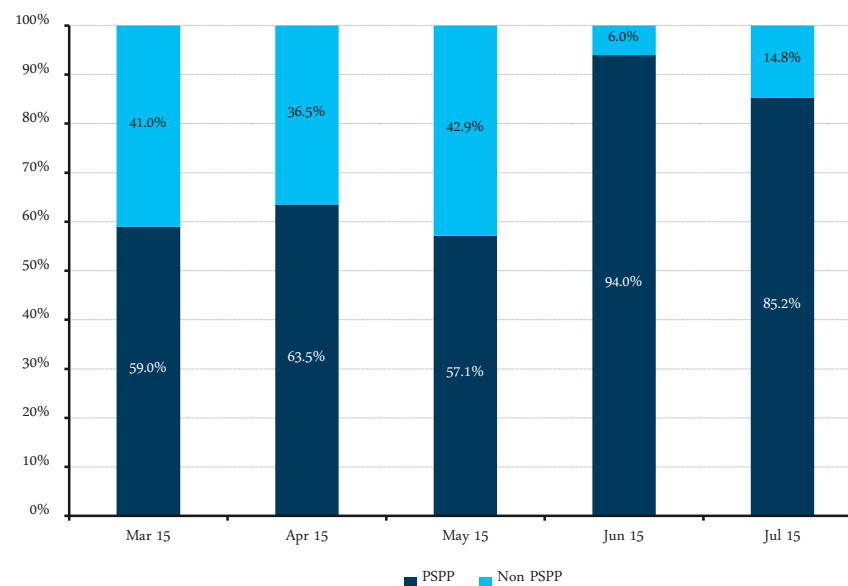


Source: Barclays Research

SSA market turnover

- PSPP is becoming the dominant player in EUR SSA turnover
- PSPP is the main source of activity not only in EUR Suprationals but also the rest of the asset class
- Some normalisation in PSPP market share after the summer spike in PSPP market share

Share of PSPP and non-PSPP activity in monthly secondary market turnover

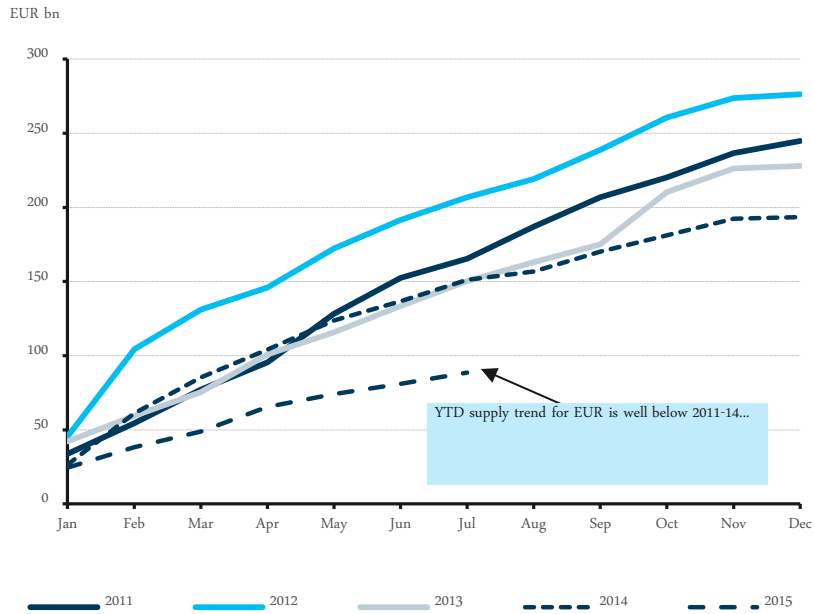


Source: Barclays Research

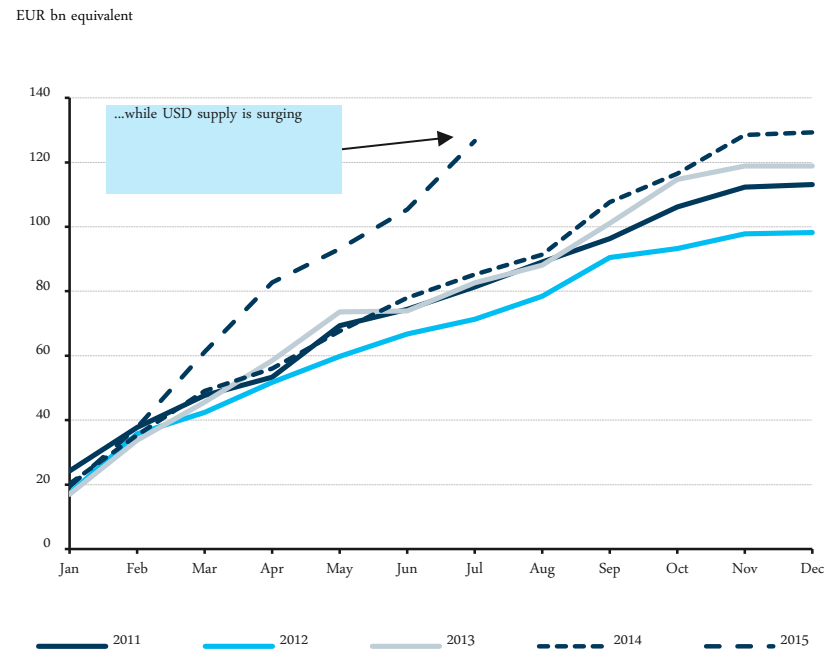
SSA Primary market activity

USD-denominated SSA issuance gained momentum in H1 2015

SSA cumulative supply trend: EUR market (2011-15 YTD)



European SSA market: Rolling 12-month shares of EUR and USD of total benchmark funding

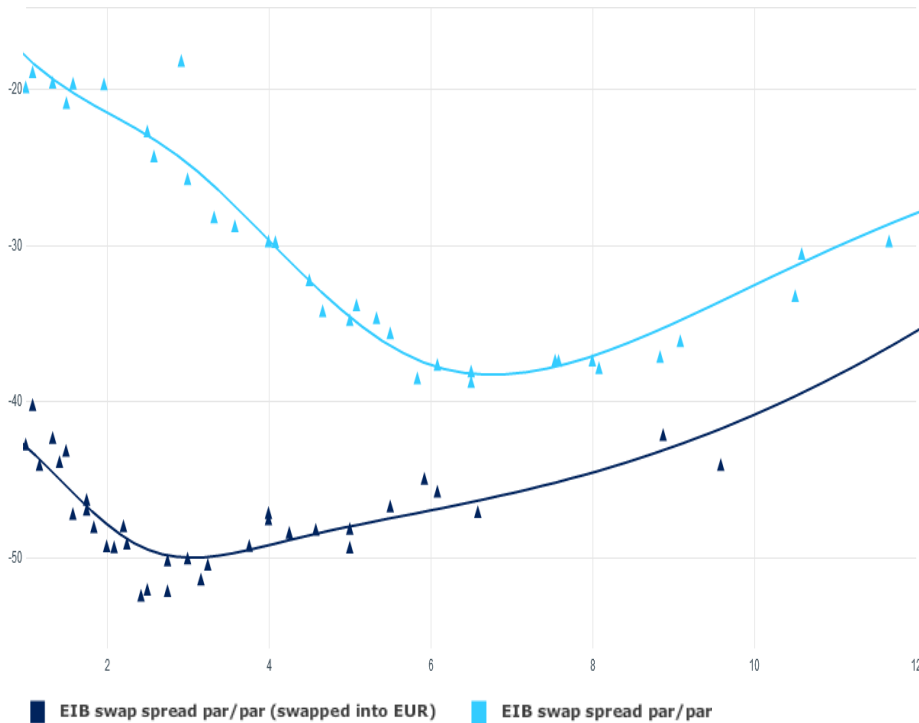


Source: Barclays Research

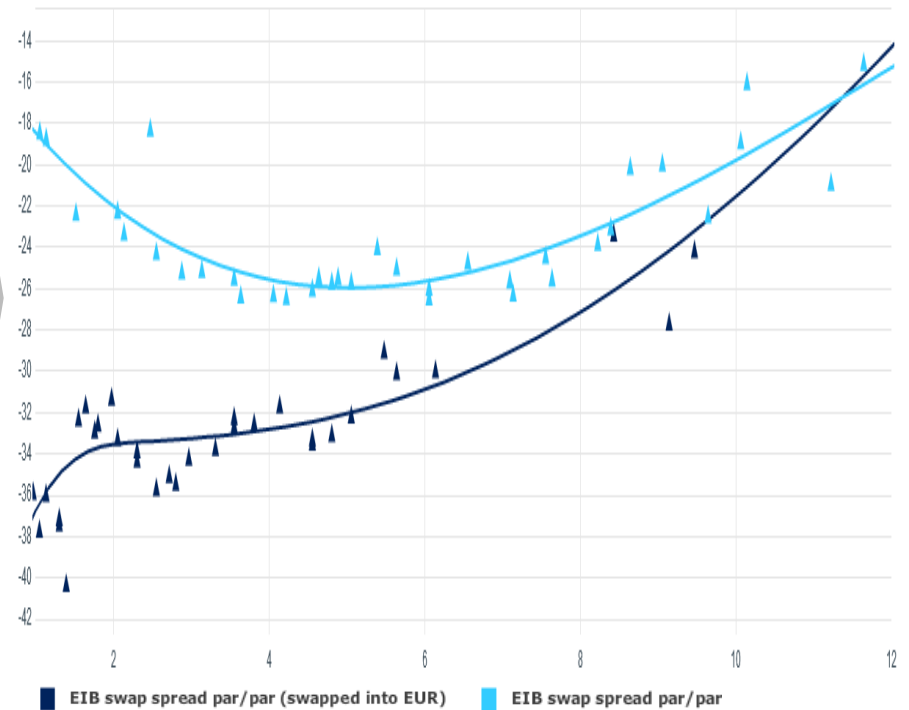
SSA Primary markets – valuations convergence

The valuations were previously very compelling for USD issuance. USD was the cheapest option for EUR based borrowers irrespective of maturity. The cross currency asset swap curves have converged materially in recent months. The choice of funding currency is now a close call.

EIB asset swap curves - 18 March 2015



EIB asset swap curves - 26 August 2015



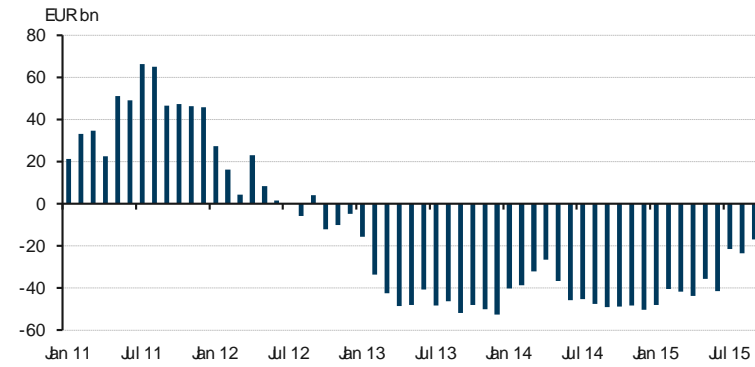
Source: Barclays Research

CBPP3

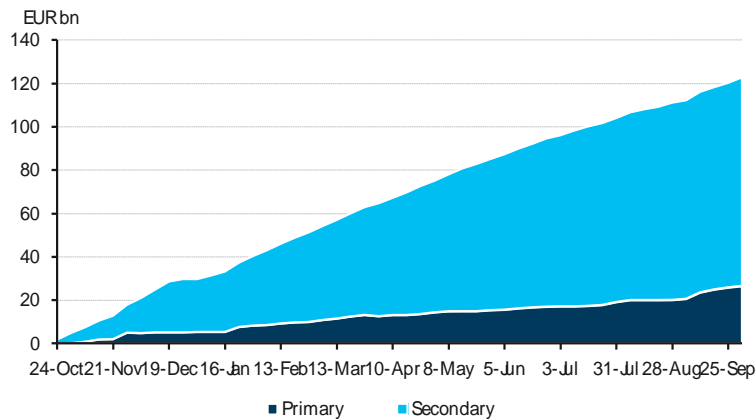
Covered Bonds

- CBs: shrinking universe even prior to CBPP3
- Primary market activity increased in September
- Secondary volumes reduced as CBPP3 activity in primary market increased

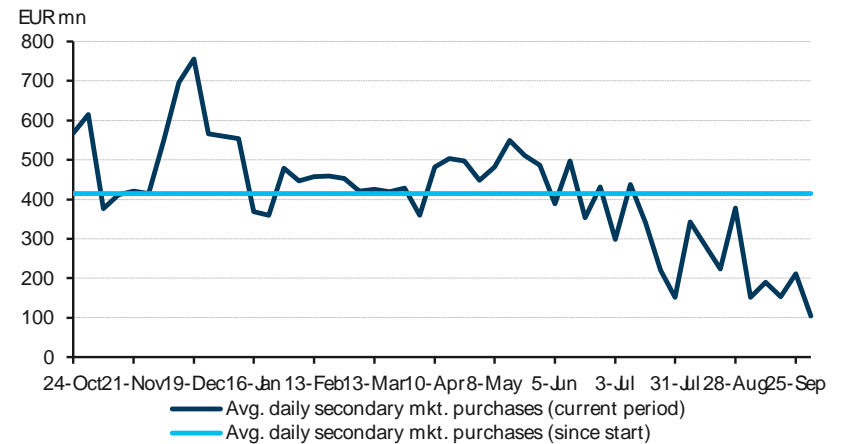
12M rolling net supply of euro area EUR denominated covered bonds



Cumulative CBPP3 purchases including estimated breakdown primary / secondary



Average daily secondary purchases: current period vs. average since start

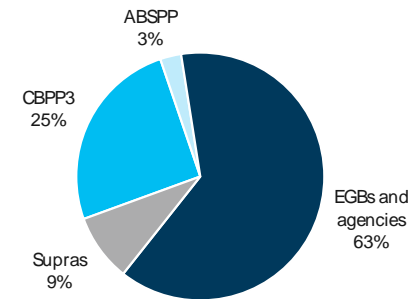


Source: ECB, Barclays Research

PSPP activity

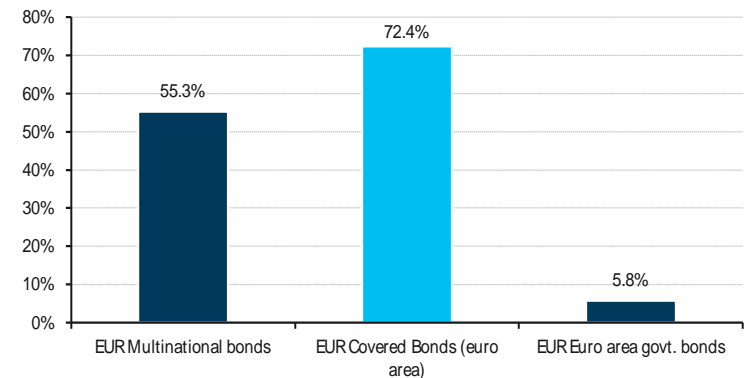
- Average monthly turnover of €11bn in CBs is a fraction of turnover in EGBs (€750bn) and recognised SSAs (€20bn)*
- ... compared to EGBs and SSAs, the CB market is much more fragmented
- ... substitution of primary versus secondary purchases has exacerbated price volatility
- Increasing new issue price concessions (more than 20bp at times)

ECB's QE portfolio (30 September 2015)



QE Portfolio (Sep-15):
€477.3bn

Monthly QE activity in % of monthly turnover*



Note: *Since start of the respective programs as of Sep. 2015. Source for all charts: ECB, TRAXX, Barclays Research

Source: ECB, Barclays Research

Discussion points – reverse auctions for PSPP purchases

1. Potential to enhance market functioning
2. Low initial auction sizes may inhibit effectiveness
3. Lack of transparency in reverse auction process cited as a concern
4. Reverse auctions for CBs also?

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