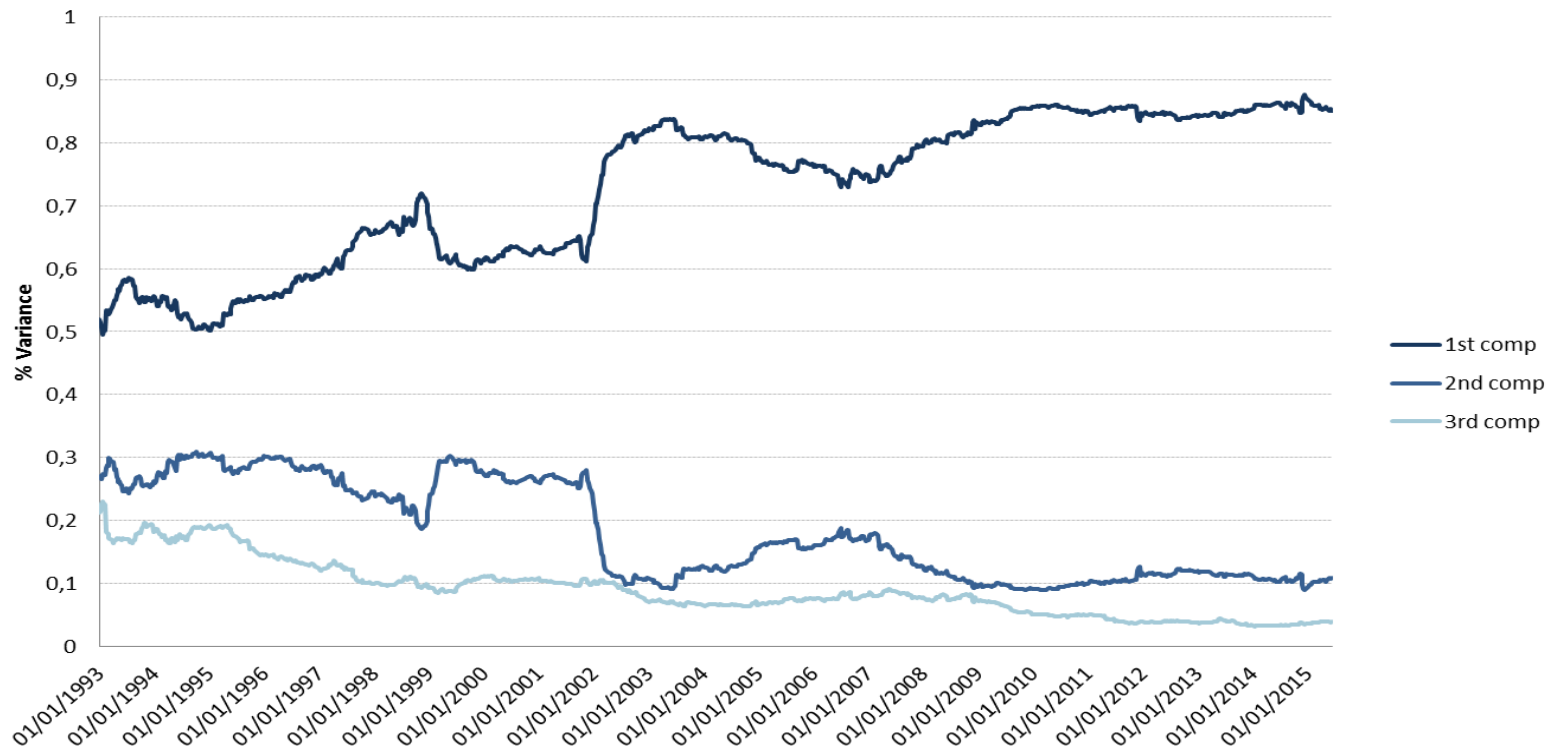


Implications of a Shift to “Normal Mode”

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ECB, 23 June 2015

Principal Component Analysis
Variance explained by each of the 3 principal components

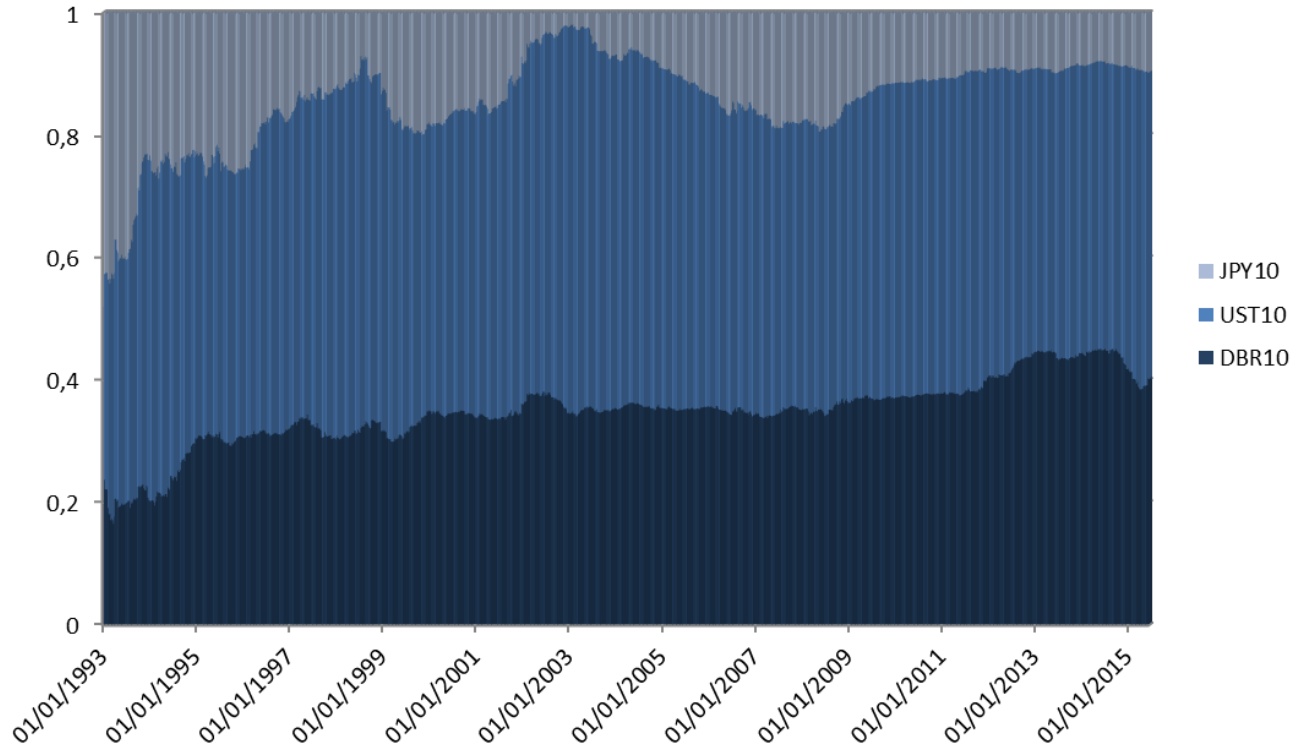


- 85 % of core markets variance is explained by the 1st common factor since 2009.
- This proportion has increased over time as capital markets globalised.

Common global factor dominates

Dominant Factor: Euro and US Yields

1st factor 3 yrs rolling

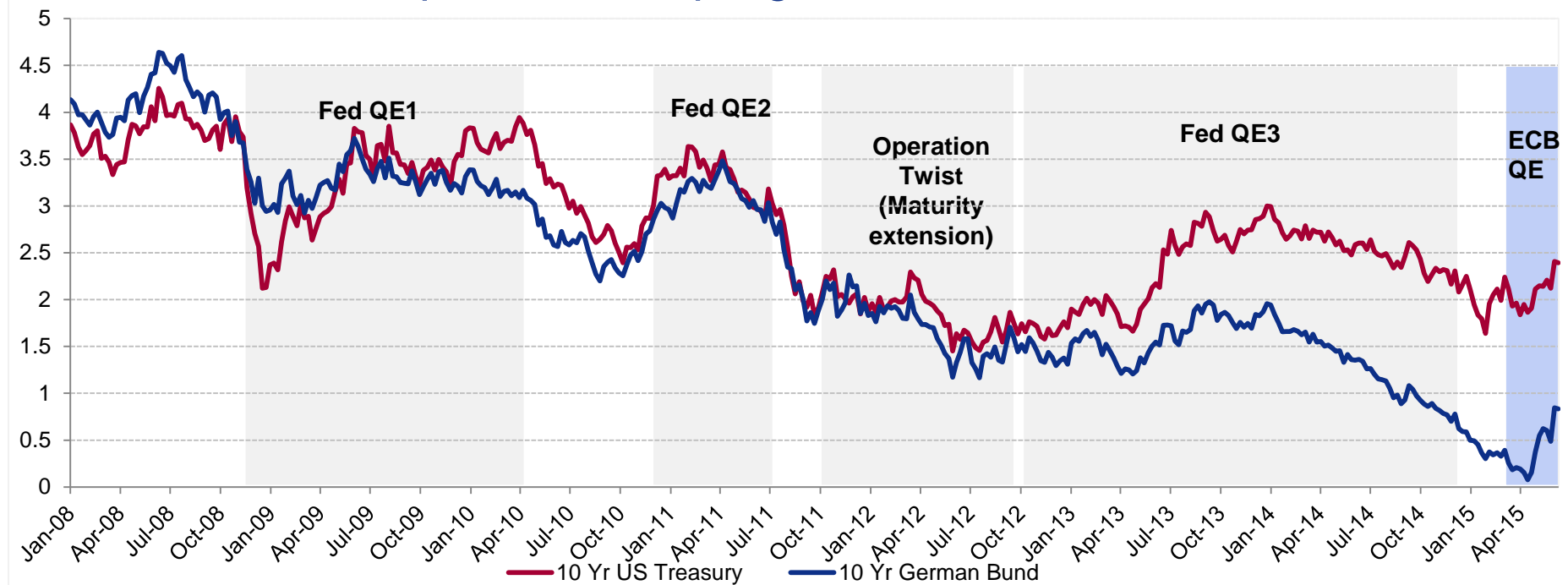


- The 1st common factor is mainly composed by the US and Euro Rates.
- Japanese market weight decreased over time as looks more and more independent over time. That means that Japanese rates moves are more country specific compared to US and Euro markets.

▶ Eurozone yields strongly influenced by US yields ... and vice versa

*The 2nd and 3rd factors explain the last 15% of market volatility. Composition changed over time, as of today it reflects an opposition between EURO and USD rates, and to a smaller extent, the Japanese rates variance.

Bond market impacts of QE programs

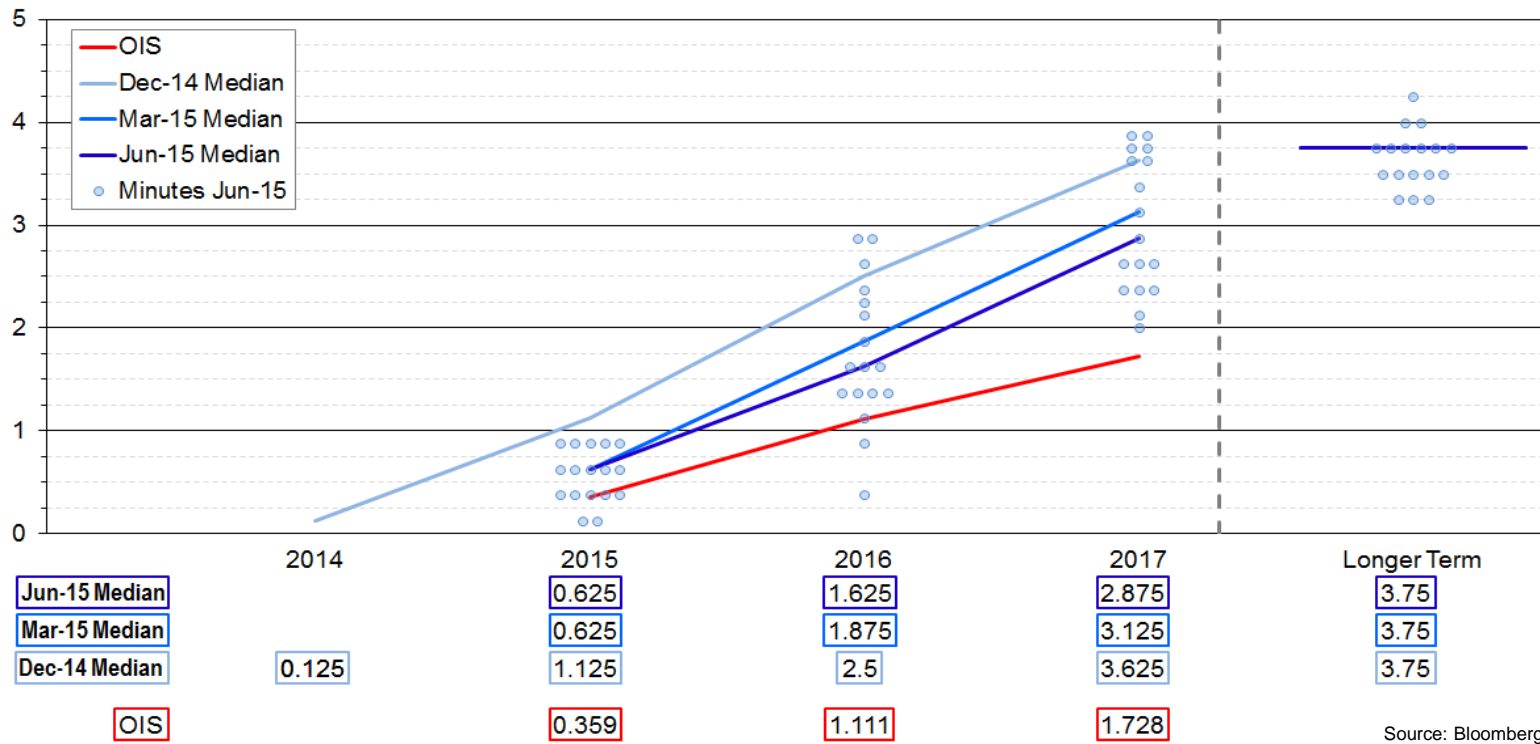


- Investors anticipated QE early: decreasing yields before each program started
- Fed QE pulled down Euro rates in sync: already a low starting point for ECB QE.
- Yields increased within program duration as investors' focus shifted to improved economic outlook
- The same scenario repeats itself in each programs.

Markets anticipate Central Bank moves

Note: QE 1 included USD 1,250bn Agency MBS, USD 200bn MBS and USD 300bn Treasuries. QE 2 comprised USD 600bn Treasuries. Operation Twist raised Treasury holdings with 6-30y maturity by USD 400bn financed by sales of maturities below 3y. QE 3 added Treasuries USD 45bn and Agency MBS USD 40bn per month.

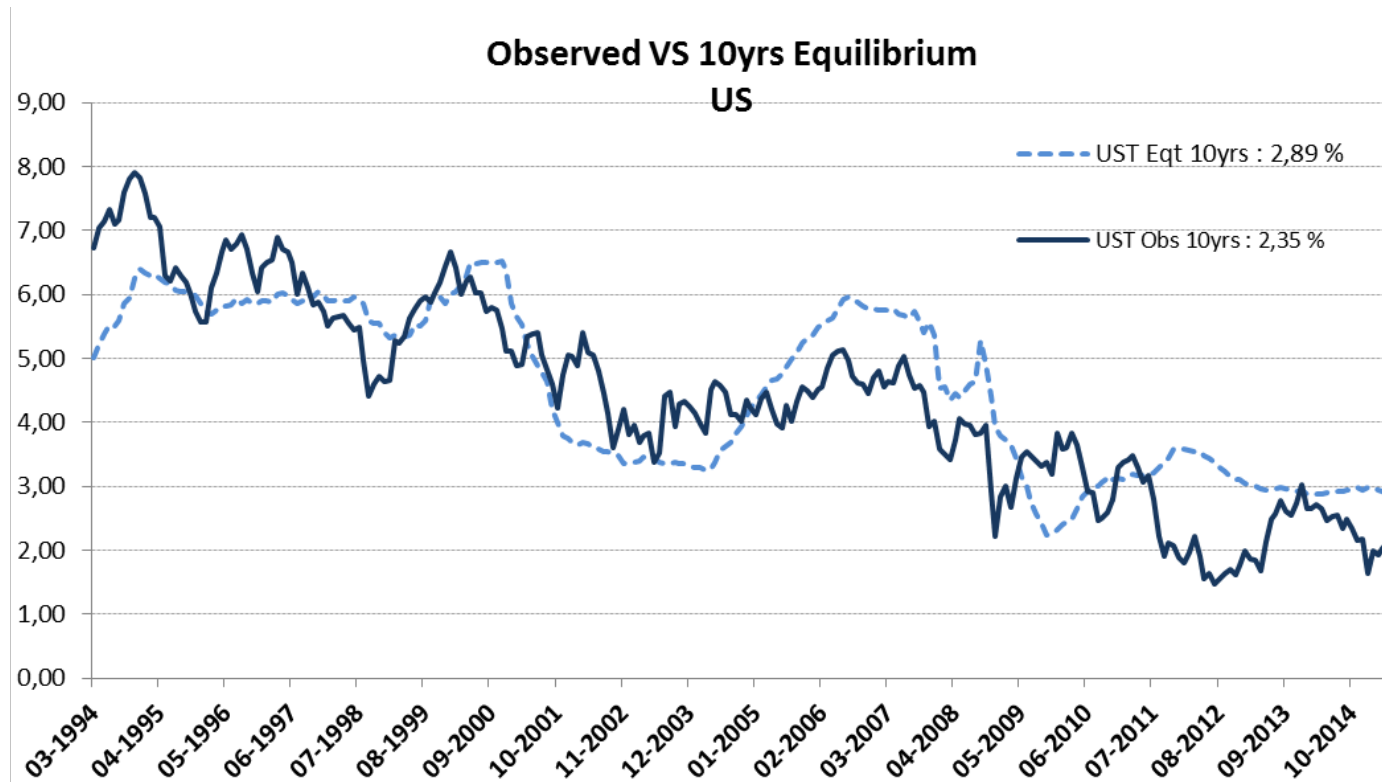
Taper Tantrum – Lessons Learned for the FED



Source: Bloomberg

- The Fed intends to guide the market to **avoid another taper tantrum**.
- But markets still see hikes more gradual and limited than FOMC projections.
- So far, except for the taper tantrum, investors were right and gained confidence

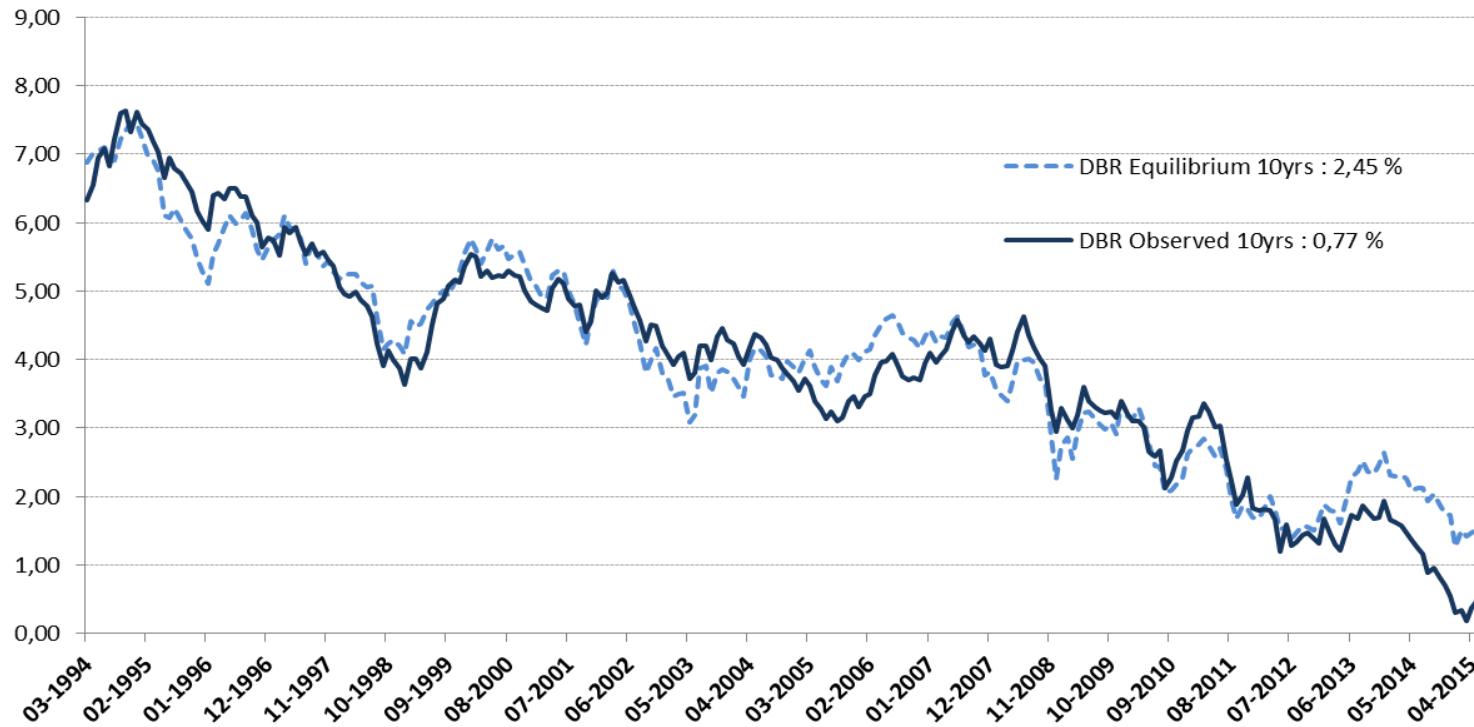
Fed is guiding markets but investors don't fully follow



- The estimated fair value of 10 years US rates is 2,89% as of 15th of June.
- Based on the assumption that markets revert to equilibrium levels, rates should converge toward fair value.

▶ US rates are artificially maintained at very low levels

Observed VS 10yrs Equilibrium
Germany



- We estimate fair value of 10 years German Rates is at 2,45 %
- According to the historically high sensitivity to US rates, german rates should increase by 65 bps as a response to a 100bps US 10 yrs rate hike.

▶ Euro rates are even more depressed : potentially sharp upside

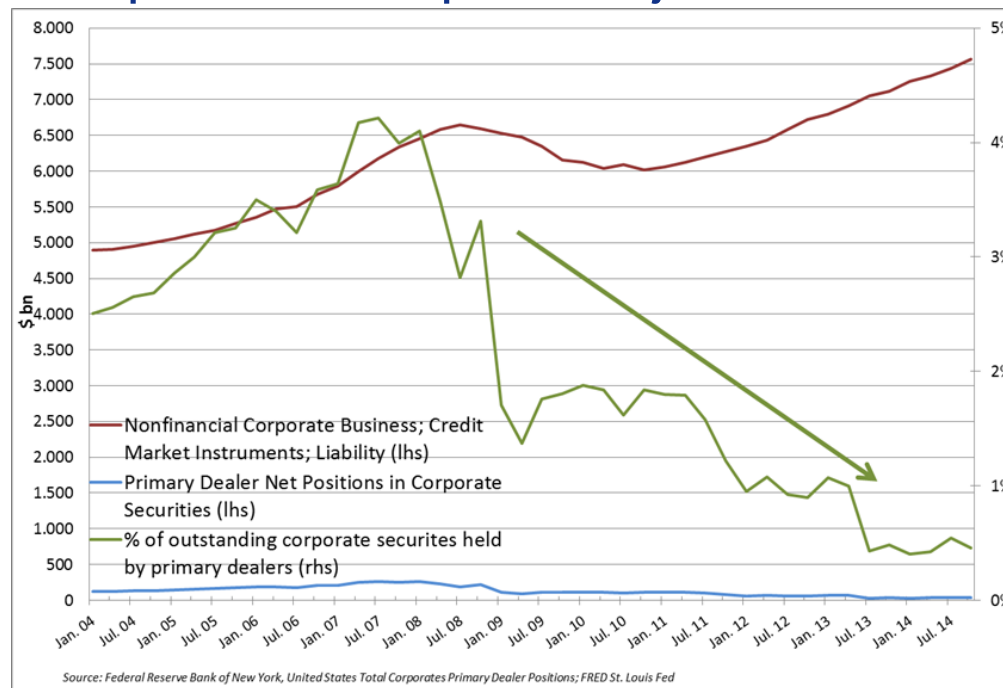
The Insurance Investor Perspective

- Many long-only investors would be negatively affected by a disruptive QE exit. On a relative basis, insurers are benefitting from higher reinvestment yields but suffer from sharp reversals.
- Risk of volatile USD corporate markets as some investors entered positions. Unhedged USD exposure by Insurers and Pension funds could lead to negative surprises.
- Attractive carry trade positioning should also affect funding currencies such as Euro and Eurozone markets.
- Low liquidity and flows are major factors determining the impact of a monetary policy reversal. How a QE exit affects liquidity is unknown territory for markets. Never before in history have we experienced 10+tn QE worldwide.
- Derivatives markets will be most affected and execution periods rise based on recent experience (Greece and rising yields).
- US might be able to manage the transition well, esp. as some easing in Eurozone and Japan will cushion impact. But BOJ and ECB are still in full QE acceleration mode and exit will be more challenging.

▶ Depressed yields bear risk of sharp reversals

- **QE technicals have driven credit spreads:** Persistent inflows into Investment Grade credit created an industry-wide overweight positioning. Technicals alone have driven expectations of further spread tightening thereby rendering the asset class overvalued.
- **ECB and BoJ QE as mitigating factors:** As the Fed raised the prospect of tapering QE, the BoJ and ECB expanded or started their own QE programs. As weaker currencies have the potential to stimulate the investment cycle of most higher grade corporates, there has been limited damage to the US growth.
- **Low mortgage demand also played a role for Yield Levels and helped reduce banks' cost of funding:** Negative real 10-year Treasury yields have been driven by the Fed's QE but low net home mortgage demand suggests that the Fed might be somewhat overstating how much credit QE deserves for reducing longer-term interest rates.
- **Corporate decisions have limited QE's success:** Decisions taken by management following the recession, such as issuing debt to buy back shares, have been logical responses to the economic environment but have restrained the effectiveness of monetary policy as little capital was used to investment in the companies' operations.

Do We Need to Expect a Disruptive Adjustment ?



- **Technicals could be a drag on performance:** a reversal of the flows is likely to cause volatility, compounded by the lack of liquidity following the credit crunch as evidenced by primary dealer net positions.
- **But as leverage is slowly rising, corporates should be able to adjust to a post QE environment**
- **And, banks would benefit from higher yields:** Should rates rise, greater-than-expected deposit mix shifts and outflows could mean a bank is not as asset-sensitive as thought. Also the capital build-up and the more conservative underwriting approach developed over the last years should allow for only moderate widening.

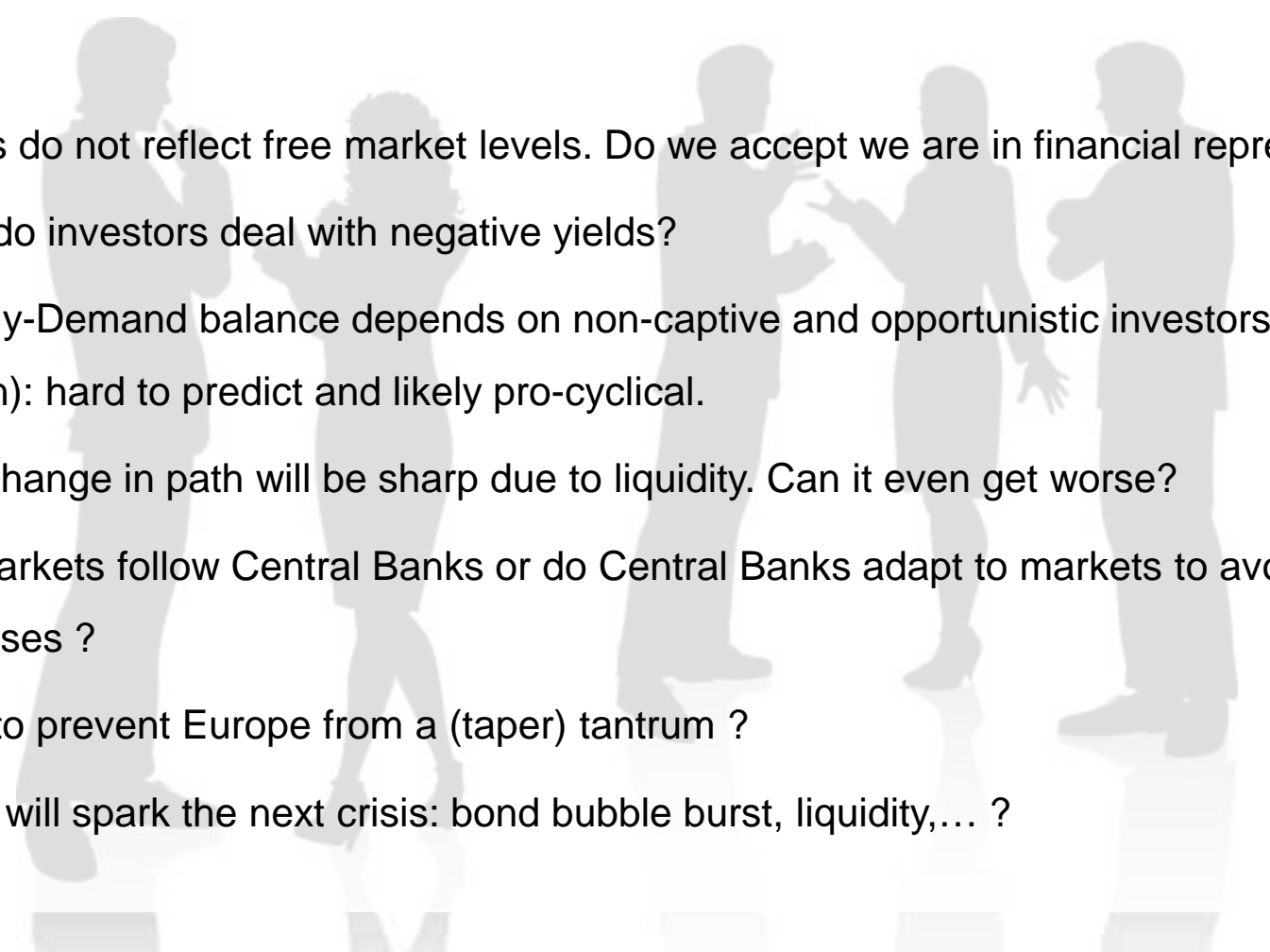
▶ Spreads should adjust but at a moderate pace

EZ Credit Spreads Most Likely Dominated by Fundamentals

- **We do not expect an adjustment comparable to 2013 Taper tantrum:** we do not see grounds for a resumption of significant spread volatility given the clear Fed communication, the stronger state of the US economy and the continuing ECB and BoJ QE.
- **Nevertheless European periphery or EM could be marginally impacted:** it is likely that non-traditional buyers of EM and peripheral credits could withdraw from further purchases in the area and chase higher yields in their native currency, i.e. USD. Despite this we think it is unlikely that we will experience a major buyers' strike as the markets will the second half of 2015 to adjust to higher yields in the US.
- **Non-European issuer base likely to disappear after Fed QE wind-down:** EM and US issuers which have taken advantage of low European yields could gradually withdraw from the market removing a positive technical factor which has counterbalanced the negative net issuance levels of European issuers, especially banks.

- Markets are still highly correlated: common global factor dominates.
- US and Eurozone easing seems to be the driving force. Japan is more distinctive.
- The Fed has learned to elevate communications as a tool for monetary policy.
- Bond markets do not reflect Fed guidance but expect rates to stay lower forever.
- Repeat of taper tantrum is unlikely as Fed wants will gently close the gap.
- A period of turbulence is to be expected due to large gap to fair value of bond yields.
- Low liquidity and trading activities are the main risks of a QE exit and may easily exacerbate any move as seen with recent market moves.
- The perspective of a QE exit would benefit to insurance investors as they need higher yielding investments. But a sharp rise would be harmful.



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- A faint, light gray background image showing the silhouettes of five people (three men and two women) standing in a circle, engaged in a discussion or meeting. They are gesturing with their hands, suggesting an active conversation.
1. Yields do not reflect free market levels. Do we accept we are in financial repression?
 2. How do investors deal with negative yields?
 3. Supply-Demand balance depends on non-captive and opportunistic investors (e.g. Japan): hard to predict and likely pro-cyclical.
 4. Any change in path will be sharp due to liquidity. Can it even get worse?
 5. Do markets follow Central Banks or do Central Banks adapt to markets to avoid surprises ?
 6. How to prevent Europe from a (taper) tantrum ?
 7. What will spark the next crisis: bond bubble burst, liquidity,... ?