

# Fixed Income in the Euro Zone

The quarterly fixed income newsletter of Allianz Global Investors



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## Editorial

Investors in the euro zone have been facing mounting macro-economic and geopolitical uncertainty over the past few months. Against this uncertain backdrop, Bund yields have returned to levels close to their record lows; surprisingly, however, this performance by the ultimate risk-free asset in the euro zone occurred without jeopardising other bond asset classes. Since the beginning of the year, corporate bonds and sovereign debt of peripheral countries have outperformed core euro zone government bonds. To us, this phenomenon is proof of a greater degree of maturity in the market, where investors are now focusing on assessing specific risks as part of a more discriminating approach, following months of alternating between “risk on” and “risk off” modes. This is undoubtedly good news for active investment approaches.

The US Federal Reserve (Fed) and the European Central Bank (ECB) are increasingly “behind the curve” in terms of monetary policy; however, this term does not describe the same reality depending on whether you approach it from a US or European standpoint.

The Fed, which is faithful to its remit, and is acting in accordance with its forward guidance, is not expected to raise its rates before mid-2015. Between now and then, the expected catch-up in terms of economic activity, following the disruption caused by the dreadful weather in the first few months of the year, is expected to result in high quarterly growth figures in the second half... which is when things will begin to get serious. Convincing markets that Fed Funds rates will increase in the distant future when growth is weak is one thing, but convincing them against a backdrop of accelerating economic activity is quite another. We do not doubt the Fed’s credibility; however, as it gradually falls further behind in normalising interest rates, as announced, it is likely that risk premiums will begin to appear on the short-end of the US yield curve.

The ECB is also “behind the curve” in its own way, but in an opposite direction to the Fed. Following the release of a consumer price inflation figure of 0.5%, the downward inflation trend in the euro zone continues to surprise the market, and is perilously close to deflationary levels. The ECB must take action to deal with this risk, and would not be fulfilling its price stability remit if it remained inactive. QE\* or not QE? The ECB is facing an unprecedented situation and must act in an innovative way!

\*QE: The term “quantitative easing” refers to a kind of “non-conventional” monetary policy that Central Banks may apply in exceptional circumstances, such as major economic and financial downturns.

# Key Macro Trends

Our base case still remains that further weakness in Emerging Markets will not derail the positive growth path in the developed markets. Purchasing Managers' Indexes (PMI) and sentiment indicators signal continued economic expansion in both the US and Europe.

## US

The Fed has changed the nature of its forward guidance from quantitative to more qualitative. It will be based on a variety of information like labor market conditions, inflation pressure indicators and financial data. The Fed's message was more hawkish than anticipated. The GDP (Gross Domestic Product) forecasts have been revised down only slightly, but forecasts for the Fed funds rates have been revised higher. In addition, Fed Governor Yellen hinted that the first rate hike could happen 6 months after the end of tapering (meaning March 2015).

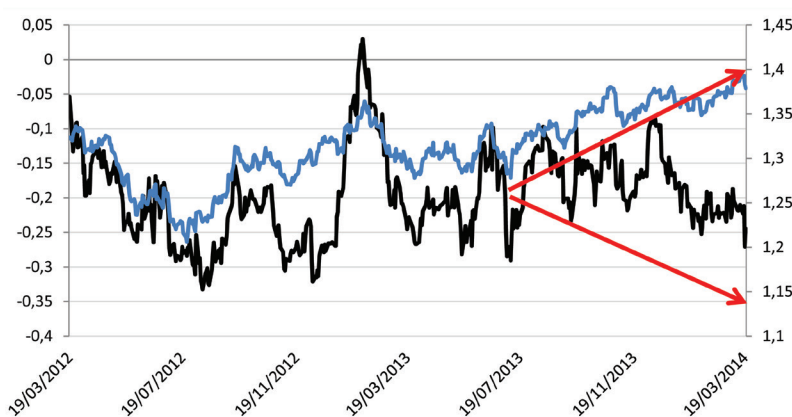
We believe that in coming weeks the headwinds caused by a particularly cold winter combined with the negative effect of seasonal adjustments will gradually disappear. This will increase the possibility of positive surprises in upcoming macro data. Following the Federal Open Market Committee (FOMC) meeting, the reaction of the financial markets was rather muted, increasing a risk of underestimation of the resoluteness of the Fed.

## Europe

PMI's signal a continued economic expansion, but the strong Euro currency adds to disinflationary pressures, but deflation is not a threat currently.

The continued strength of the Euro is adding to disinflationary pressures

**Chart 1: EUR/USD (blue) vs 2 year yield differential US - Germany (black)**



Source: AllianzGI, Bloomberg – March 2014

and worries of deflation by market participants. We feel that these worries of deflation are unfounded because economic growth in the Euro-Zone should prevent inflation from falling into deflationary territory. Let us examine why this is the case and also what is contributing to the Euro's persistent strength.

Developed market currency prices are driven primarily by interest rate differentials. Based on this historical precedent, then EUR-USD should be lower (please see chart 1).

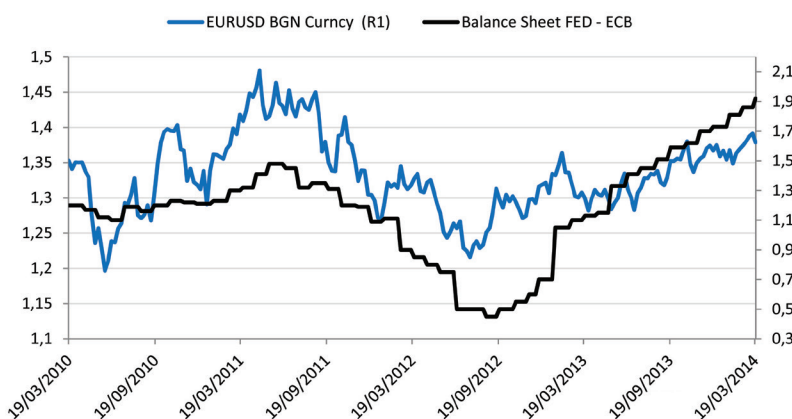
The answer to the Euro's strength seems to lie in the expansion of the Fed's balance sheet vs. that of the ECB (please see chart 2).

## Euro strength: "A tale of 2 balance sheets"

**What is driving the EUR-USD exchange higher ?**

**The Fed's aggressive QE programs has weakened the US Dollar vs. the Euro.**

**Chart 2: EUR/USD vs. Fed – ECB Balance Sheets Total**



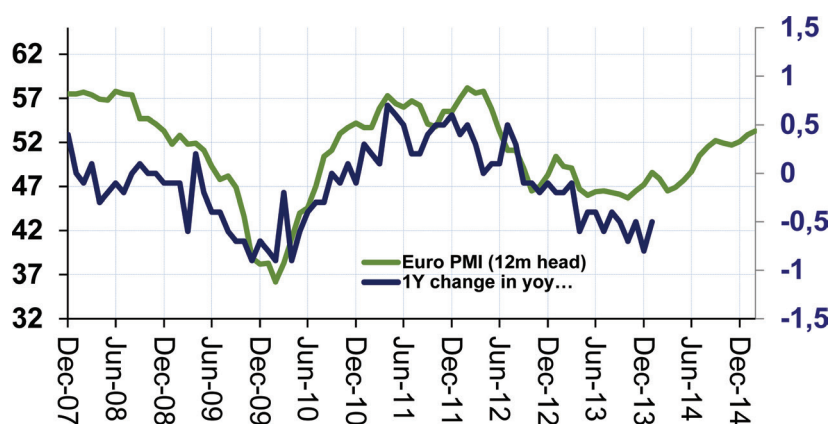
Source: AllianzGI, Bloomberg – March 2014

As the Fed has bought nearly \$ 3 Trillion of bonds in the secondary market through its quantitative easing programs....the Fed has flooded the world with dollars. Remember, that the ECB conducted Long term refinancing operations (LTRO) of around Euro 1 Trillion...but the European banks have paid nearly all of that money back over the course of the past year. This has led to a contraction of the ECB's balance sheet, thereby reducing the supply of Euro's in the market.

### A stronger Euro adds to deflationary pressures.

Mario Draghi stated that a sustained 10 big figure move higher in the Euro for 1 year would cause inflation to fall 0.5%. This would place European inflation at 0.3% ceteris paribus in 1 year time. So the ECB is clearly concerned about a stronger Euro potentially adding to

Chart 3: Euro PMI index (12 month lead) vs. 1 year chg in Inflation



Source : AllianzGI, March 2014

disinflationary pressures pushing the inflation rate dangerously close to deflationary territory.

### There is no danger of deflation in the medium-term.

We believe that disinflation will remain, but that deflation is highly unlikely.

Why ?

The strength in European PMI's (above 50 indicates economic expansion) should act as a support mechanism and try to lift inflation slightly higher over the next months due to the anticipated economic growth which should serve to buoy inflation.

## China and Japan

China is on the path to become a developed market as export-led growth declines and internal consumption picks up. This will lead to lower levels in long term growth.

Private sector debt together with current account balance deterioration represents a serious short term issue. Anyhow China, due to its low level of indebtedness, has the capacity to use

public finances to smooth the effect. The Japanese picture, instead, is becoming more problematic. Despite a huge increase in the monetary base, growth is not picking-up substantially and external balances have deteriorated due to depreciation in the Japanese Yen. The base case scenario remains for a recovery that accelerates in 2H 2014. However, the VAT increase and

rate of growth in salaries represent a significant challenge.

The Risk is increasing that a slowdown in China coincides with a Japan that fails to meet economic growth targets. Should this unfold, then the collateral damage to developed economies could be material.

## Investment Policy

### Duration: Neutral stance

German 10-year Bund yields remain in a range between 1.50%-1.70%. Overall the front end of the curve should remain anchored by monetary policy. Interest rates in the European Union (EU) may remain at low levels following growing

speculation that the ECB may eventually conduct Quantitative Easing (QE) following the acknowledgment by the Bundesbank that both QE and negative deposit rates are on the table as policy options.

In the Eurozone, the geo-political risk surrounding Russia's activities in

Crimea/Ukraine remain on investors' radar screens while fundamentally leading indicators and economic sentiment are confirming a steady recovery for the Euro-Zone. This is true for both core and peripheral countries (see chart below) and supports our view to remain overweight in Spain and Italy.

Currently, fundamentals are not strong enough to decisively push yields higher in the Euro-Zone due to subpar growth, disinflation, and continued concerns regarding emerging countries.

**We see no reason to change our neutral positioning on duration.**

As we are already short German government bonds vs long risky assets, we don't want to add similar risk by reducing now the duration exposure of our portfolios. Nevertheless, we keep our long call option positions, in order to hedge tail risks and we also recommend to be short 10-year T-note vs German Bund futures.

**Curve Positioning:** Neutral

- *German: Neutral*
- *France: Flattening 10-30y*
- *Italy: Flattening 3-10y*
- *Spain: Neutral*

**Inflation Linked Bonds:** long position

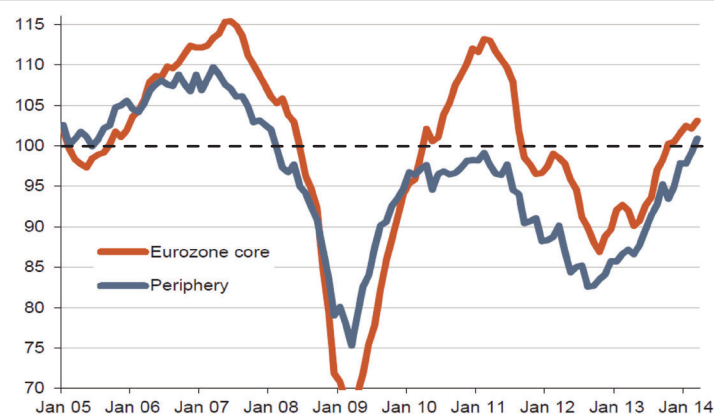
The main scenario is that the Euro-Zone will not fall into deflation. Instead, we expect the inflation rate to remain at low levels until 2016. However, we must remain aware of the fact that the euro inflation rate is very close to the deflation danger zone and vulnerable to external shocks. None of the Euro-Zone member countries has a HICP (Harmonised Index of Consumer Prices) above 2%. Core in Spain and Portugal are already negative.

The fundamental side also underpins a moderate and gradual rise of the core inflation with the recent improvement in the momentum of the consumer side: confidence, PMI supports, albeit at a modest pace.

The ECB is ready to act if the situation is deteriorates further. Any action will be viewed positively by the Inflation Linked Bonds (ILB) market and give a lift to the front-end of the ILB curve.

Valuations are still low. The ECB's projection for Q4 2016 is 1,5%,

**From pain to gain: Eurozone reform countries bounce back**  
Economic sentiment rises beyond long-term average



*EU Commission survey of economic sentiment, periphery: Italy, Spain, Greece and Portugal; no date for Ireland. Long-term average = 100. Source: EU Commission*

Source: Berenberg Bank – march 2014

compared with the 2y1y swaps at 1.25%. Momentum is improving on inflation rate and this should support breakevens.

- *Indexation: neutral*
- *Country selection: OW Italy*

We maintain our long recommendation consistent with our scenario of inflation rates stabilizing and for no deflation.

**Eurozone countries :**

**Market development and outlook**

**Big picture:** unchanged, long peripherals vs core.

The FOMC change of tone regarding the possible timing and extent of a Fed Funds increases did not cause a large impact on the Euro-Zone countries spreads as was the case in May 2013 where risky assets experienced a sell-off and spread widening.

Basically, it appears that bond markets judge the peripherals as “the new safe assets, with a nice spread”. It is possible that in a global context where Emerging Market (read China...) have some troubles, and the US is getting closer to changing its monetary policy stance that Euro-Zone (higher yielding) assets are the preferred choice.

The Ukraine crisis seems no longer a threat, judging from the complacency that bond and equity markets have shown recently. It is hard to forecast geopolitical events, but being long call on bunds still appear to us the best way to take advantage of extremely low volatility and to hedge the risk that Mr. Poutine will not easily allow Ukraine joining the North Atlantic Treaty Organization (NATO). After the result of the municipal elections both in France and in The Netherlands, the European elections in May could become a catalyst: some improvement in the results for anti-euro, anti-EU parties in the European elections is probably already discounted, but the extent of the expected strength may still be a reason for surprise (and worry) in the marketplace. Results for the FN in France, PVV in the Netherlands, AfD in Germany (no threshold in European elections...), Lega Nord, FI and M5S in Italy, Syriza in Greece, will therefore be closely scrutinized to understand how widespread the “crisis of the euro” actually is among the electorates.

We nevertheless maintain our overweight in Italy, Spain and Belgium, an underweight exposure to Austria, Portugal, The Netherlands and Germany and a neutral position on France, Ireland and Finland.

## Covered Bonds: Overweight

**We have maintained a global Overweight (OW) exposure on the Covered Bonds (CB) market.** The country allocation is still OW on Spanish and Irish names, Underweight (UW) on Swedish, Finish and Austrian CBs and Marketweight (MW) elsewhere. From a fundamental point of view, positive comments and actions from agencies (Spain and Ireland) and Troika (Portugal) have provided positive background to support further outperformance of peripheral CBs. Moody's and Fitch have modified their CB rating methodology in order to reflect the preferential treatment of CBs under the EU Bank Resolution Directive. Regarding Moody's methodology, the anchor point for CB rating is the higher of the issuer's adjusted Baseline Credit Assessment (BCA) plus 0 to 2 notches and the issuer's senior unsecured rating plus 0 to 1 notch. From a regulatory point of view, the European Commission stated that it will deviate from the recommendations to classify CBs as level 2 regarding Liquidity Coverage Ratio (LCR) eligibility (liquid asset) if there are very strong arguments. Thus, there are still options on the table such as raising the 40% limit of level 2 assets or lowering the haircut for covered bonds.

## Supranationals: Neutral

**On Supranationals, we suggest to keep our neutral stance.** This sector should continue to benefit from their strong fundamentals and their appeal in providing diversified exposures to European sovereign credit (LCR effect).

## Agencies: Neutral

**On Agencies, we maintain our neutral stance,** as lower net supply this year and ongoing demand link to the introduction of the new LCR requirement from 2015 which should reinforce investor's appetite for Sovereign Supranational & Agency (SSA).

## FX : Bullish USD

The question is why the USD has not managed to strengthen more sharply?

1. A US rate hike is still more than a year away.
2. There have been some episodes of hawkish Fed rethink in the last 12 months, which never had a sustainable positive effect on the USD versus major currencies
3. The ECB –despite some dovish words– still seems to lack dovish action, so that the EUR remains strong and stable for now.

Despite these three factors, the USD may remain bullish and given the hawkish Fed language, the US currency will be more sensitive to positive data surprises going forward.

## Credit: Neutral

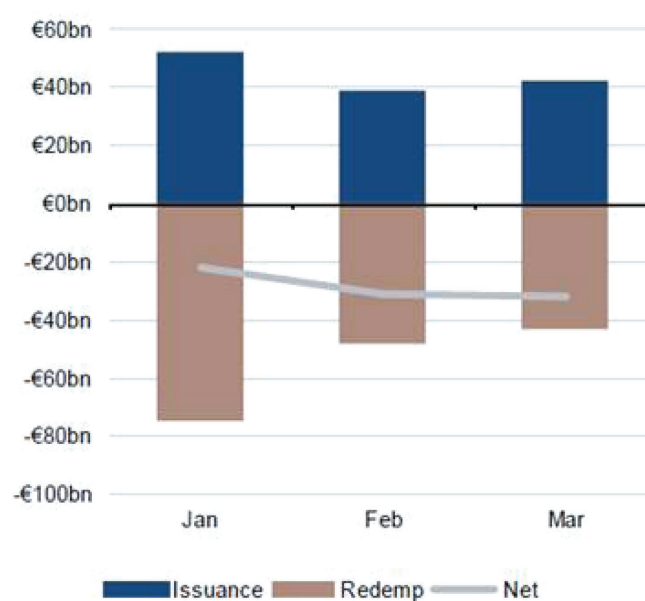
Technicals are positive as redemptions exceed new issuance, but valuations are not compelling.

Performance remains positive Year To Date (March 31) with High Yield and Investment Grade generating +2.33% and 1.91% respectively. Interest for the asset class remain strong, as the demand and performance of new issues can attest. All bonds are well oversubscribed and price inside the initial guidance, even when the sizes are increased. New issue volumes are heavy but demand exceeds supply in part due to redemptions.

Q1 issuance stands at €135 bn (more than the €117bn seen in Q1 2013). However, this is still well behind the €166bn of scheduled redemptions.

**We maintain our current NEUTRAL positioning in our Credit flagship portfolios.**

## Redemptions exceed new issuances



Source: SG Cross Asset Research/Credit

# Glossary

**Breakeven:**

See *inflation expectations*.

**Bund:**

German Treasury bond. Unless otherwise indicated, with a residual life of 10 years.

**Covered bond:**

A bond issued by a bank and this is backed by collateral, or a guarantee, most often mortgage loans.

**Duration:**

Average life span of a bond or a bond portfolio, including all related flows, i.e., coupons and partial or full repayments. The more a 10-year bond pays out high coupons and makes partial repayments, the shorter its duration. The lower its coupons and the closer its repayments are to maturity, the longer, or higher, its duration.

**Eonia (Euro OverNight Interest Average):**

Average euro zone overnight (see this term) money-market rate.

**Euribor:**

Benchmark money-market rate for terms ranging from one week to two years.

**Haircut:**

A haircut is a percentage that is subtracted from the market value of an asset that is being used as collateral. The size of the haircut reflects the perceived risk associated with holding the asset.

**Inflation expectation:**

This is the spread between the bond market yield on a certain duration and the real rate (ex-inflation) as results from the market value of a bond linked to inflation of the same duration.

**Inflation-linked bond:**

Bond whose principal is indexed regularly to inflation of the issuing country or the euro zone. The remuneration rate, which is based on the principle plus inflation, therefore offers a real remuneration (ex-inflation).

**Investment approach:**

In each region (US, euro zone, and emerging markets) we review the following [variables](#) over the medium and long term: growth potential, inflation risk, monetary policy, long bond yield potential, and risk appetite.

**Money market:**

Cash market. Banks place their short-term cash on this market or go to it to borrow the funds they need on a short-term basis. See also *Eonia*, *Euribor*, *overnight rate*.

**Overnight rate:**

Refers to a 24-hour loan that may be rolled over indefinitely.

**OAT:**

French Treasury bond. Unless otherwise indicated, with a residual life of 10 years.

**Spread:**

The difference in yield between two bonds with the same maturity, with the former often offering greater risk than the latter.

**Treasuries:**

US Treasury bonds. Unless otherwise indicated, with a residual life of 10 years.

**Variable:**

See *investment approach*.

All data provided in this document come from the following sources: Datastream, Reuters, Boursorama. The variation listed are calculated from one month to the other. It concerns the indexes established by assessment organism commonly recognized unless stated otherwise (INSEE, IFO - Institut für Wirtschaftsforschung, ZEW - Zentrum für wirtschaftsforschung, GfK - Gesellschaft für Konsumforschung, etc.).

The weekly variations of equity indices, the 10-year rate and the exchange rates mentioned in this article are computed or recorded on the last business day of the previous week.

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