Bond Market Contact Group
(European Central Bank)

Bond market outlook

10 October 2017

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Key developments

- **Politics**: Major political roadblocks have passed in a market-friendly manner, but **Europe is still not running short of political risks**, with Italy set to return to the spotlight.
- **Macro**: Cross-country divergences have started to build against a still solid global economic backdrop. While the Eurozone continues to stand out with a healthy, regionally broad-based growth momentum, underlying inflationary pressures (wage growth) remain subdued. **The narrowing of output gap should lead to a gradual rise in core inflation over time.**
- **Monetary policy: Peak liquidity should constitute a major turning point for global monetary policy in 2018.** The ECB's QE programme will likely accompany us well into 2018, but the direction of travel – a cautious normalization of monetary policy along the lines of "QE-exit first, rate hikes second" – remains clear. The imminent scarcity of eligible assets (issuer/issue limit) implies that winding down QE purchases is more of a necessity than a choice. However, the ECB will likely use the built-in flexibility. Will deviations from the capital key, also regarding the reinvestment of principal payments, provide some extra "wiggle room"?
- **Fixed Income**: Currently, about 45 % of the Eurozone government bond universe is carrying a negative nominal yield. Eurozone sovereign bond markets remain prone to volatility, even if the ECB is inclined to follow a smooth path of normalisation. Overall, **forthcoming withdrawal of monetary policy accommodation and negative term premia pose material downside risks for government bond markets** in the developed world **over the medium term**.
- **FX**: The rapid pace of the euro's appreciation came as a surprise, but relative fundamentals speak in favour of a stronger euro over the medium term. **The euro still appears moderately undervalued versus the US dollar and is trading close to fair value against the broader G-10 industrialized FX universe.** Given fading disinflationary appreciation pressure on their domestic currencies, "smaller" European central bankers such as the CNB, Riksbank and SNB are set to preempt, move along or follow the same direction as the ECB.

Note: CNB: Czech National Bank. SNB: Swiss National Bank. Source: Datastream, Allianz Global Investors, as of 2nd October 2017. The statements contained herein may include statements of future expectations and other forward-looking statements that involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. We assume no obligation to update any forward-looking statement.

Politics: Major political roadblocks passed in a market-friendly manner, but Europe is still not running short of political risks

Eurozone
Refugee crisis. Terror fears. Growing anti-establishment and centrifugal political forces.

UK
Paralyzing political uncertainty after Brexit "leap in the dark" and snap elections on 8 Jun 2017 (weakened mandate for PM May). Negotiations on terms of withdrawal and future partnership set to be a drawn-out process. Another Scottish independence referendum unlikely given SNP support fell at elections.

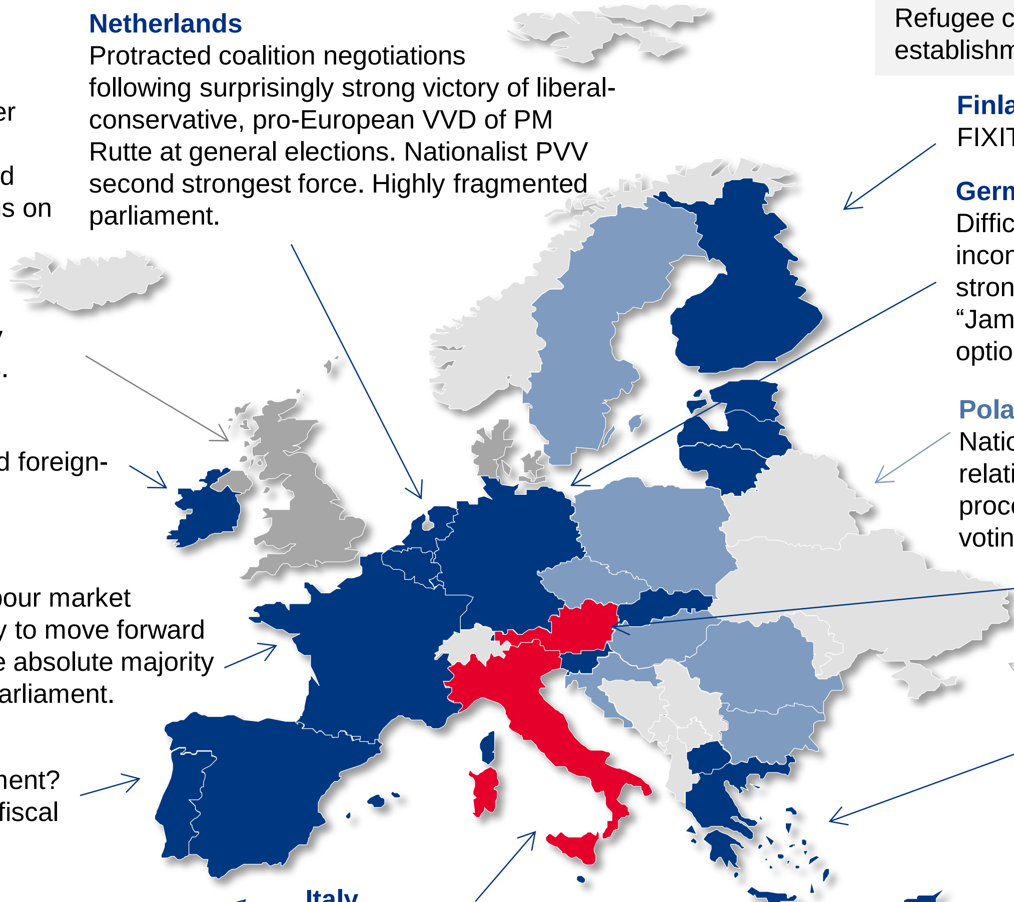
Netherlands
Protracted coalition negotiations following surprisingly strong victory of liberal-conservative, pro-European VVD of PM Rutte at general elections. Nationalist PVV second strongest force. Highly fragmented parliament.

Ireland
Minority government. Brexit-related foreign-policy challenges ahead.

France
Planned union protests against labour market reform, but President Macron likely to move forward with supply-side reforms, given the absolute majority of "La République en Marche" in parliament.

Portugal
How stable is the minority government? Potential clash with Brussels over fiscal stance.

Spain
Minority government tolerated by socialists. Repeated budget clash with Brussels likely due to lacking budget discipline. Increased uncertainty following (legally non-binding) independence vote in Catalonia on 1 Oct 2017.



Italy
Lame-duck administration and political instability impede reforms. Fiscal consolidation fatigue. NPL / Bad bank problems. General elections on **23 May 2018** the latest. Polls suggest nearly half of the voters are in favour of EU-sceptic parties. Renzi's PD weakened by split of left wing.

Finland
FIXIT movement

Germany
Difficult process to build new government after inconclusive general election and surprisingly strong support for right-wing populist AfD. "Jamaika" (CDU/CSU, FDP, Greens) most likely option.

Poland/Hungary
Nationalist / Anti-EU governments. Worsening relationships with the EU incl. infringement procedures. Will Warsaw risk loosing its EU voting rights?

Austria
Snap parliamentary elections on **15 Oct 2017**. Far-right FPO to enter government?

Continued conflict over **Ukraine**

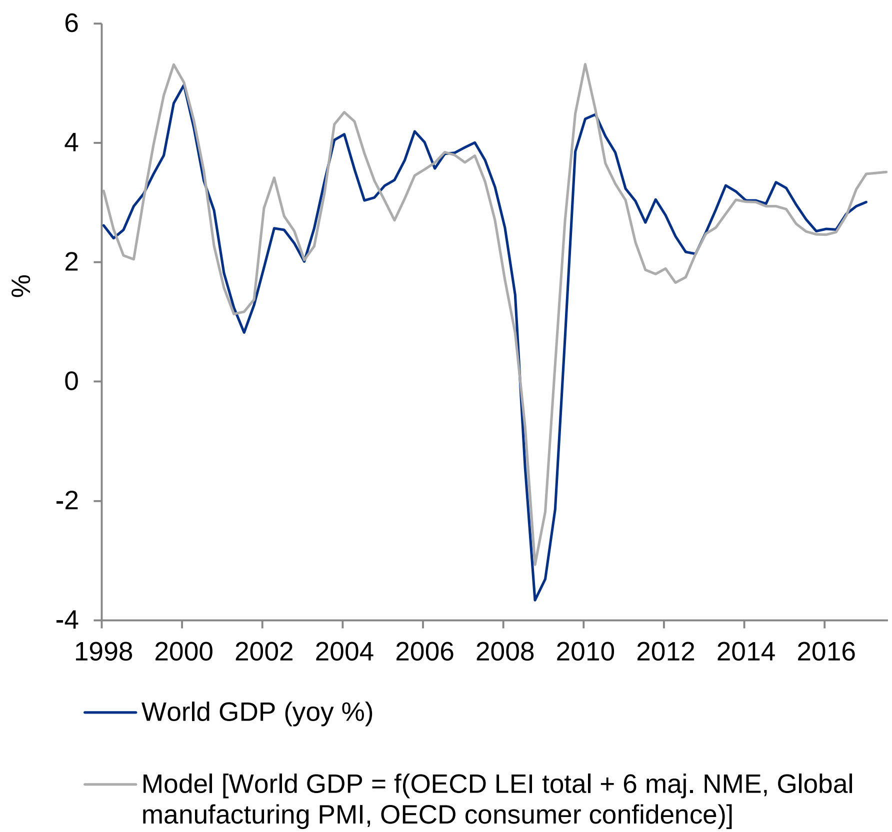
Greece
Fragile government. Pending reform agenda. Unresolved fiscal sustainability issue. Will creditors grant substantial medium-term relief measures after the third programme ends in mid-2018?

EMU member state
EU, non-EMU member state
EU member state with an opt-out

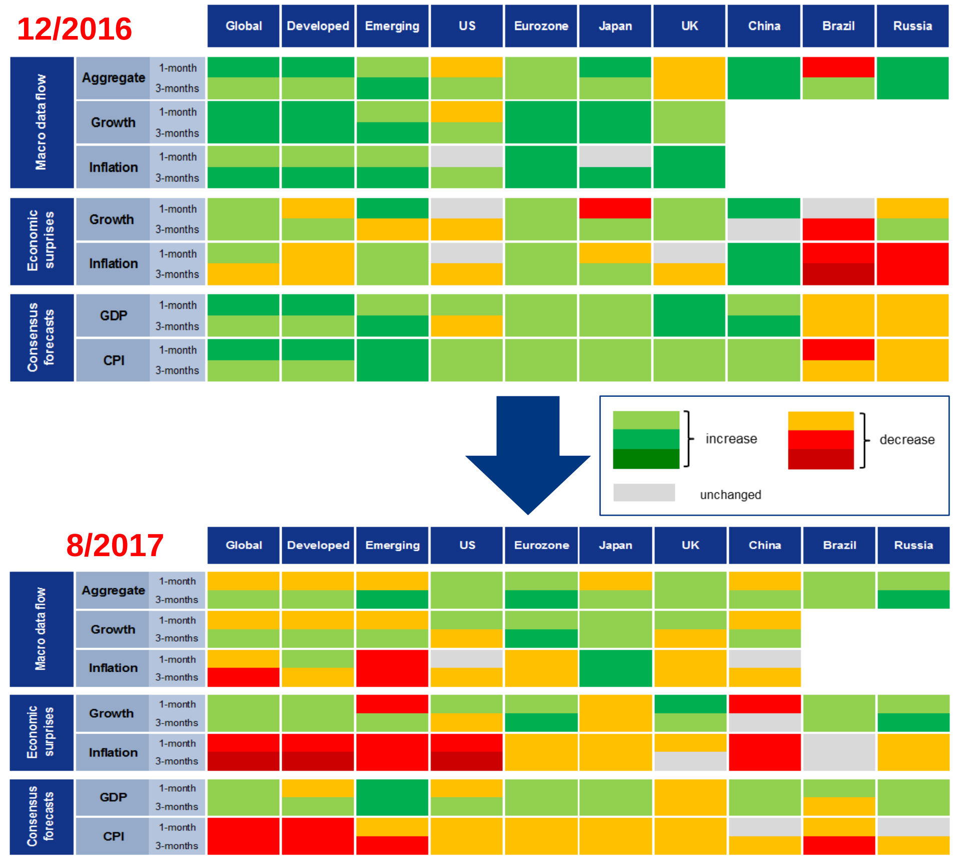
Sources: EU, national governments, J.P. Morgan, DZ Bank, Allianz Global Investors. As of 2nd October 2017.

Macro: Global economy – still solid but momentum has started to fade

While the global economic backdrop is still solid,...



...the macro news flow has become more patchy recently

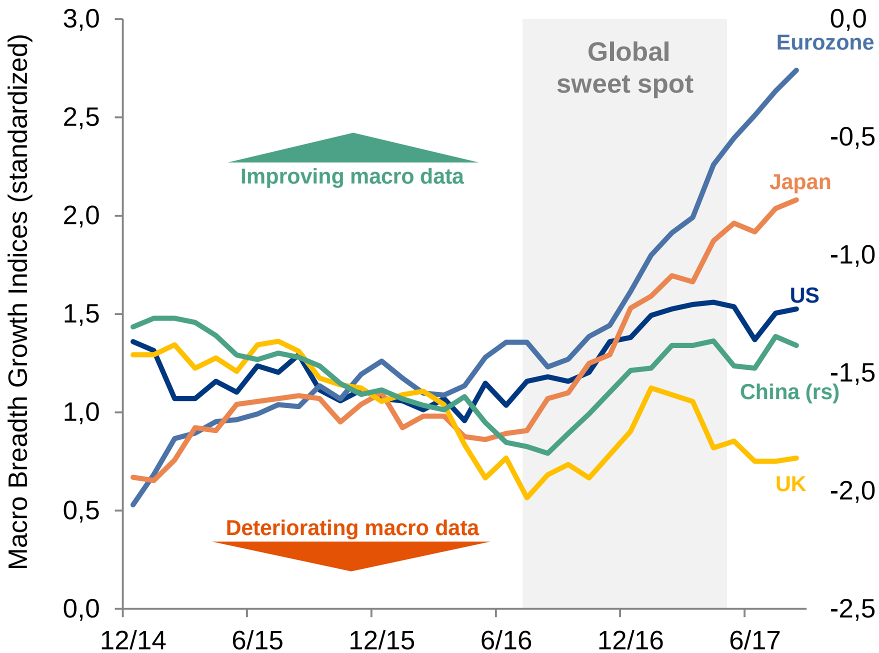


While the world economy is expected to grow slightly above potential in H2/2017, the global macro data flow has started to lose momentum more recently.

Sources: Allianz Global Investors, Bloomberg, Datastream, Consensus Economics, as of 2nd October 2017. The statements contained herein may include statements of future expectations and other forward-looking statements that involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. We assume no obligation to update any forward-looking statement.

Macro: Cyclical tide is no longer lifting all countries equally

Following a global cyclical sweet spot,...



...regional/country differentiation has become more important for investors

Cyclical economic backdrop in H2/2017

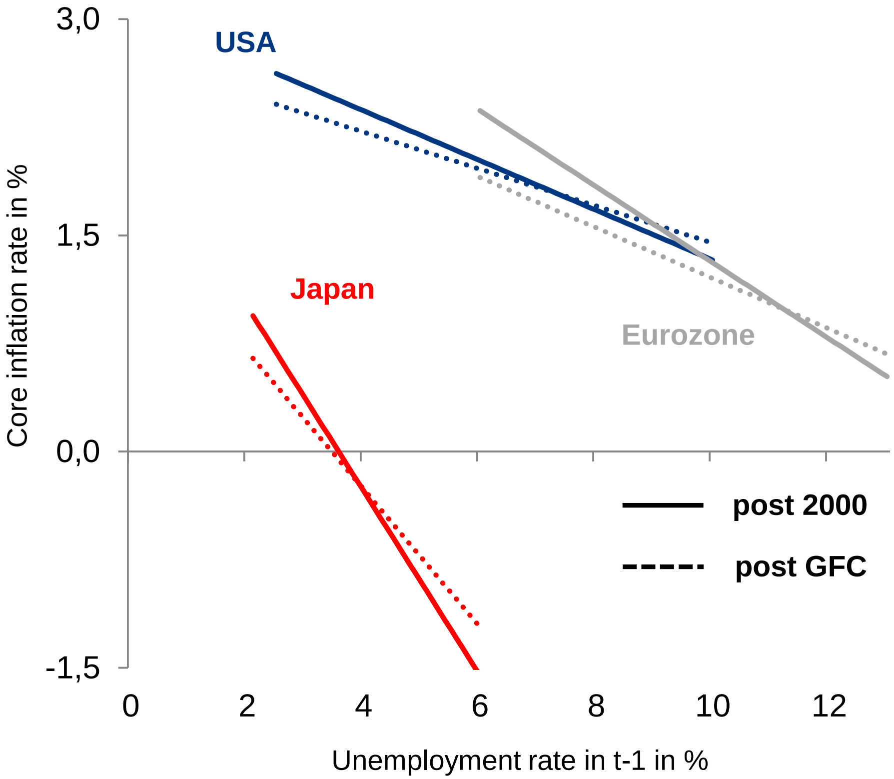
Cross-country divergences have started to build against a still solid global economic backdrop. The country factor should continue to regain importance for asset allocation decisions.

Note: Macro Breadth Growth Indices track the direction of important economic sentiment and activity data on a monthly basis. Standardization based on z-scores.

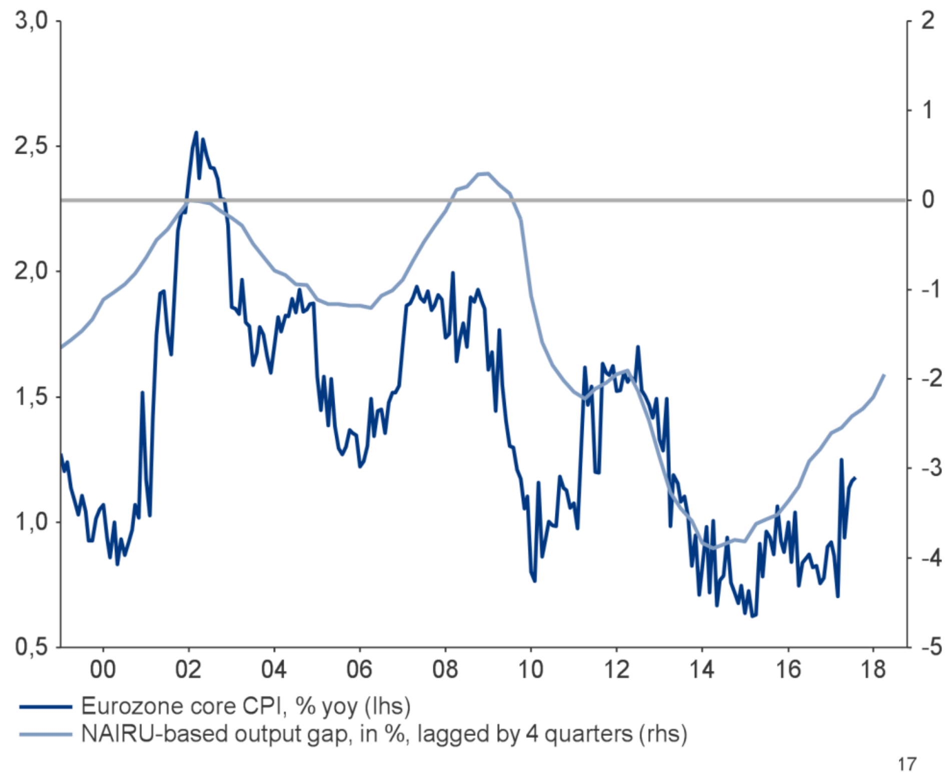
Source: Allianz Global Investors, Bloomberg, Datastream, as of 2nd October 2017. The statements contained herein may include statements of future expectations and other forward-looking statements that involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. We assume no obligation to update any forward-looking statement.

Macro: Inflation is not dead

Inflation is not dead: the Phillips curve still matters



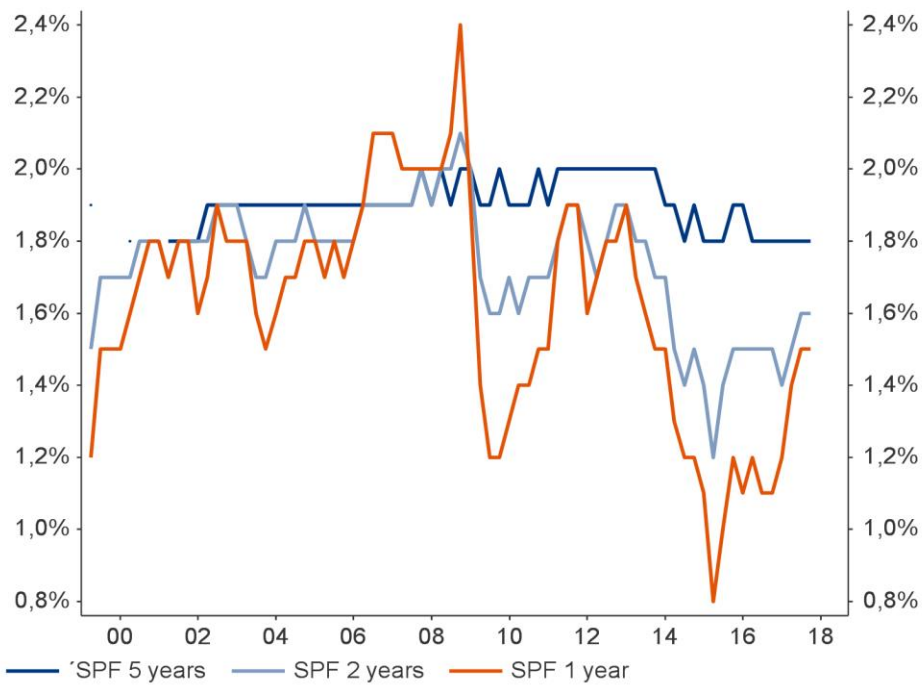
Eurozone core inflation expected to increase gradually as NAIRU-based output gap[1] narrows



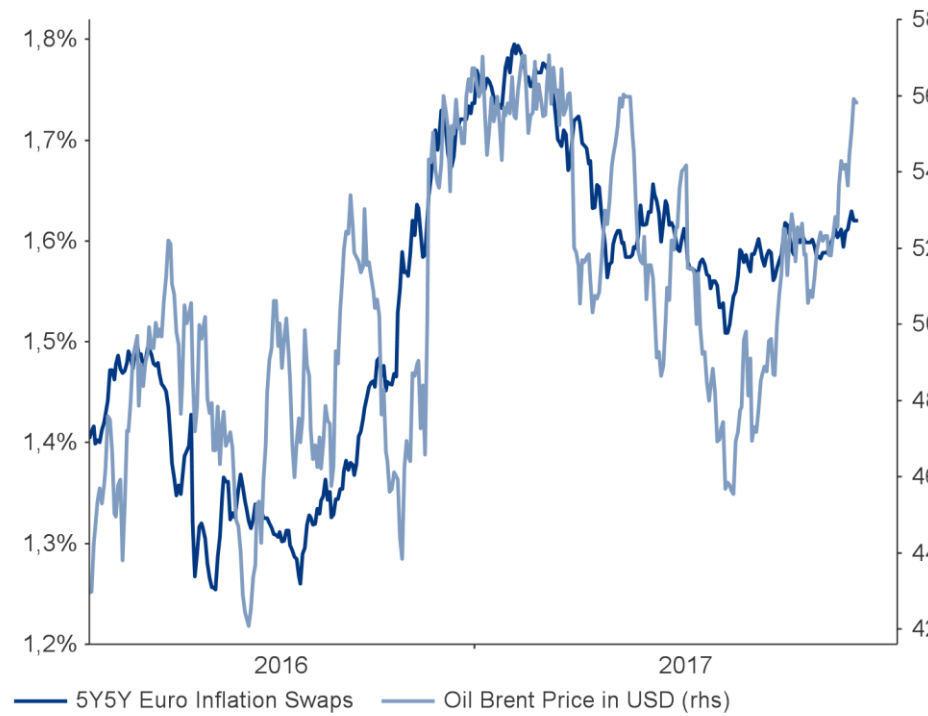
[1] Difference between the actual and the non-accelerating inflation rate of unemployment (NAIRU); these deviations are associated with deviations of output from its potential level. Sources: Datastream, Allianz Global Investors, as of 18th September 2017. Future expectations involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such expectations. We assume no obligation to update any future expectations.

Macro: Survey-based measures of longer-term inflation expectations remain well-anchored, market-based measures prone to oil price developments

Short-term SPF[1] inflation expectations reflect oil price developments, longer-term well anchored at 1.8 %



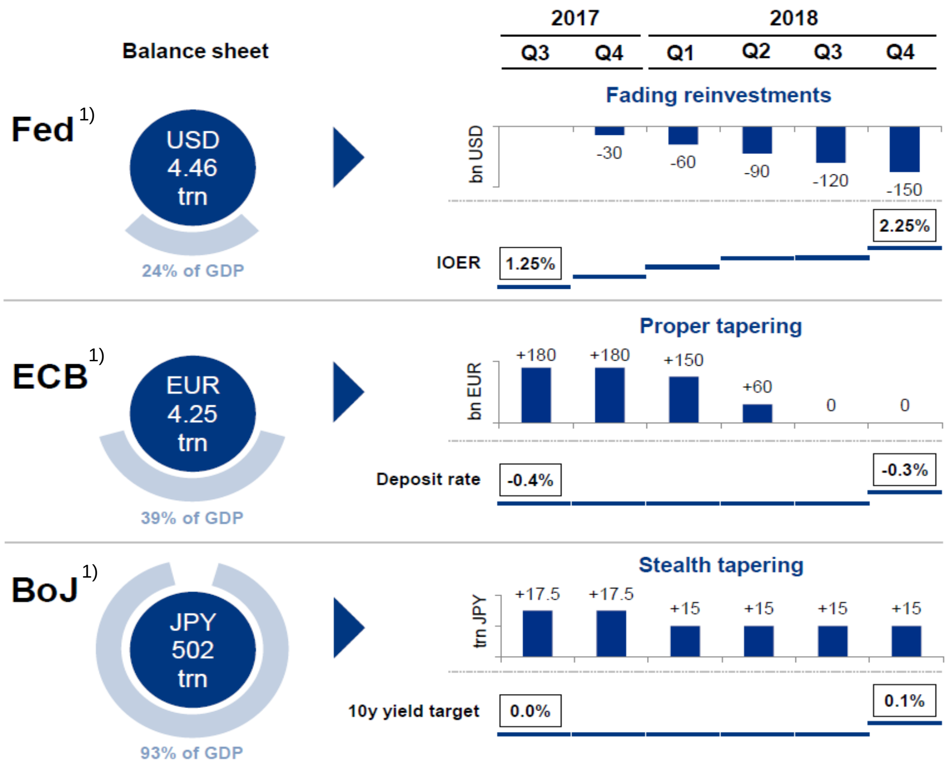
Market-based long-term inflation expectations[2] vs. crude oil Brent price



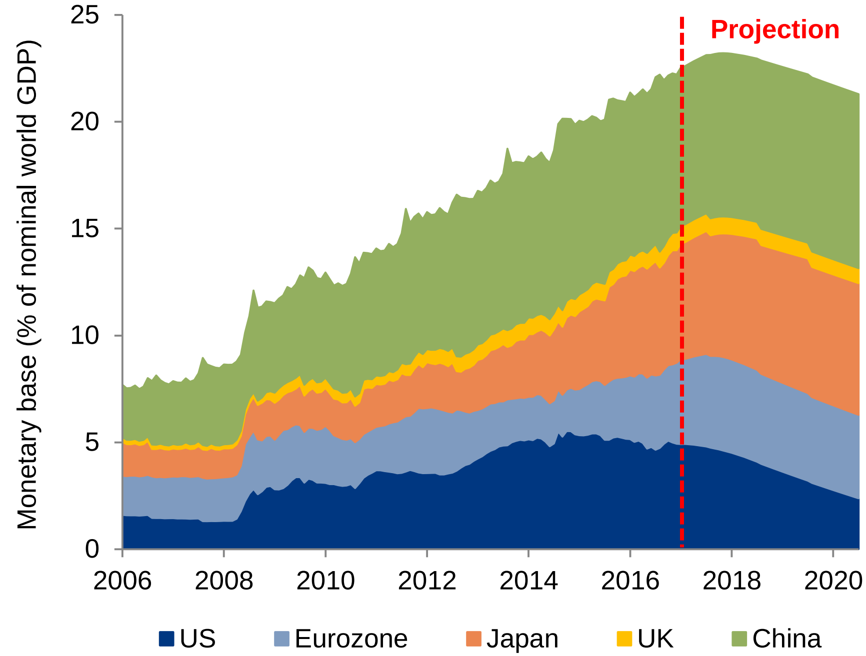
1) Survey of Professional Forecasters (latest as of 21 July 2017). 2) Long-term inflation expectations as measured by the five-year, five-year forward swap rate of inflation , i.e. the expectations for inflation over five years in five years' time. Sources: Datastream, Allianz Global Investors, as of 18th September 2017. Future expectations involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such expectations. We assume no obligation to update any future expectations.

Monetary policy: Major central banks heading towards gradual normalization

Unconventional policy normalization will lead...



...to a climax in central bank liquidity in H1/2018



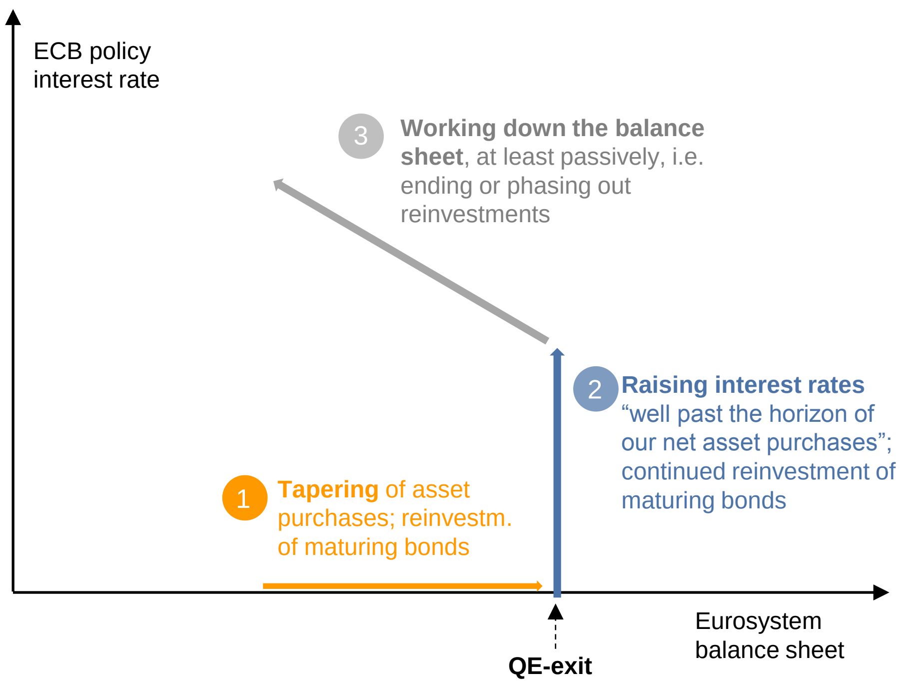
Peak liquidity should constitute a major turning point for global monetary policy in 2018.

[1] Expected evolution of G-3 policy rates and balance sheets in 2017/18 based on Allianz Global Investors‘ macroeconomic scenario. Balance sheet normalization by the Federal Reserve in accordance with „Policy Normalization Principles and Plans” as published by the Federal Reserve (https://www.federalreserve.gov/monetarypolicy/policy-normalization.htm)

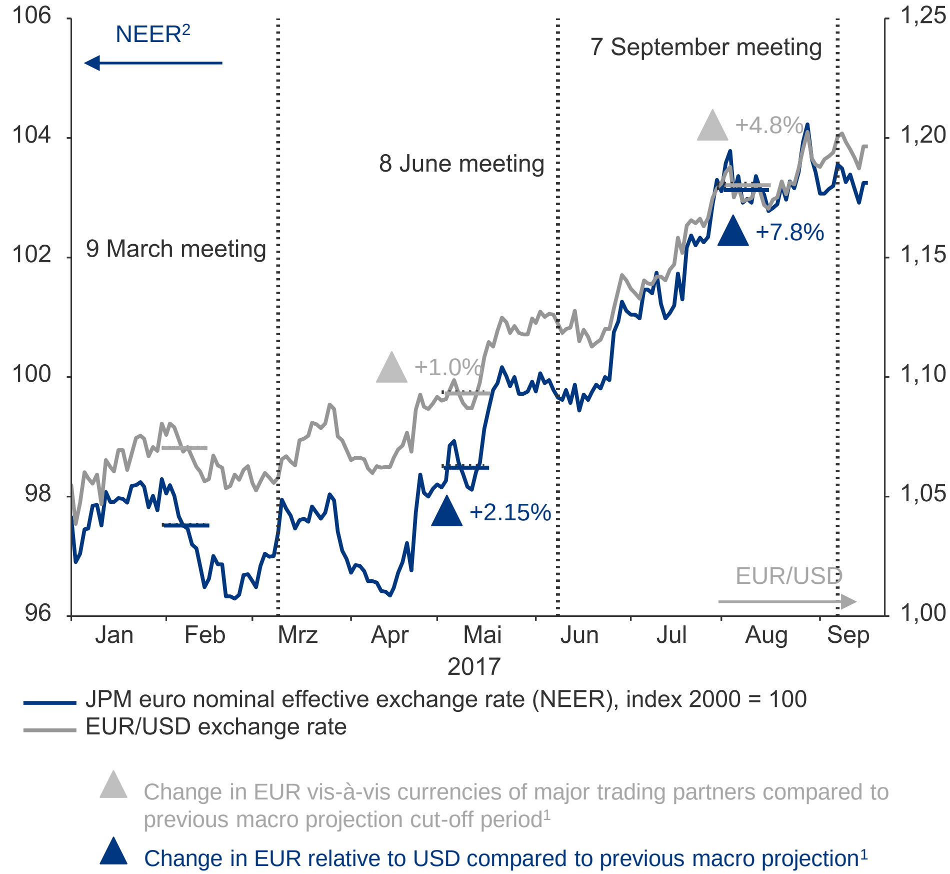
Source: Allianz Global Investors, Bloomberg, Datastream, as of 2nd October 2017. Future expectations involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such expectations. We assume no obligation to update any future expectations.

Monetary policy: The ECB's exit strategy: The long goodbye

Stylised exit strategy in line with the ECB's forward guidance: QE-exit first, rate hikes second



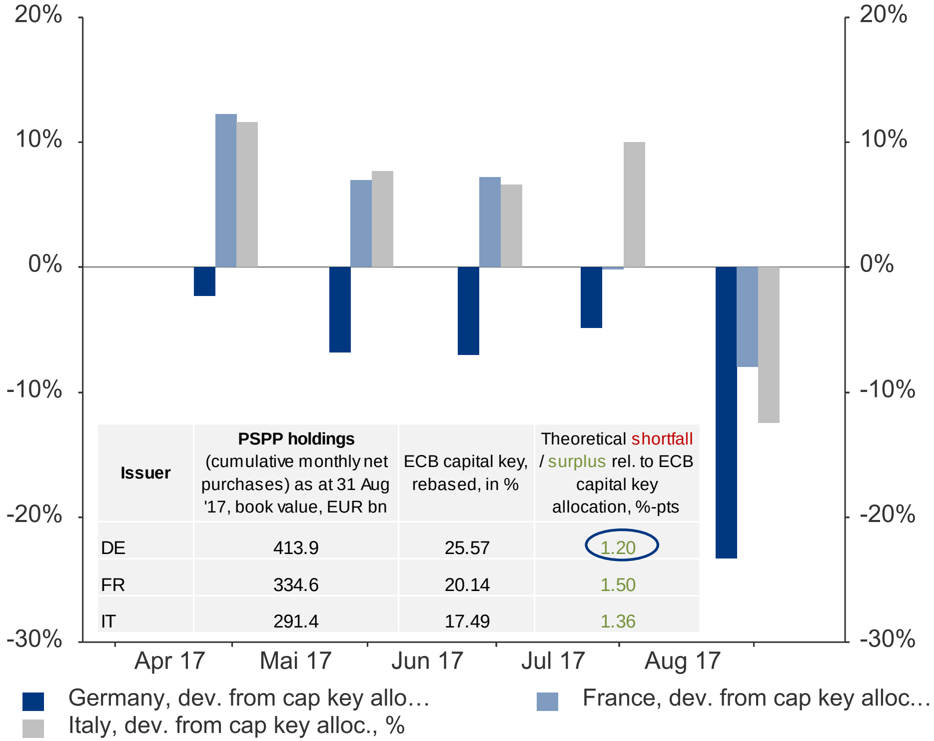
ECB delays "tapering decision" to October, not least in view of concerns about the euro



[1] Please note that the Eurosystem/ECB staff macro projections are based on the nominal effective exchange rates (NEER) computed against a broader group of 38 trading partners. This index is only available on a monthly basis, though. [3] Exchange rates are assumed to remain unchanged over the projection horizon at the average levels prevailing in the two-week period ending on the cut-off date. September projection: NEER-38 2.1% higher in 2017 and about 4.4% higher over 2018-19. Past performance is not a reliable indicator of future results. Sources: Datastream, ECB, Allianz Global Investors, as of 18th September 2017.

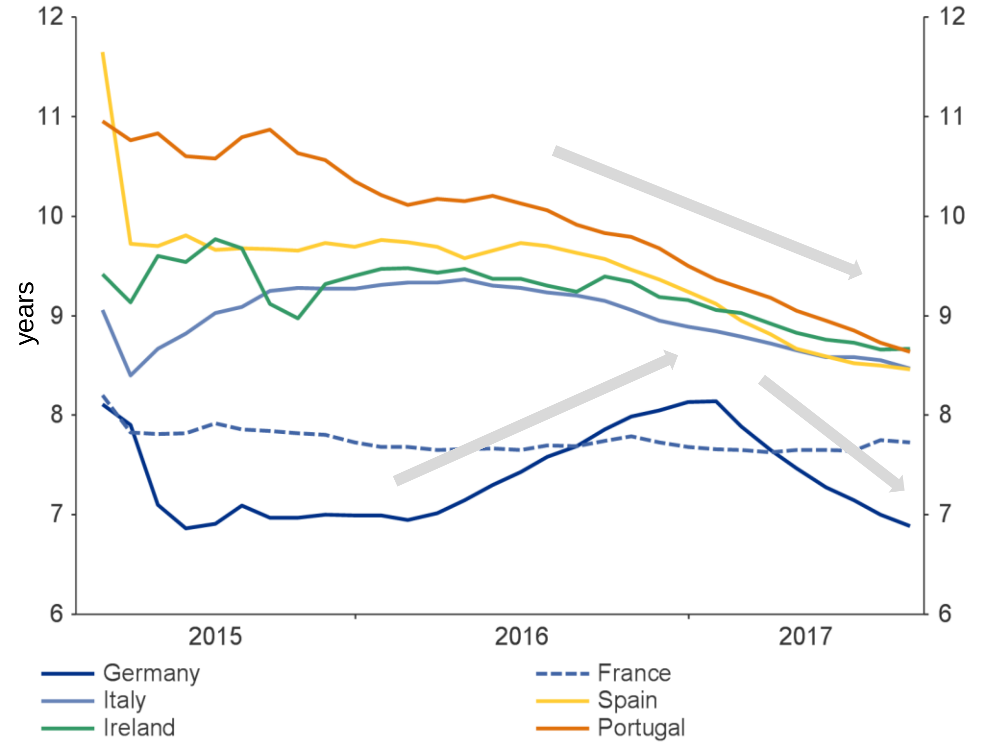
Monetary policy: Scarcity scares are not off the table. Will the reinvestment policy provide some extra "wiggle room"?

No bottleneck in Bund purchases yet, but the Bundesbank seems to already "live on its reserves"[1]



Issuer	PSPP holdings (cumulative monthly net purchases) as at 31 Aug '17, book value, EUR bn	ECB capital key, rebased, in %	Theoretical shortfall / surplus rel. to ECB capital key allocation, %-pts
DE	413.9	25.57	1.20
FR	334.6	20.14	1.50
IT	291.4	17.49	1.36

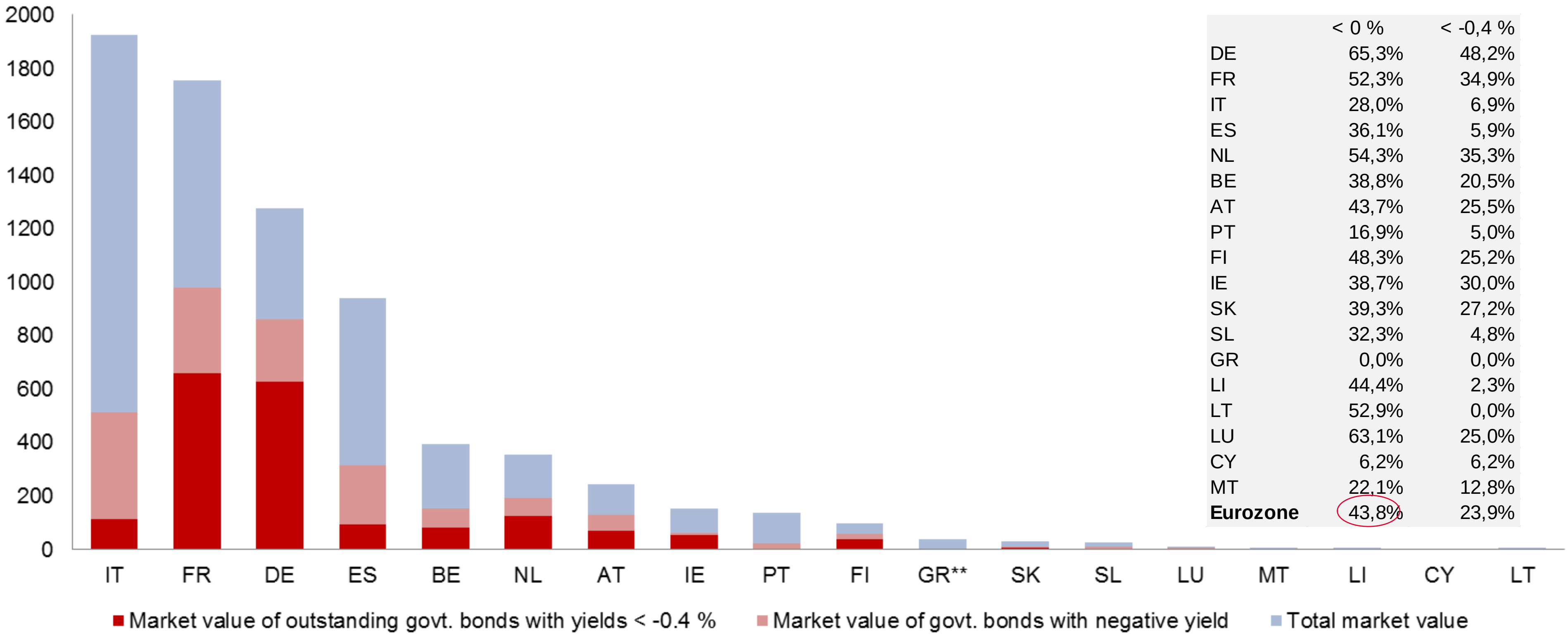
National central banks are taking advantage of revamped PSPP parameters,[2] shorter duration = higher near-term reinvestments



[1)] Monthly purchases of Bunds within the PSPP have undershot the target volume for the fifth time in a row (despite the frontloading strategy ahead of the traditionally more illiquid summer months), but the Eurosystem's entire Bund portfolio is still hovering above the target level implied by the ECB's capital key. Please note that in August, the "summer drought" on sovereign bond markets inevitably resulted in lower purchase volumes across all jurisdictions (backloading). [2)] Bundesbank has continued to buy shorter durations – likely a result of the rise in yields since autumn and removal of the depo floor. Past performance is not a reliable indicator of future results. Sources: Bloomberg, ECB, Allianz Global Investors, as of 18th September 2017.

Fixed income: Currently, about 45 % of the Eurozone government bond universe is carrying a negative nominal yield

Market volume of outstanding public debt* with negative yields and yields below the ECB's deposit rate (in EUR bn)

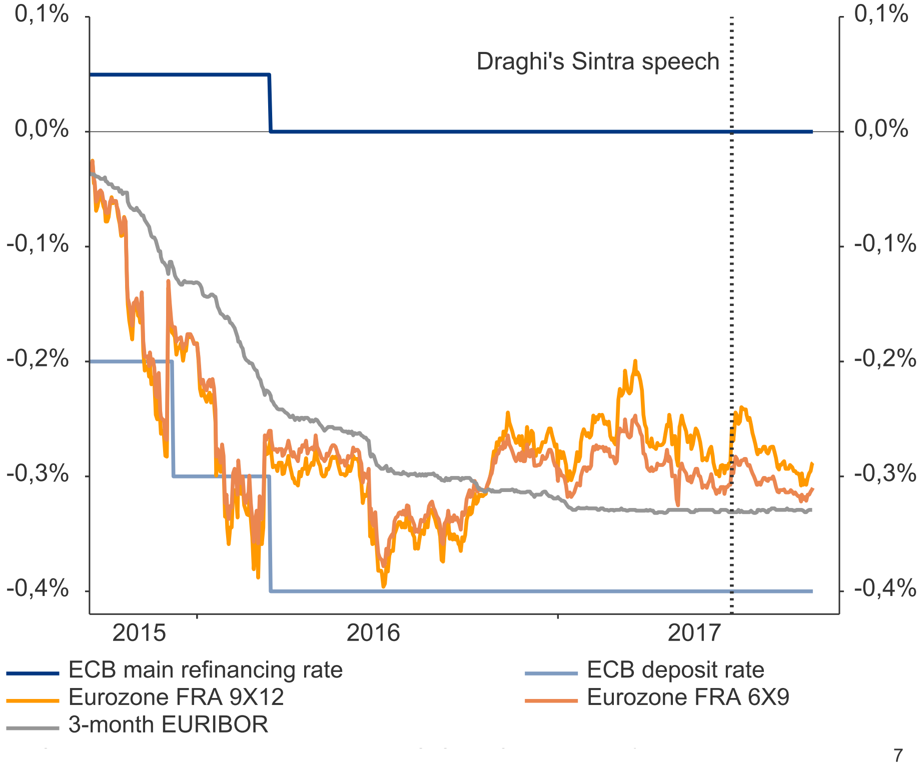


	< 0 %	< -0,4 %
DE	65,3%	48,2%
FR	52,3%	34,9%
IT	28,0%	6,9%
ES	36,1%	5,9%
NL	54,3%	35,3%
BE	38,8%	20,5%
AT	43,7%	25,5%
PT	16,9%	5,0%
FI	48,3%	25,2%
IE	38,7%	30,0%
SK	39,3%	27,2%
SL	32,3%	4,8%
GR	0,0%	0,0%
LI	44,4%	2,3%
LT	52,9%	0,0%
LU	63,1%	25,0%
CY	6,2%	6,2%
MT	22,1%	12,8%
Eurozone	43,8%	23,9%

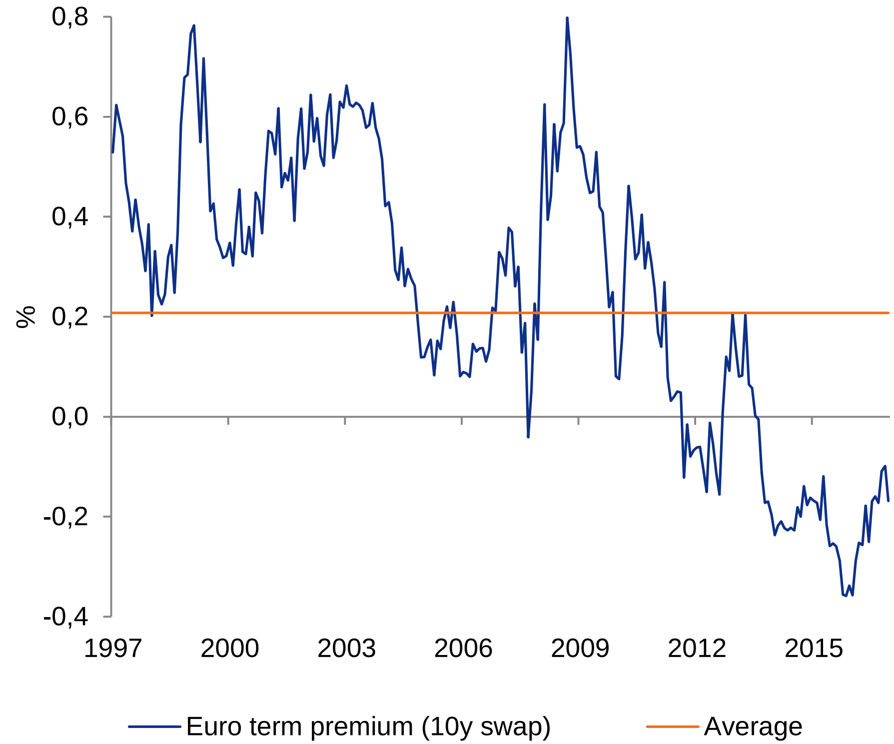
*) excl. T-Bills, incl. inflation-linked bonds **) incl. ECB and EIB holdings of GGBs. Past performance is not a reliable indicator of future results. Sources: Bloomberg, Allianz Global Investors, as of 22nd September 2017.

Fixed income: Are markets pricing in too much of the “three Ps”[1] of policy normalization?

Markets have dovishly re-priced their ECB expectations



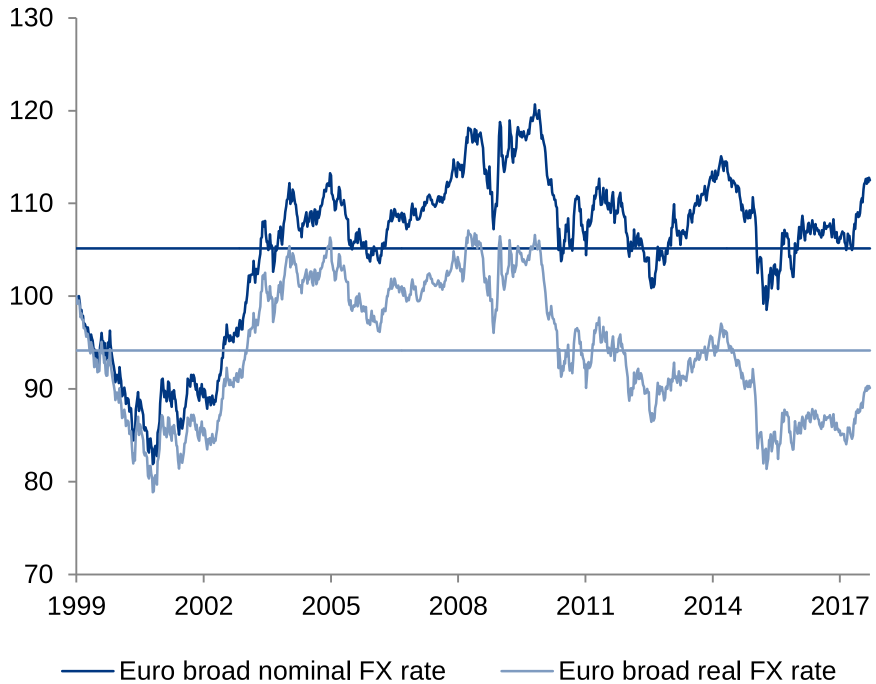
Negative term premia as additional valuation headwind for Euro sovereign bond markets



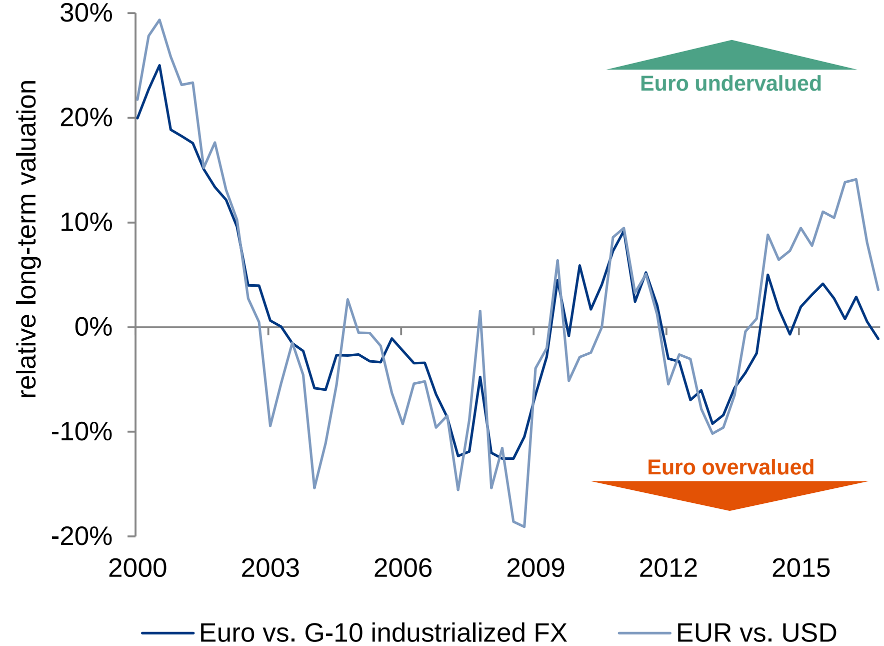
[1] Patience, prudence and persistence. Past performance is not a reliable indicator of future results. Sources: Datastream, ECB, Allianz Global Investors, as of 18th September 2017.

FX: Broad euro FX rate close to long-term fundamental fair value

Euro real broad FX rate still trading below long-term average



...but not materially out of line with fundamentals

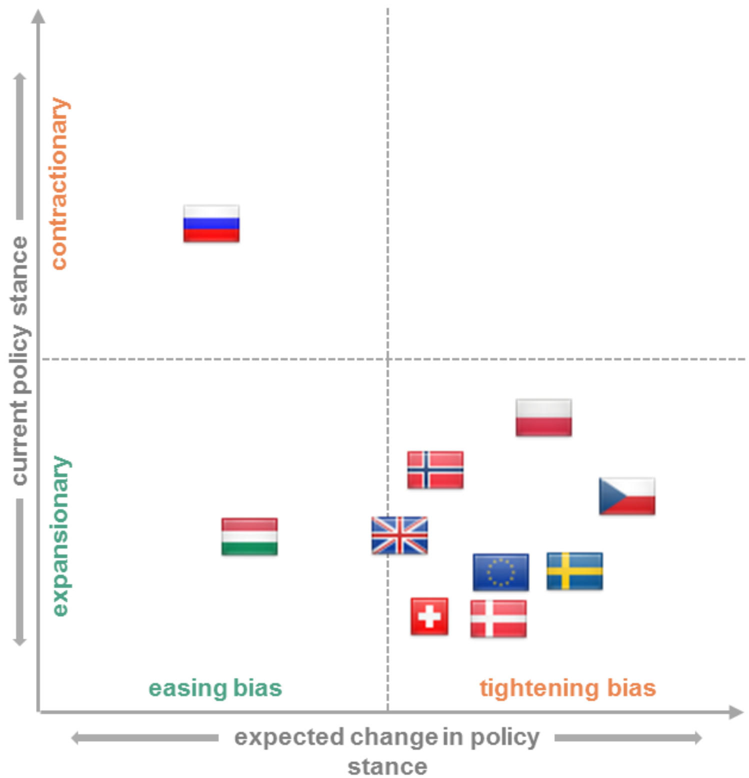


While the euro still appears moderately undervalued versus the US dollar according to the long-term BEER model, it is trading close to fair value against the broader G-10 industrialized FX universe.

Note: The BEER (behavioral equilibrium exchange rate) model is based on relative terms-of-trade, relative productivity, trends in sovereign debt and long-term real interest rate differentials
Source: Allianz Global Investors, Bloomberg, J. P. Morgan (Euro broad FX rates), as of 2nd October 2017.

Outlook: European central bank landscape - Follow thy neighbour?

Policy stance: European central banks are inching towards policy normalization, albeit slowly



Policy tools: Unconventional policy at work, unconventional normalization[1] pending

	Key policy rate Current	Key policy rate Δ 2018e	QE	FX	Comment
Eurozone	0.00	↑	√	–	Unconventional normalizer[1]. "Proper tapering" in 2018. Rate hikes second
UK	0.25	↑	√	–	Unconventional normalizer. Trade-off: overshooting inflation vs. Brexit risks
Switzerland	-0.75	(↑)	–	√	CHF caught between ECB policy and global risk aversion
Norway	0.50	(↑)	–	–	Conventional normalizer. But prone to commodity price / NOK developments
Sweden	-0.50	↑	√	–	Unconvent. normalizer. QE until Dec. "Forced" ECB follower to avoid unwanted SEK appreciat.
Denmark	-0.65	↑	–	√	"Forced" ECB follower to maintain peg to EUR
Poland	1.50	↑	–	–	Conventional normalizer. First hike only at a later stage in 2018
Hungary[2]	0.90	=	(√)	–	Dovish relative to CE3 peers
Czech Republic	0.25	↑	–	–	Conventional normalizer. First hike since 2008. More to follow, timing also subject to CZK
Russia	8.50	↓	–	(√)	Withdrawal of tightening. Prone to commodity price / RUB developments

√ QE still ongoing
√ QE already terminated

[1] "Unconventional normalization" understood as policy of gradual rate hikes in response to closing output gaps, but no immediate shrinkage of central banks' balance sheet. This entails, by way of example, the ongoing reinvestment of principal payments on the securities purchased as they mature. [2] No outright QE, but 3-month depo tender with HUF 500bn cap (300bn by Sep '17) to move bank liquidity into government bonds / bank lending. Sources: National central banks, Allianz Global Investors, as of 18th September 2017. Future expectations involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such expectations. We assume no obligation to update any future expectations.

Discussion: A few issues for discussion

Bond Market Outlook Ingo Mainert – 10 October 2017

- What mid-term inflation path is currently priced into the euro area bond markets?
- What is currently priced into euro area bond markets with regard to the APP?
- What is the expected market reaction in case of a unilateral declaration of independence in Catalonia? What are the implications of prolonged political instability in Spain?
- What is the expected market reaction in case of a political instability in Italy after the election (latest May 2018)?
- Are currency movements pivotal in the eyes of the market participants?
- Volatility puzzle in the equity markets? What are the reason for such a low volatility?

Disclaimer