FINANCIAL PARTNERS

Weekly Digest

Week ending **25 October 2015**

Last week the European Central Bank (ECB) President Mario Draghi issued a dovish statement which the market greeted positively. Yet, compared to a couple of years ago, the column inches dedicated to the European Government Bond market is modest. It is clear that the stress of 2012 has dissipated, but given the continued uncertainty over the strength of the European economy and the huge levels of liquidity being used as a prop, this is a good time to reflect on the European Bond market's recent history.

To get a measure of the markets I have looked at yield spreads amongst 10-year European sovereign bonds. When all else is equal, including currency of issue, yield spreads are the prime method for markets to express a differing view over the creditworthiness of two debtors (bond issuers). To set the scene, if we look back over the past twenty years, there are four broad phases discernible in the data. The first phase (between 1995 and 2002) can be thought of as the 'convergence' period where over time European governments increasingly came to be treated as more or less pari passu as a result of the establishment of the euro. The second phase (between 2003 and 2007) may be considered to be the 'euro honeymoon' where yield differentials were extremely low and there were regular instances of 10-year debt issues having a lower yield than Germany (but then Germany was yet to shake off its reputation as the 'sick man' of Europe). The third 'crisis' period (2008 to 2012) spans the global financial and the euro debt crises which blew spreads out until Mario Draghi's landmark 'whatever it takes' speech in 2012. The fourth period (2013 to date) shows anxiety dropping once more leading to the return of convergence and gradually dropping yields, but crucially, differentials in yield remaining.

These are very different regimes and the changes of spread, even for any individual issuer, has been substantial over the period. Greece is most notable with a low of 0.08 percentage points and a high of 35.30 percentage points, but even bonds that have avoided the limelight have followed a similar path albeit less spectacularly (e.g. France, whose maximum and minimum spreads are 1.90 and -0.19 percentage points, respectively). Indeed, looking at the evolution of France's spread over German bunds over the four identified regimes, the answer to whether France's debt was viewed as fungible with Germany's would be 'no', 'yes', 'definitely not' and 'not quite' respectively.

While spreads are back to the sorts of levels seen before the convergence trade really kicked in, there is one key differential between the returns available today compared to two decades ago, which is a function of how low the German government bond's yield is today. I have referred to 'spread' repeatedly in this article and this refers to a premium over the prevailing Bund rate. It is important to bear in mind that twenty years ago the 10-year Bund annual yield was 6.55% and today it is 0.50%, so while the spreads are normalising back to levels seen 20 years ago, prevailing total yields are a long way off.

A final interesting observation can be made when comparing the relative ranks between these various issuers in terms of the tightness of their spreads. Optically, the rankings are relatively static: despite some inevitable noise from month to month, those debtors deemed relatively low risk compared to their peers twenty years ago are, in the main, still viewed as such today. Plus ça change, plus c'est la même chose, as French bond holders might say.

The **Marketplace**

- ECB strikes dovish tone
- Europe sees uptick in business loans
- China eases monetary policy
- US Tech firms see encouraging earnings
- Brent crude falls back below $50 a barrel

Market **Focus**

Global

- Global equities added 1.4% last week, while emerging markets lagged with a return of 0.4%. European stocks were the stand-out performer, rising by 4.0% in euro terms.
- US Treasuries fell by 0.3%, while in the high yield space US bonds added 0.6% and their European counterparts returned 0.7% in euro terms.

United States

- US equity bourses were aided by better than expected earnings results from US technology giants Microsoft, Amazon and Alphabet (the newly formed parent of Google), although earlier in the week bank stocks had disappointed.

Europe

- Mario Draghi, President of the European Central Bank (ECB), announced that he was ready to "adjust the size, composition, and duration" of the bank's quantitative easing (QE) programme.
- Furthermore, Mr Draghi did not rule out a further cut in the euro area's benchmark interest rate, which currently stands at -0.2%.
- The euro fell by 2.9% against the dollar, while the 2-year German bund yield hit a record low of -0.325%.
- Earlier in the week, the ECB bank lending survey indicated an uptick in business loan demand and an increase in supply by the continent's banks, suggesting that QE is starting to have its desired effect.

China

- The People's Bank of China eased policy further last week, cutting its one-year lending rate by 0.25 percentage points to 4.35%, its deposit rate by 0.25 percentage points to 1.5% and decreasing banks' reserve requirements by a further 0.50 percentage points.

Commodities

- Commodity prices experienced some volatility towards the end of the week, as investors sought to understand the implications of China's latest easing, and as the dollar strengthened against the euro.
- Brent crude ended the week below $50 a barrel, falling by 4.9%.

Russell Andrews & Scott Gordon

Source: Bloomberg. Returns in US dollars unless otherwise stated.

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Asset Class/Region	Currency	Currency returns			
		Week ending 23 Oct. 2015	Month to date	YTD 2015	12 months
Developed Market Equities					
United States	USD	2.1%	8.2%	2.0%	7.9%
United Kingdom	GBP	1.1%	6.6%	0.7%	3.3%
Continental Europe	EUR	4.0%	8.7%	13.3%	18.3%
Japan	JPY	2.8%	9.7%	11.9%	28.0%
Asia Pacific (ex Japan)	USD	0.8%	10.3%	-4.9%	-5.6%
Australia	AUD	1.6%	6.6%	2.7%	4.1%
Global	USD	1.4%	8.0%	1.4%	4.8%
Emerging Market Equities					
Emerging Europe	USD	-0.5%	9.1%	-1.9%	-18.9%
Emerging Asia	USD	0.8%	10.2%	-3.9%	-2.8%
Emerging Latin America	USD	0.2%	8.4%	-23.2%	-29.2%
BRICs	USD	0.5%	9.8%	-6.2%	-7.8%
MENA countries	USD	-2.4%	-0.2%	-8.2%	-20.2%
South Africa	USD	-1.3%	11.0%	-7.5%	-6.8%
India	USD	0.3%	5.3%	-1.6%	-1.5%
Global emerging markets	USD	0.4%	9.7%	-7.2%	-9.4%
Bonds					
US Treasuries	USD	-0.3%	0.0%	1.8%	2.7%
US Treasuries (inflation protected)	USD	-0.1%	0.7%	-0.4%	-1.4%
US Corporate (investment grade)	USD	0.1%	0.9%	0.8%	1.2%
US High Yield	USD	0.6%	2.8%	0.3%	-1.7%
UK Gilts	GBP	-0.6%	-1.0%	1.5%	6.0%
UK Corporate (investment grade)	GBP	-0.3%	0.0%	0.2%	3.7%
Euro Government Bonds	EUR	0.5%	1.0%	2.2%	5.4%
Euro Corporate (investment grade)	EUR	0.5%	1.3%	-0.5%	0.9%
Euro High Yield	EUR	0.7%	2.5%	2.0%	3.2%
Japanese Government	JPY	0.1%	0.4%	0.5%	2.7%
Australian Government	AUD	0.0%	0.1%	3.1%	6.7%
Global Government Bonds	USD	-1.3%	-0.1%	-1.6%	-3.4%
Global Bonds	USD	-1.1%	0.1%	-2.1%	-3.6%
Global Convertible Bonds	USD	0.1%	3.4%	1.3%	1.5%
Emerging Market Bonds	USD	0.0%	3.8%	3.8%	1.6%

* Estimate

Source: Bloomberg

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Asset Class/Region	Currency	Currency returns			
		Week ending 23 Oct. 2015	Month to date	YTD 2015	12 months
Property					
US Property Securities	USD	0.9%	6.8%	1.4%	7.7%
Australian Property Securities	AUD	1.9%	4.1%	8.6%	15.6%
Asia Property Securities	USD	-0.1%	7.7%	5.8%	7.4%
Global Property Securities	USD	0.7%	6.7%	1.8%	5.5%
Currencies					
Euro	USD	-2.9%	-1.4%	-8.9%	-12.9%
UK Pound Sterling	USD	-0.8%	1.2%	-1.7%	-4.5%
Japanese Yen	USD	-1.6%	-1.3%	-1.5%	-10.5%
Australian Dollar	USD	-0.6%	2.9%	-11.7%	-17.6%
South African Rand	USD	-4.1%	1.6%	-15.1%	-19.6%
Swiss Franc	USD	-2.6%	-0.6%	1.6%	-2.5%
Chinese Yuan	USD	0.0%	0.0%	-2.3%	-3.7%
Commodities & Alternatives					
Commodities	USD	-3.0%	-0.1%	-16.9%	-28.9%
Agricultural Commodities	USD	-0.7%	1.2%	-11.9%	-11.3%
Oil	USD	-4.9%	-0.8%	-16.3%	-44.7%
Gold	USD	-1.1%	4.4%	-1.7%	-5.5%
Hedge funds	USD	-0.3%	0.6%	-2.5%	-2.3%

* Estimate

Source: Bloomberg

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