Trade Booster

09 September 2014

Deflation at the gates: ECB's QE bearish for bonds; bullish for equities

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Summary

- **Stalling growth spreads to Eurozone's core. As disinflation drives bond yields into the ground in strong countries, deflation worsens the creditworthiness of the weak.**
- **Macro risks for the Eurozone are mitigated by ECB's QE stimulus, which boosts bank balance sheets and opens up new credit channels to revive domestic demand.**
- **The QE stimulus bypasses government bonds and rebuilds inflation expectations. While bearish for Eurozone government bonds, it is bullish for Eurozone equities: the stimulus benefits financials while euro devaluation revives sentiment for industrials.**
- **Investors who share this sentiment may consider the following Boost ETPs: *(www.boostetp.com/products)***

Short government bonds:

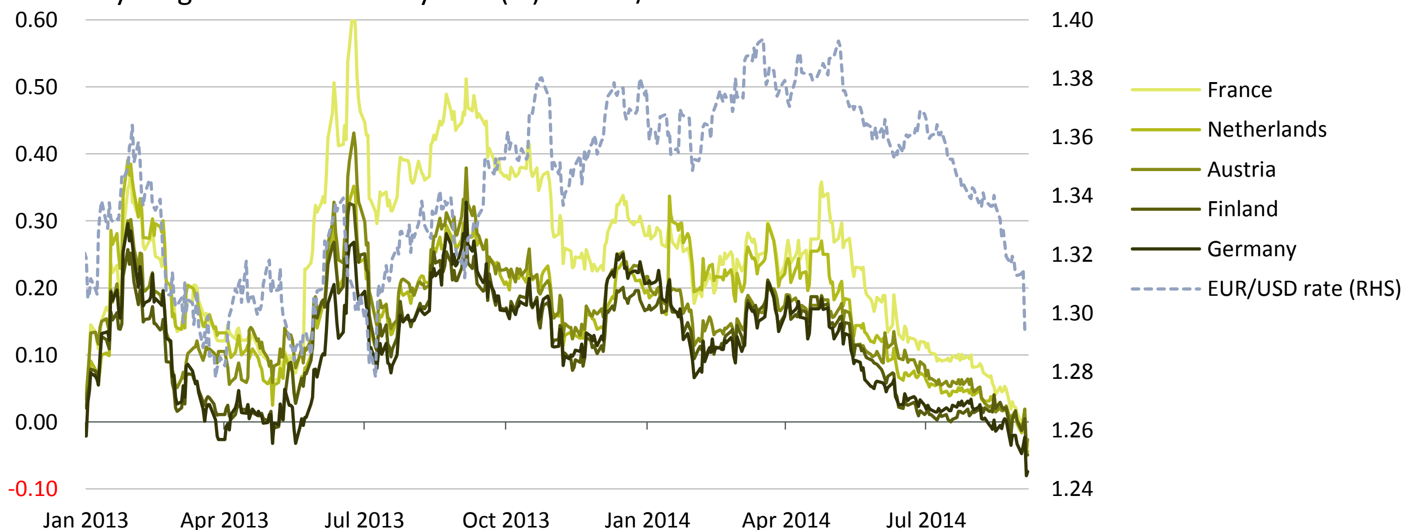
1. Boost BTP 10Y 3x Short Daily ETP (3BTS)
2. Bund 10Y 3x Short Daily ETP (3BUS)

Long equities:

1. Boost EURO STOXX 50 3x Leverage Daily ETP (3EUL)
2. Boost FTSE MIB 3x Leverage Daily ETP (3ITL)
3. Boost LevDAX 3x Daily ETP (3DEL)

Chart 1: deflation is devaluing the euro

2 year government bond yields (%) vs EUR/USD



Source: Boost ETP Research, Bloomberg. Data as at 04 September 2014

Record low Eurozone government bond yields are a reflection of deflation fears, not a reflection of good credit. Deflation's deteriorating effect on indebted economies' ability to service debt is rekindling the kind of macro risks that the ECB's OMT program suppressed. Having cut policy rates as far as it can, the ECB has set a precedent for QE. By buying asset backed securities instead of government bonds, the ECB revives dormant lying credit flows to the real economy, and in the process revives inflation expectations.

Unlike the Fed's QE, the design of the ECB's QE is bearish for eurozone government bonds. It revives momentum into Eurozone equities, as QE boosts the assets of Eurozone financials while exporters benefit from the pressures building on the euro as a result. Investors who share this sentiment may consider the following short debt and long equity ETPs:

Short Eurozone government bonds:

1. Boost BTP 10Y 3x Short Daily ETP (3BTS)
2. Boost Bund 10Y 3x Short Daily ETP (3BUS)

Long Eurozone equities:

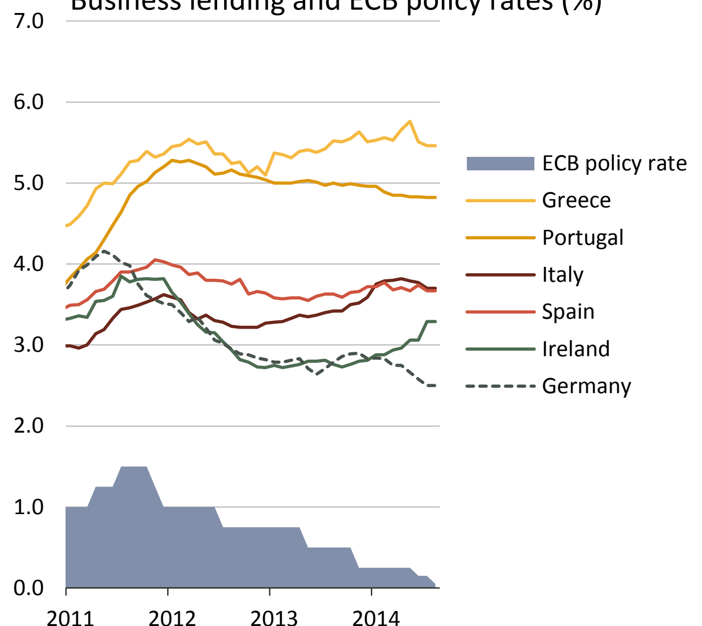
1. Boost EURO STOXX 50 3x Leverage Daily ETP (3EUL)
2. Boost FTSE MIB 3x Leverage Daily ETP (3ITL)
3. Boost LevDAX 3x Daily (3DEL)

Deflation destabilises the credit outlook of Eurozone's indebted economies

Eurozone's 'healthier' governments of France, Finland, Austria and BENELUX can now issue 2 year debt yielding 0% or less with the latter implying investors to effectively be accepting a haircut on debt they bought from the government (see chart 1 in previous page). The German treasury enjoyed this luxury briefly in the summer of 2012, when amidst Eurozone's default fears, investors resorted to hoarding shorter dated German government bonds for fear that anything else was toxic. But after a string of sovereign ratings downgrades and spiking bond yields risked Spain being shut out from the bond market, the ECB's launched its OMT[1] programme, which helped to engineer a rapid restoration of confidence in Eurozone credit markets. Until last week, the ECB merely offered an implicit promise to do 'whatever it takes' to save the euro, without actually having to intervene in fixed income markets.

However, what little growth the Eurozone's core economies were able to squeeze out has recently ground to a halt. As Italy's economy recently entered into a triple dip recession, France posted zero growth in Q1 and Q2. Together with disappointing German growth (a 0.2% contraction of GDP in Q2 this year, albeit largely driven by seasonal anomalies), bond yields of Eurozone's core have hit fresh lows. The low yielding environment portends a deepening domestic demand fallout, threatening once again the survival of the euro. The OMT programme has shown not to be bullet proof in keeping a sustained lid on bond yields, as evidenced by two sharp sell offs this year in Italian BTPs (in response to Italian GDP contracting in Q1 on May and then again in Q2 on August). Hitting the nerves of bond investors were the deflation threats looming large in Italy and the destabilising effect deflation will have on the country's public finances: it reduces tax revenues as households and businesses are incentivised to postpone and cut back spending, while at the same time raises the value of government's outstanding debt in real terms. Hence, by worsening the state of Eurozone's indebtedness, deflation is reviving the macro risks of 2010 and 2011, exposing the systemic risks in the banks that hold too much government debt on the one hand, and the fragile state of coalition governments torn between calls for more austerity by the right and for more deficit spending by the left on the other. Bond yields in the Eurozone may be low in nominal terms, but in real terms they remain high enough potentially to force investors back into discriminating forcefully amongst sovereign debt issuers. Amidst the spreading of economic weakness in Eurozone's core, the perceived security under the veil of ECB's OMT programme is wearing thin.

[1] Outright Monetary Transactions, launched in 2012



Source: Boost ETP Research, Bloomberg. Data as at 04 September 2014

QE boosts riskier bank assets, not sovereign debt

With the official launch of an asset backed securities (ABS) programme, the ECB will be looking to purchase outright illiquid pooled loans from Eurozone banks. Since banks have already regularly been posting ABS as collateral in order to obtain ECB funding (with currently around EUR 300 billion of ABS posted and EUR 684 billion of ABS eligible as collateral), the ECB should, together with the advise and IT support of BlackRock, be in a strong position not only to manage the ABS portfolio but importantly to erase one of its main concerns: namely that of being able to buy ABS at a price close to fair value, so as to mitigate the credit risks on the ECB's balance sheet to the fullest extent possible.

Outright purchases of covered bank bonds are also on the cards. While around EUR 360 billion of covered bank bonds posted by Eurozone banks is currently on the ECB's balance sheet, an estimated EUR 1.3 trillion of covered bank bonds is eligible for collateral. Hence, while details of the size of ECB's QE are unknown, the potential liquidity injection into the banking system (by enabling Eurozone banks to offload ABS and covered bank bonds to the ECB and in the process free up loanable funds to the private sector), is enormous. The urgency to implement QE is evident in the failure of previous ECB rate cuts to translate into easing credit conditions for the private sector and in particular to small and midsized enterprises (SMEs). This problem remains acute across most of the Eurozone's distressed economies which, unlike the strongest few, remain cut off from affordable credit. As also shown in chart 2, while German businesses have seen bank

lending rates fall by around 100 bps on the back of successive ECB policy rate cuts of 145 bps since September 2011, the existing lending rates to Spanish and Italian businesses have more or less remained unchanged over the same period. Worse, faced with deflation, the nominal borrowing rates there are actually much more punitive than the spread over business lending rates in Germany suggests.

The direct stimulus to SMEs that the ECB can provide through QE will initially be small, not least because of the relatively small size of securitised business loans. As an indication, of the EUR 975 billion in securitised assets held by banks, less than EUR 200 billion are backed by pooled business loans. The rest is predominantly backed by (residential) mortgage loans (a.k.a. mortgage backed securities, or MBS). Since banks represent the overwhelming majority of originating entities of securitised assets, it is likely that the institutional investors from whom the ECB could also buy ABS will have disproportionate allocations to MBS and few allocations to ABS backed by business loans. But this misses a crucial point, in that the indirect result of ECB intervention is ultimately one of freeing up illiquid assets sitting on eurozone banks' trading book and enticing pension funds and insurance companies to trade them. This is an attempt to revive credit flows in a dormant, but what in pre-crisis periods was an important, liquidity enhancing credit channel for banks. One way or another, the unlocking of liquidity in the trading book should help banks reinvigorate lending to the private sector, not least because with rock bottom longer term interest rates, the lucrative carry trade on the bond market is largely over.

In fact, following the rate cut on the marginal lending facility, the TLTRO programme has become the new (and potentially lucrative) carry trade proposition for banks. Together with a revival of the ABS market, it is likely to encourage the origination of riskier private sector loans.The overall effect is one of a potentially strong expansion in the asset base of Eurozone banks, enabling them to revive profitability through top line growth as opposed to cost line cuts. With Eurozone banks and institutional investors being the immediate beneficiaries of QE, those equity markets where the financial sector is overly represented are likely to see most momentum. Given the marked weakening of the euro in recent months, (a 6% fall against USD this year on the back of the widening interest rate differential between reflating US and deflating Eurozone), the improved bottom line outlook of Eurozone exporters may encourage upbeat sentiment to spill over to other, more broadly diversified and industrial-led Eurozone equity markets.

The ECB's exceptional stimulus efforts since June (rock bottom policy rates, TLTROs and QE) will take time to translate into domestic demand led growth in the Eurozone and to spur the region into achieving the kind of 'escape velocity' growth needed to firmly entrench inflation. Even the ECB itself indicated that it will likely take 12 months for the full effect of TLTRO on the real economy to be felt. Against this macro backdrop, the near term risks to the bond markets remain, in particular deflation's destabiling effect on the economy's credit outlook. And unlike QE in the US, the ECB is not buying government bonds, not least because at such low yields, it would have little justification to do so. Until then, it may be prudent to position bearishly in eurozone fixed income even as the rebounding risk sentiment may compel investors to allocate bullishly in Eurozone equity markets.

All data is sourced from Boost ETP, and Bloomberg

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