KBC Market Research Desk - Havenlaan 12, 1080 Brussel

Sunrise

Friday, 11 March 2016

Rates: Bund sell-off despite additional easing

The ECB eased monetary policy significantly, but Draghi mentioned that policy rates won't be lowered further. The latter triggered a violent sell-off in the Bund. Technically, the German 10-yr yield tested 0.3% resistance. A break higher becomes likely and suggests more downside for the Bund.

Currencies: ECB delivers, but Draghi propels the euro sharply higher

Yesterday, an early euro decline on the ECB policy announcement was reversed as Draghi indicated no need for further rate cuts. EUR/USD rebounded sharply to the 1.12 area. Today, the eco calendar is thin. So, the post-ECB repositioning might continue. We look out for a euro topping out process.

Calendar

Headlines

S&P	→
Eurostoxx50	↘
Nikkei	↗
Oil	→
CRB	↗
Gold	↗
2 yr US	↗
10 yr US	↗
2 yr EMU	↗
10 yr EMU	↗
EUR/USD	↗
USD/JPY	→
EUR/GBP	↗

- **US Equities ended mixed** yesterday as early losses reversed towards the end of the session. This morning, **most Asian shares trade in positive territory. Chinese stocks underperform,** trading slightly lower.
- **The Chinese central bank allowed the renminbi to strengthen by the most in more than four months this morning**. As a result, the onshore yuan rose to its highest level since the start of the year against the US dollar. The move follows a sharp drop in the US dollar yesterday.
- **Brent crude oil prices rebound this morning, gaining 1%,** following significant losses yesterday as the meeting between major oil producer to coordinate a freeze in output levels is unlikely to take place as Iran did not attend. **The WTI oil price suffered less yesterday** and currently trades at its highest level since the first days of the year.
- **Irish lawmakers failed to choose a new government at their first meeting since the inconclusive elections**, setting the scene for weeks of bargaining between political parties and independents or even a new vote.
- **China is drafting rules to make it easier for lenders to convert bank loans into equity stakes** of debtor companies, a source familiar with the matter said, a move that would help authorities clean up the nation's high levels of soured credit.
- Today, **the eco calendar remains thin** with only some national inflation and production data in Europe and the UK visible trade balance.

Rates

German yields sharply higher

Peripherals profit initially but give back part of the gains

CDS corporates drops 23 bps (crossover) to 6 bps (investment)

Subordinated bank CDS falls 15 bps, Senior bank drops 7 bps

	US yield	-1d
2	0,9353	0,0450
5	1,4608	0,0813
10	1,9432	0,0636
30	2,6995	0,0352

	DE yield	-1d
2	-0,4460	0,0860
5	-0,2390	0,0960
10	0,3110	0,0670
30	1,0892	0,0693

ECB cut deposit rate by 10 bps, but without tiered system, repo cut to 0%

PPSP monthly purchases raised by €20B

Corporate bonds eligible

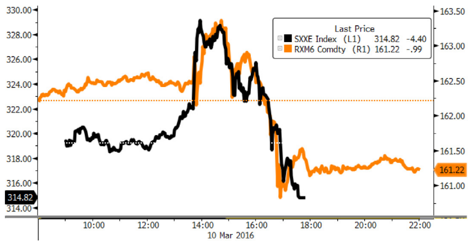
New TLTRO2 lending scheme at generous financing cost

Markets doubt effectiveness of ECB's measures

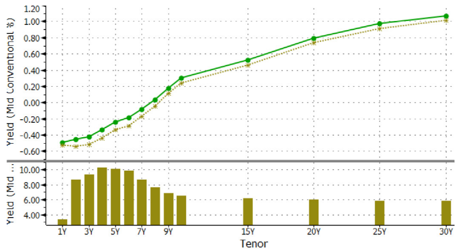
The ECB clearly delivered more than the market expected (see below), but market enthusiasm dissipated faster than it arrived as Draghi strongly suggested that the deposit rate won't be cut again. That's also why the ECB didn't introduce a tiered deposit rate system. If more easing needs to be done, it will have to be done via other non-conventional measures. We suspect that G-20 participants agreed not to start a currency war via ever lower negative rates.

The ECB eventually ended up with stronger euro, weaker equities and higher yields. That's not exactly the financial easing where they aimed at. If it isn't rapidly reversed, the ECB will be the big loser of its own actions and risks to stay side-lined for a long time, unable to reach its objectives. Will fiscal policymakers, entangled themselves in an existential refugee crisis and the Brexit referendum, come to the rescue anytime soon? We can only doubt. In a daily perspective, German yields rose up to 10 bps with the 2-to-5-yr underperforming. The 10 and 30 yr yields rose by 6.5 and 5.8 bps respectively. The market almost completely priced out further deposit rate cuts.

More specifically the ECB cut its refi rate and marginal lending rate by 5 bps to 0% and 0.25% respectively. They lowered the deposit rate by 10 bps to -0.40%. The pace of monthly QE-purchases increased from €60B/month to €80B/month and investment-grade, non-bank, corporate bonds became eligible. Buying **corporate bonds** could unlikely be done in size though. It might turn out to be a side-show like the ABSPP this year. Additionally, the ECB raised the issuer and issue share limit from 33% to 50% for securities eligible for international organisations and multilateral development banks. A new series of **four targeted longer-term refinancing operations**, each with a maturity of four years, will start in June 2016 on a quarterly basis. Borrowing conditions in these operations happen at the repo-rate (0%), but can be as low as the deposit rate if banks lend out more than the lending benchmark the ECB defines! **Counterparties will be able to borrow a total of up to 30% of a specific part of their loans (corporate and household non-mortgage lending), less any amount outstanding under the (by 2.5% at as 31 January 2018) will be charged at a lower rate, but minimal the deposit rate (now -0.40%). These new TLTRO's look advantageous for banks** given the long tenors and the zero or lower financing cost, but given the amount of excess liquidity and the slow increase of demand for loans, it remains to be seen whether there is a sizeable net take-up (old TLTROs may be rolled into the new ones). Aside from the first TLTRO1, the uptake in subsequent TLTROs1 was disappointing. We also question the effectiveness of this measure.



Bund future (orange) & EuroStoxx (black): Initial positive reaction on ECB package rapidly turned around and ended in a rout-



German curve bear flattens on ECB decision and Draghi's comments

Italian supply: unattractive pricing?

The Italian debt agency taps the on the run 3-yr BTP (€1.5-2B 0.3% Oct2018) and 15-yr BTP (€1-1.5B 1.65% Mar2032) while also creating a new 7-yr BTP (€3.5-4B 0.95% Mar2023). The bonds on offer didn't cheapen in the run-up to the auction and especially the Mar2032 is expensive on the Italian curve. Grey market trading suggests that the new 7-yr BTP will be priced with a 0.3 bps pick-up in ASW spread terms compared to the previous 7-yr benchmark (1.45% Sep2022). That's a 8 bps pick-up in yield terms. We believe that the pricing of the three BTP's isn't really attractive, which could hamper demand. **The US Treasury concluded its mid-month refinancing operation with a solid $12B 30-yr Bond auction.** The auction stopped well through the 1:00 PM bid side and the bid cover was in line with the prior year's average (2.33).

R2	164	-1d
R1	163,4	
BUND	**161,19**	-0,9100
S1	160,81	
S2	160,14	

More downside ahead

Overnight, most Asian equity markets trade positive with China underperforming. The oil price is marginally higher and the US Note future has a downward bias, suggesting some weakness in the Bund opening.

Today's eco calendar is empty so markets can further digest the ECB meeting (see KBC FLASH). Draghi delivered on additional easing, but warned that rates won't be cut again. The market reaction (bear flattening yield curve) suggests that investors **no longer believe in the effectiveness of the experimental monetary policy.** The ECB's armoury is also running low on ammunition and several of yesterday's non-conventional measures are nothing mere but eyewash. Extreme positioning was evidently another reason for the huge move. We believe that yesterday's move could go further, but of course not at a similar pace.

Going forward, we think that there is a firm bottom below rate markets in yield terms. The ECB doesn't intend to lower rates further and also gives the Fed more leeway to become more hawkish. **The German 10-yr yield tested 0.3% resistance (neckline double bottom). A break higher becomes very likely and would be a signal to sell the Bund.** Last week, three other important markets already broke more or less similar key technical levels. The Brent oil price ($37.55/barrel), S&P 500 (1950) and US 10-yr yield (1.85%) all moved above resistance levels, painting double bottoms on the charts. **This suggests that risk sentiment changed compared to the beginning of the year (more positive) and gives more downside for core bonds).**

German Bund (June contract): Bund sell-off despite additional ECB easing

US Note future (June contract): break below double top suggests more downside

Currencies

ECB delivers, but Draghi propels euro sharply higher

ECB delivers substantial easing

Euro jumps higher as Draghi suggests no need for further rate cuts

R2	1,1376	-1d
R1	1,1218	
EUR/USD	**1,1158**	0,0177
S1	1,1068	
S2	1,0826	

On Thursday, the ECB policy decision dominated trading. Immediately after the policy announcement with lots of new measures, European bond yields and the euro declined substantially. However, this decline was abruptly reversed, as the ECB president said he didn't see a need for further rate cuts and as markets doubted the other measures would help the ECB much in reaching their objectives. EUR/USD rebounded forcefully and jumped well north of the pre-announcement levels. EUR/USD closed the session at 1.1177 (compared to 1.0999 on Wednesday). USD/JPY initially declined in line with USD/EUR, but it found a bottom as US stocks reversed most initial gains.

Asian equities trade mostly in positive territory

PBOC fixes the yuan at strong level

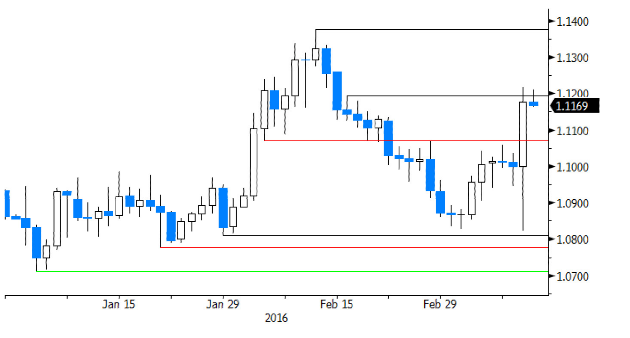
EUR/USD maintains most of yesterday's gains

This morning, Asian equity markets react in a guarded way to yesterday's ECB-induced volatility. The rise of the euro and the prospect that Europe is nearing the end of its rate cut cycle diminishes the risk of a race to the bottom in currencies. This is positive from a global perspective. Yesterday's USD decline allowed the PBOC to fix the yuan strong at USD/CNY 6.4905 vs 6.5127. **The strong yuan at least partially supported market stability in Asia**. Major Asian equity indices trade with modest gains. Commodities also rebounded after yesterday's setback. USD/JPY trades in the 113.50 area, off yesterday's low (112.61). EUR/USD preserves most of the gains and trades around 1.1170.

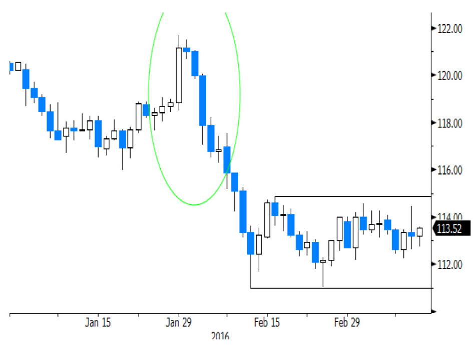
The eco calendar is again thin

Markets ponder the consequence of ECB policy action/communication

Today, the eco and event calendars are empty. So, market will ponder the impact of yesterday's ECB action and Draghi's comments. The ECB deposit rate cut by 'only' 10 bps to -0.40% and suggestion the rate cycle is done pushed ST European yields higher. The 2-year US-German rate differential narrowed from about 145 bps to about 138 bps. **A market repositioning, as it occurred yesterday, takes most often more than one day**. So, some further fall-out today is likely. In a daily perspective, the euro can stay relatively strong. That said, **we don't expect that yesterday's move is already a real game changer for euro trading**. Extremely low/ negative interest rates will remain in place for a very long time. This should still cap the topside of the euro. A the same time, the ECB nearing the end of its rate cut cycle gives the Fed and the other central bankers of stronger economies a bit more room to normalize policy, if deemed useful. This keeps the dollar well support for now versus the euro and other currencies



EUR/USD: jumps sharply higher on Draghi rate comments .



USD/JPY: still showing no clear directional trend

Of late, we advocated sideways EUR/USD trading within the 1.1193/1.0810 range. The top of this range was extensively tested yesterday and remains under pressure. Some further repositioning in favour of the euro might be on the cards short-term. 1.1376 is the next important support on the charts. For now, we assume that this level will hold, unless the news flow from the US would turn really negative. We look out for an EUR/USD topping out process. USD/JPY perfectly holds within the 110.99/114.87 sideways consolidation pattern. The pair still shows no clear trend, but it looks like the downside is well protected. This is partially due to market fears for BOJ action in case of a sharp rise of the yen. At the same time, the dollar might perform rather well in the run-up to next week's Fed meeting.

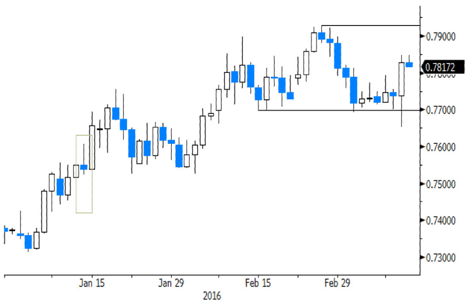
EUR/GBP: downside test rejected on euro strength

R2	0,8066	-1d
R1	0,7929	
EUR/GBP	**0,7817**	0,0088
S1	0,7652	
S2	0,7525	

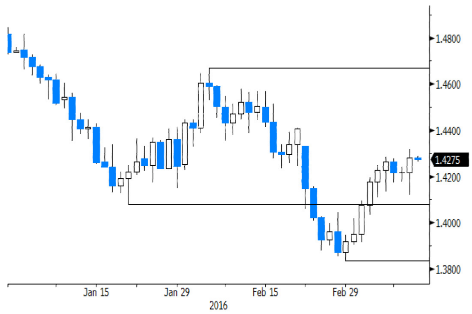
The EUR/USD swings after the ECB policy decision also filtered through into cable and EUR/GBP. Both cross rates initially declined. Cable tested the 1.4120 area. EUR/GBP dropped temporary below the 0.7690 support. However, the declines in cable and EUR/GBP were also reversed after the 'no need' comment of Draghi. EUR/GBP rebounded sharply as EMU interest rates rose. EUR/GBP closed the session at 0.7825, sharply higher from Wednesday's close at 0.7737. Dollar weakness also propelled cable back higher later in the session. The pair finished the session at 1.4281 (from 1.4217)

Today, the UK trade balance data and the construction output for January will be published. The trade deficit is expected to widen again. Construction output is expected soft at 0.2% M/M and 1.6% Y/Y. We don't expect the data to given sterling support. However, the focus for sterling trading will be on the global, post-ECB developments.

Last week, sterling rebounded as the Brexit-fears moved to the background, but the rebound slowed at the end of last week. For cable, the hypothesis of a bottoming out process remains in place. For EUR/GBP the picture is damaged by yesterday's overall euro rebound. As is the case for EUR/USD, we look for signs of a topping out process in EUR/GBP. **The medium-term technical picture of sterling against the euro remains negative as EUR/GBP broke above the 0.7493 Oct top. Short-term, EUR/GBP tested a first support at 0.7696 last week and this area was temporary broken yesterday. However, the test was rejected. 0.7652 is now the first important level on the downside.**



EUR/GBP: test of the downside rejected



GBP/USD: bottoming-out hypothesis survives

Calendar

Friday, 11 March		Consensus	Previous
US			
14:30	Import Price Index MoM YoY (Feb)	-0.7% / -6.5	-1.1%/ -6.2%
Canada			
14:30	Unemployment Rate (Feb)	7.2%	7.2%
14:30	Net Change in Employment (Feb)	10.0K	-5.7k
Japan			
00:50	BSI Large All Industry QoQ (1Q)	--	4.6
00:50	BSI Large Manufacturing QoQ (1Q)	--	3.8
UK			
10:30	**Visible Trade Balance GBP/Mn (Jan)**	**-£10300**	**-£9917**
10:30	Trade Balance (Jan)	-£3000	-£2709
10:30	Construction Output SA MoM YoY (Jan)	0.2% / -1.7%	1.5% / 0.5%
Germany			
08:00	Wholesale Price Index MoM YoY (Feb)	A-0.5%/-1.9%	-0.4%/-1.0%
08:00	CPI MoM YoY (Feb F)	A 0.4%/0.0%	0.4%/0.0%
08:00	**CPI EU Harmonized MoM YoY (Feb F)**	**A0.4%/-0.2%**	**0.4% / -0.2%**
Italy			
10:00	**Industrial Production MoM YoY (Jan)**	**0.7% / --**	**-0.7% /-1.0%**
Spain			
09:00	CPI Core MoM (Feb)	-- / 0.8%	-1.6% / 0.9%
09:00	CPI EU Harmonised MoM (Feb F)	-0.4%/-0.9%	-0.4%/ -0.9%
Greece			
11:00	Industrial Production YoY (Jan)	--	5.2%
Sweden			
09:30	Average House Prices (Feb)	--	2.717m
Events			
Italy	**BTP Auction (€1.5-2B 0.3% Oct2018, €3.5-4B 0.95% mar2023, €1-1.5B 1.65% mar2032)**		

10-year	td	-1d	2-year	td	-1d	STOCKS		-1d
US	1,94	0,06	US	0,94	0,04	DOW	16995	16995,13
DE	0,31	0,07	DE	-0,44	0,09	NASDAQ	'or Exch - NQI	#VALUE!
BE	0,59	0,06	BE	-0,36	0,06	NIKKEI	16939	16938,87
UK	1,54	0,06	UK	0,51	0,17	DAX	9498,15	9498,15
JP	-0,01	0,01	JP	-0,17	0,02	DJ euro-50	2971	2970,78

							USD	td	-1d
IRS	EUR	USD (3M)	GBP	EUR	-1d	-2d	Eonia EUR	-0,242	-0,006
3y	-0,082	1,117	0,892	Euribor-1	-0,29	0,00	Libor-1 USD	0,51	0,51
5y	0,091	1,349	1,074	Euribor-3	-0,22	0,00	Libor-3 USD	0,59	0,59
10y	0,660	1,758	1,504	Euribor-6	-0,14	0,00	Libor-6 USD	0,74	0,74

Currencies		-1d	Currencies		-1d	Commoditie	CRB	GOLD	BRENT
EUR/USD	1,11665	0,0185	EUR/JPY	126,76	1,94		171,8868	1268,8	40,77
USD/JPY	113,535	-0,14	EUR/GBP	0,7818	0,0089	-1d	2,42	20,80	-0,09
GBP/USD	1,4275	0,0072	EUR/CHF	1,1006	0,0056				
AUD/USD	0,7498	0,0011	EUR/SEK	9,3504	0,06				
USD/CAD	1,3258	0,0001	EUR/NOK	9,4823	0,11				

Contacts

Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41	**Brussels**	
Peter Wuyts	+32 2 417 32 35	Corporate Desk	+32 2 417 45 82
Joke Mertens	+32 2 417 30 59	Institutional Desk	+32 2 417 46 25
Mathias van der Jeugt	+32 2 417 51 94	France	+32 2 417 32 65
Dublin Research		London	+44 207 256 4848
Austin Hughes	+353 1 664 6889	Singapore	+65 533 34 10
Shawn Britton	+353 1 664 6892		
Prague Research (CSOB)			
Jan Cermak	+420 2 6135 3578	**Prague**	+420 2 6135 3535
Jan Bures	+420 2 6135 3574		
Petr Baca	+420 2 6135 3570		
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8809	**Bratislava**	+421 2 5966 8820
Budapest Research			
David Nemeth	+36 1 328 9989	**Budapest**	+36 1 328 99 85

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