

Bond Market Outlook

Bond Market Contact Group
Meeting of January 22th, 2013



Government Bonds

Market outlook

■ Market Outlook

- Lower gross issuance in the Eurozone from €811bn in 2012 to €732bn(e) in 2013
- Substantial issuance decline from AAA/AA Eurozone countries from €190bn in 2012 to €130bn (e) in 2013
- Higher need of highly rated paper for collateral uses (EMIR, central clearing set up)

- But macro economic conditions still challenging in Europe and sovereign rating downgrade risks not excluded
- Substantial net new issuance from France at €62bn, Spain €28bn or Italy €23bn expected for the year 2013
- Italy the second largest gross issuer in the Eurozone with €155bn expected in 2013

- Announcement of OMT by ECB: a critical breakthrough perceived by markets and investors to stabilise the government bond markets
- Progressively re-opening risk appetite for periphery countries among investors

Government Bonds

Current appetite and investment considerations

■ Investment considerations :

- Long term investment for duration management purpose
- But existing investments already sizeable exposing us to potential rating downgrade and yield volatility
- A credit component introduced in what was formerly perceived a risk free asset
- Inclusion of Collective Action Clause, CAC, not a game changer and no additional cost seen relative to non CAC bonds
- Greek PSI left a bad case in memories

■ Current appetite :

- Current absolute low yield in AAA/AA countries
- Risk of yield increase / normalisation
- No significant appetite for taking long Core government bonds at current levels
- Reallocation towards quasi-govies (supranationals / agency) with potential spread pickup versus Government bonds
- Search for new asset classes with low volatility and stable cash flow profiles enabling long term investments (such as infrastructure debt)
- Renewed appetite for selected Periphery government debts but with shorter duration

■ Search for long dated assets to match duration target remains a key ALM challenge

Bank senior, covered and structured

Market outlook

■ **Bank senior bonds :**

- Market size of €450bn
- €160bn expected gross issuance and negative net issuance of minus €100bn in 2013
- Impacted by substantial rating downgrades in the last 3 years
- New resolution framework and bail-in clauses after 2018
- Massive spread compression after the period of market stress with elevated spread volatility

■ **Bank covered bonds :**

- Market size over €1tn
- Negative net issuance expected for the year 2013
- Importance of covered bond legislation and protective framework
- Credit quality resilience and relatively highly rated instruments in Core European Countries
- Some emerging concerns over the degree of asset encumbrance of bank balance sheets

■ **Bank securitization products :**

- Limited issuance expected in Europe with relatively tight spread pick-up
- More opportunities expected from the US markets (size, issuance level)

Bank, covered and structured

Current appetite and investment considerations

■ **Bank senior bonds :**

- Improving credit profile mitigating new bail-in legislation risk for investors
- No appetite for subordinated bonds given elevated equitization risk
- Very selective process and risk/reward analysis to identify investment opportunities
- Focus on “National champions “

■ **Bank covered bonds :**

- Secured investments backed by resilient pool of assets in most Core countries
- Can be considered for long dated investments
- Current spread level and low yield constraining attractiveness
- Some few opportunities in Periphery Countries after very selective process and relative value analysis versus government bond/unsecured senior debt

■ **Bank securitization products :**

- Limited appetite in Europe under current market conditions
- Some opportunities found in the US market (CLO, credit cards, auto loans, etc)

Corporate Credit

Market outlook and current appetite

■ Market outlook :

- Growing asset class with a market size over €600bn for investment grade corporates
- €170bn(e) gross issuance and positive net issuance of €30bn(e) in 2013
- High Yield European market of smaller size around €250bn
- Macro economic conditions in Europe still challenging
- Compressed yield and spread for IG Core Corporate (less 2% of market average yield)

■ Current appetite :

- Key rationale for investment remains diversification of fixed income exposure and yield pick-up versus Government bonds
- Targeted duration of 5 to 7 years due to uncertainty risk over longer horizon
- Very selective process due to credit, rating migration and liquidity risk
- Diversification outside Europe remains a clear objective through Emerging markets and US, but already few left opportunities in the US after the rally
- Search for new opportunities in the loan market (infra / private placement) to get spread pick-up while forgiving some liquidity