Current Sovereign Market Trends

17th November 2011

Dr. Jan Holthusen, Head of Fixed Income Research

DZ BANK

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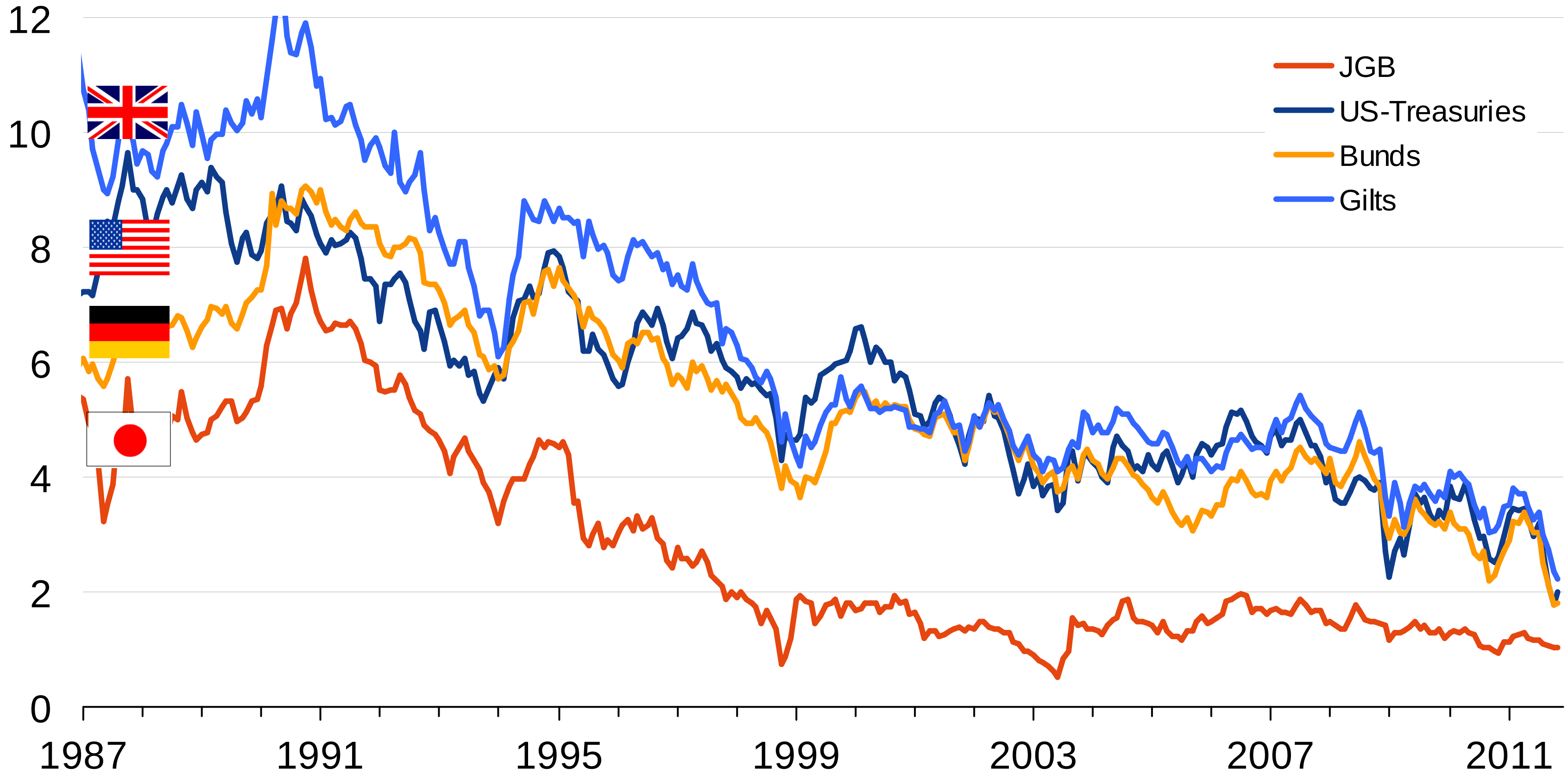
2. Rating downgrades
3. Volatility and liquidity
4. Real yields and financial repression

1. Flight to quality

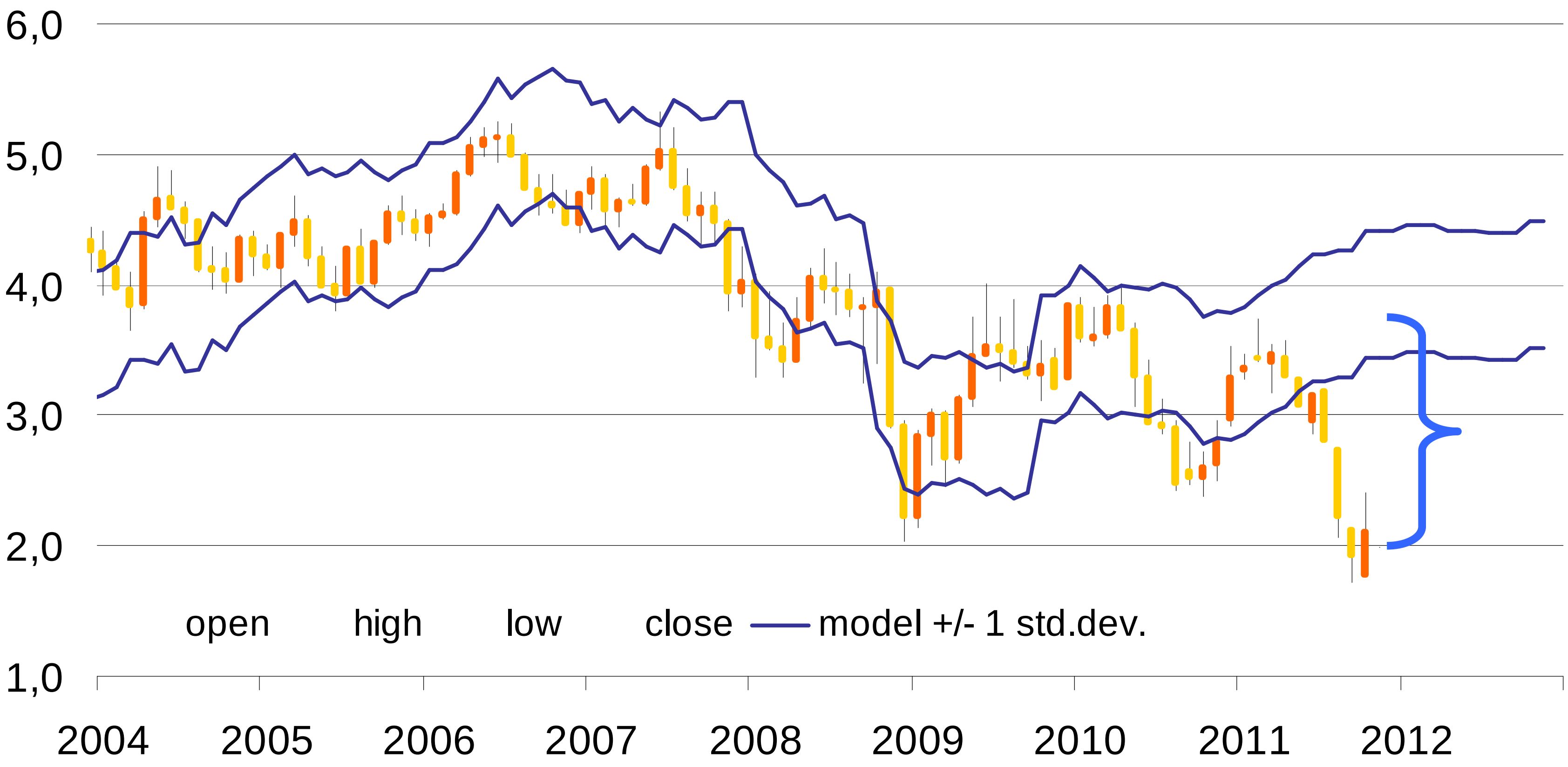
Bonds yields at or near record lows

10 yr government bond yields



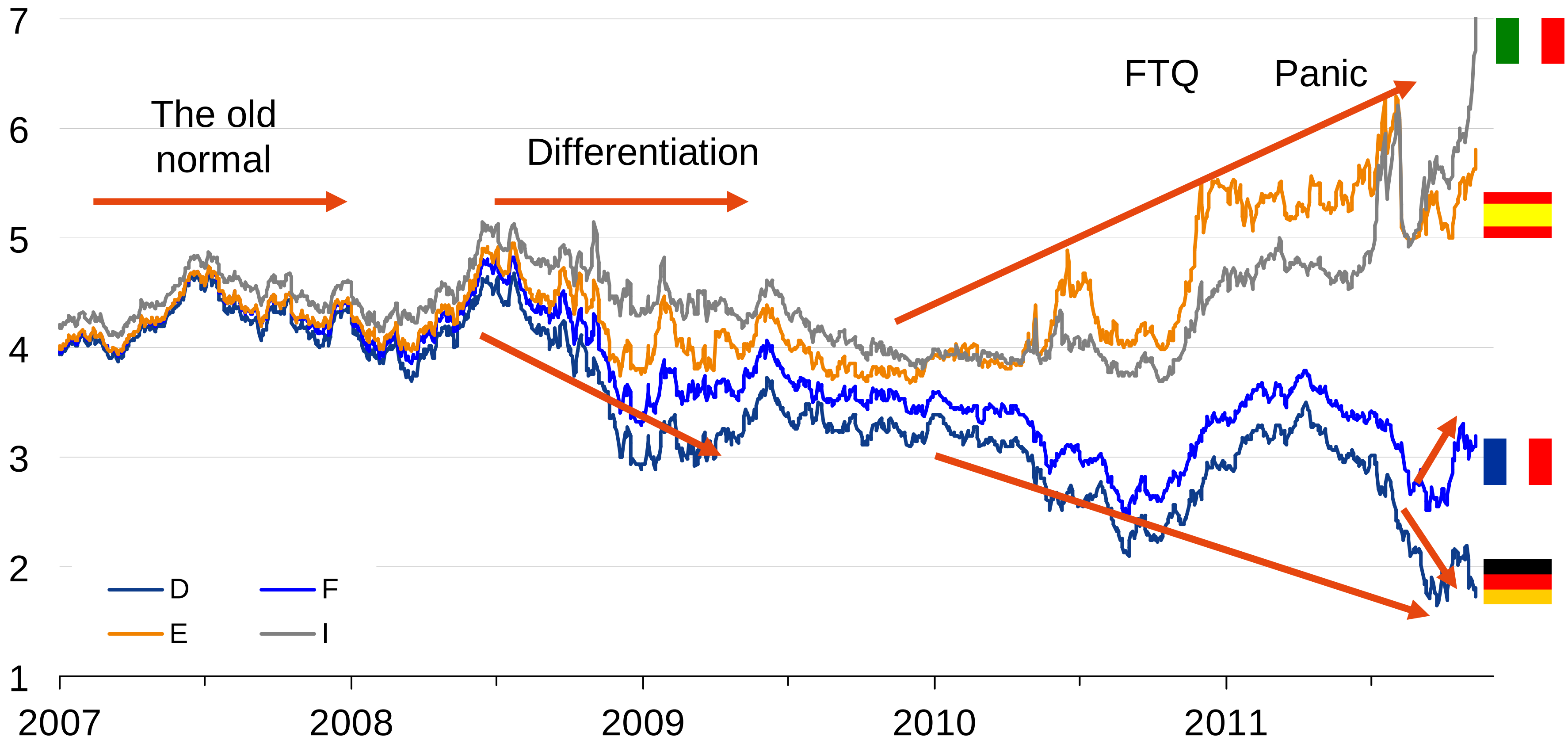
Fears of recession and flight to safety prompt yields to fall despite rating concerns

GDP growth (+), inflation (core rate) (+), Fed funds (+), flows (+)

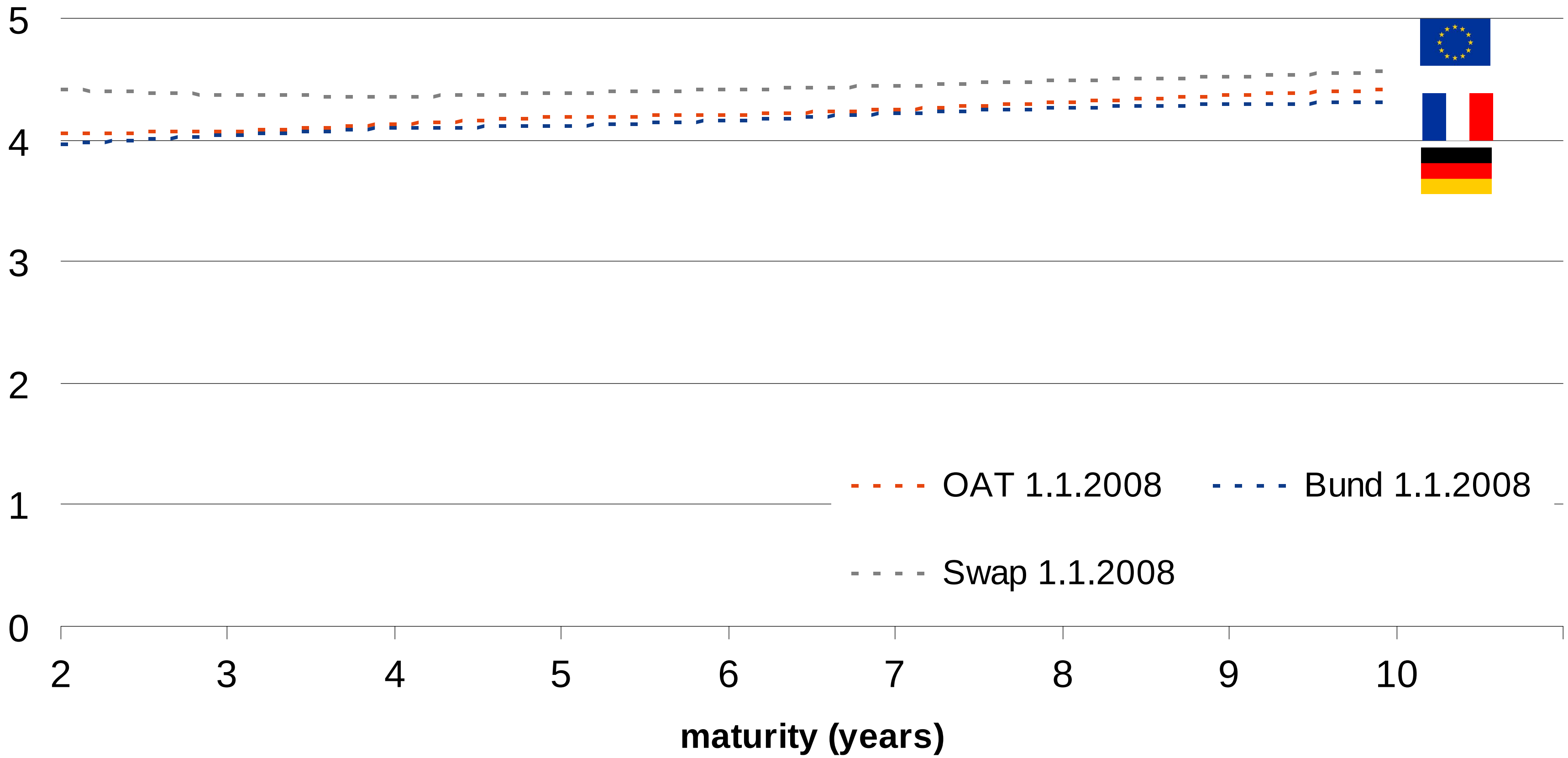


Investors rolling back diversification

10 yr government bond yields



Bund, OAT, and swap curve



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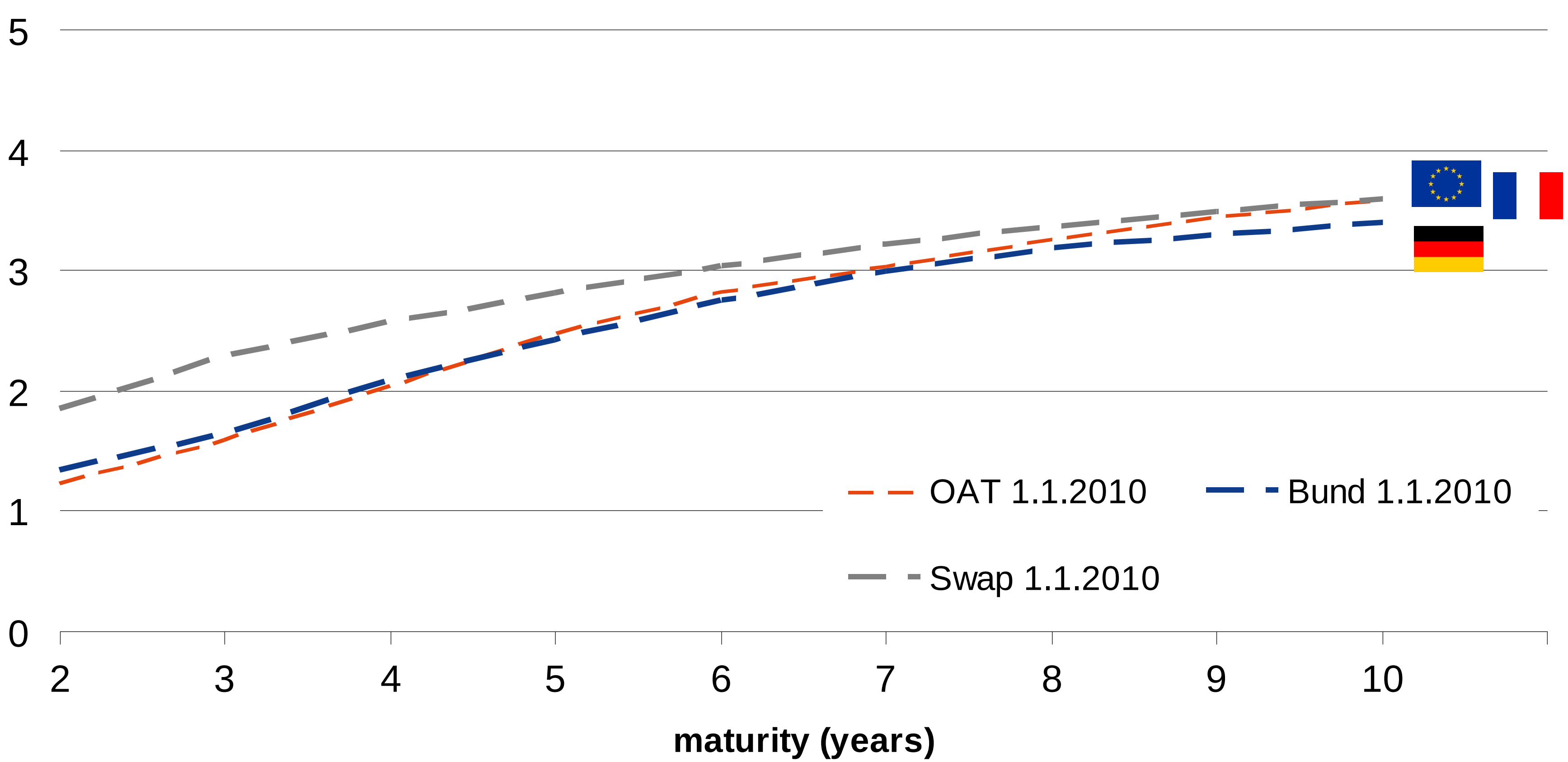
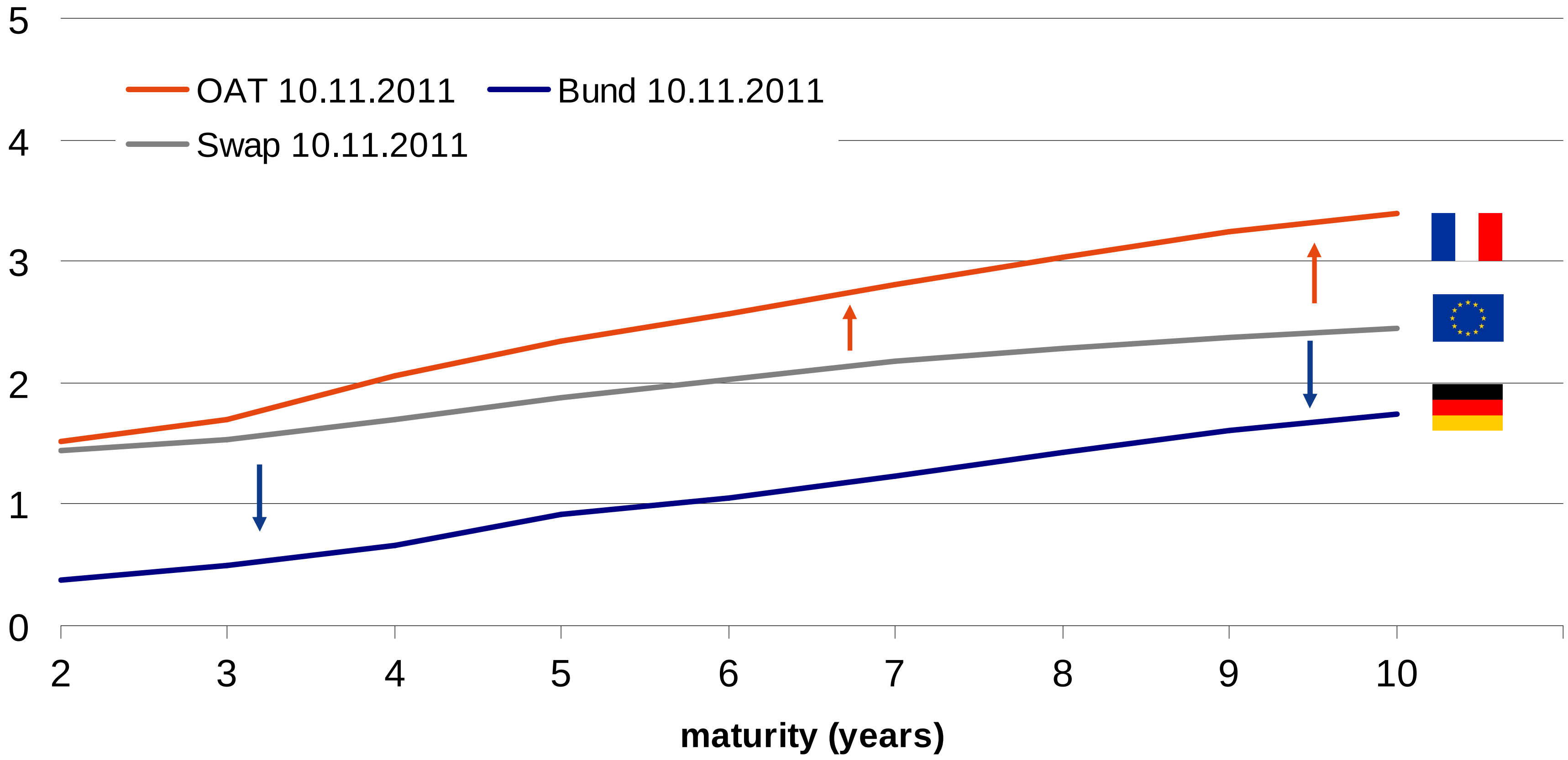
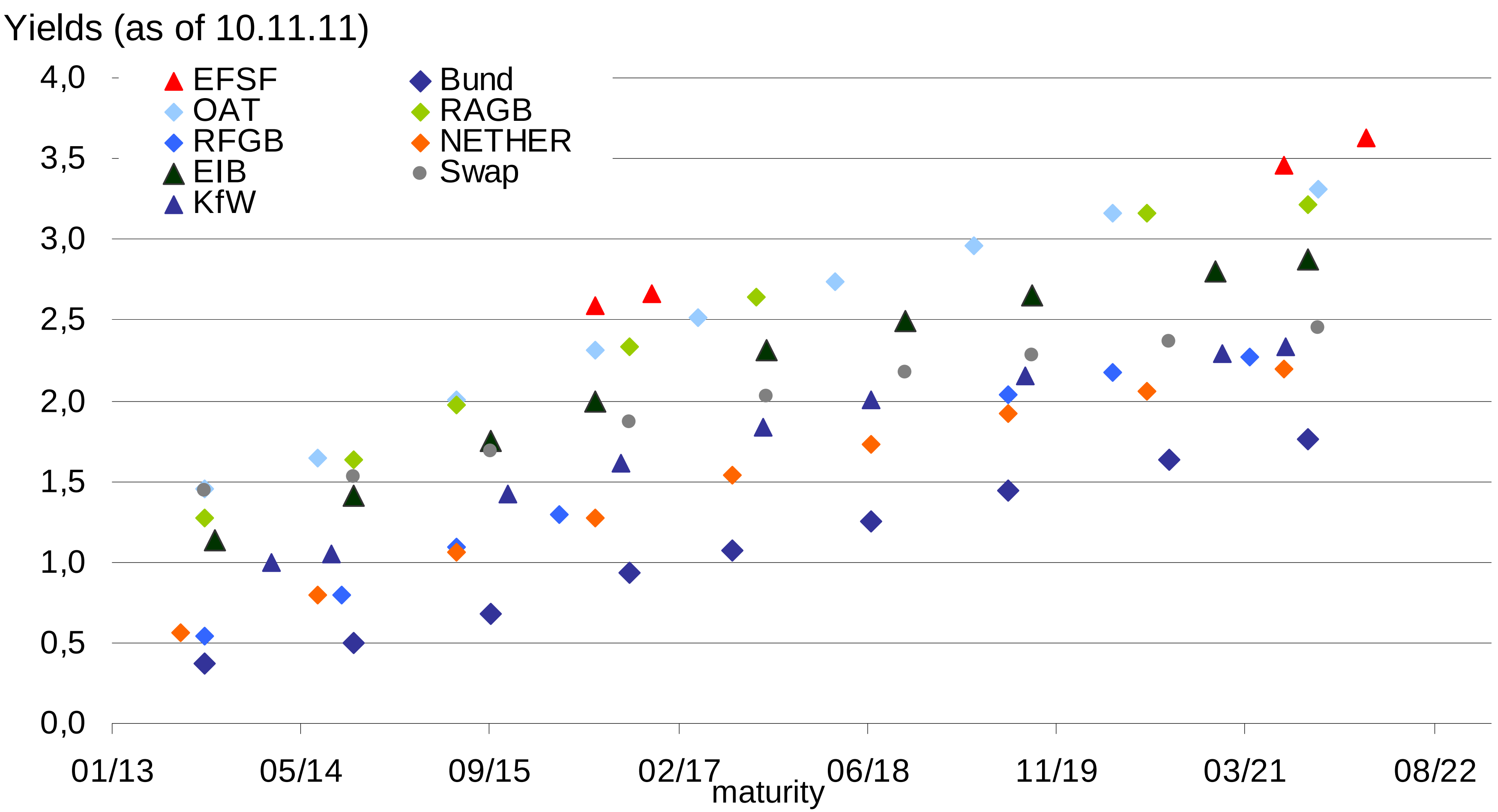


Bund, OAT, and swap curve



The AAA-Universe in the euro area



2. Rating downgrades

Ratings are deteriorating

Long term domestic ratings

	15.09.2001			15.09.2006			31.10.2011		
	Moody's	S&P	Fitch	Moody's	S&P	Fitch	Moody's	S&P	Fitch
Germany	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
France	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Italy	Aa3	AA	AA-	Aa2	AA-	AA	A2	A	A+
Spain	Aa2	AA+	AA+	Aaa	AAA	AAA	A1	AA-	AA-
Netherlands	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Austria	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Finland	Aaa	AA+	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Denmark	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Sweden	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Norway	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
United Kingdom	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Switzerland	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Japan	Aa2	AA+	AA+	A2	AA-	AA-	Aa3	AA-	AA-
United Staates	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AA+	AAA
Canada	Aa1	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Australia	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
New Zealand	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AA+	AA+

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	15.09.2001			15.09.2006			31.10.2011		
	Moody's	S&P	Fitch	Moody's	S&P	Fitch	Moody's	S&P	Fitch
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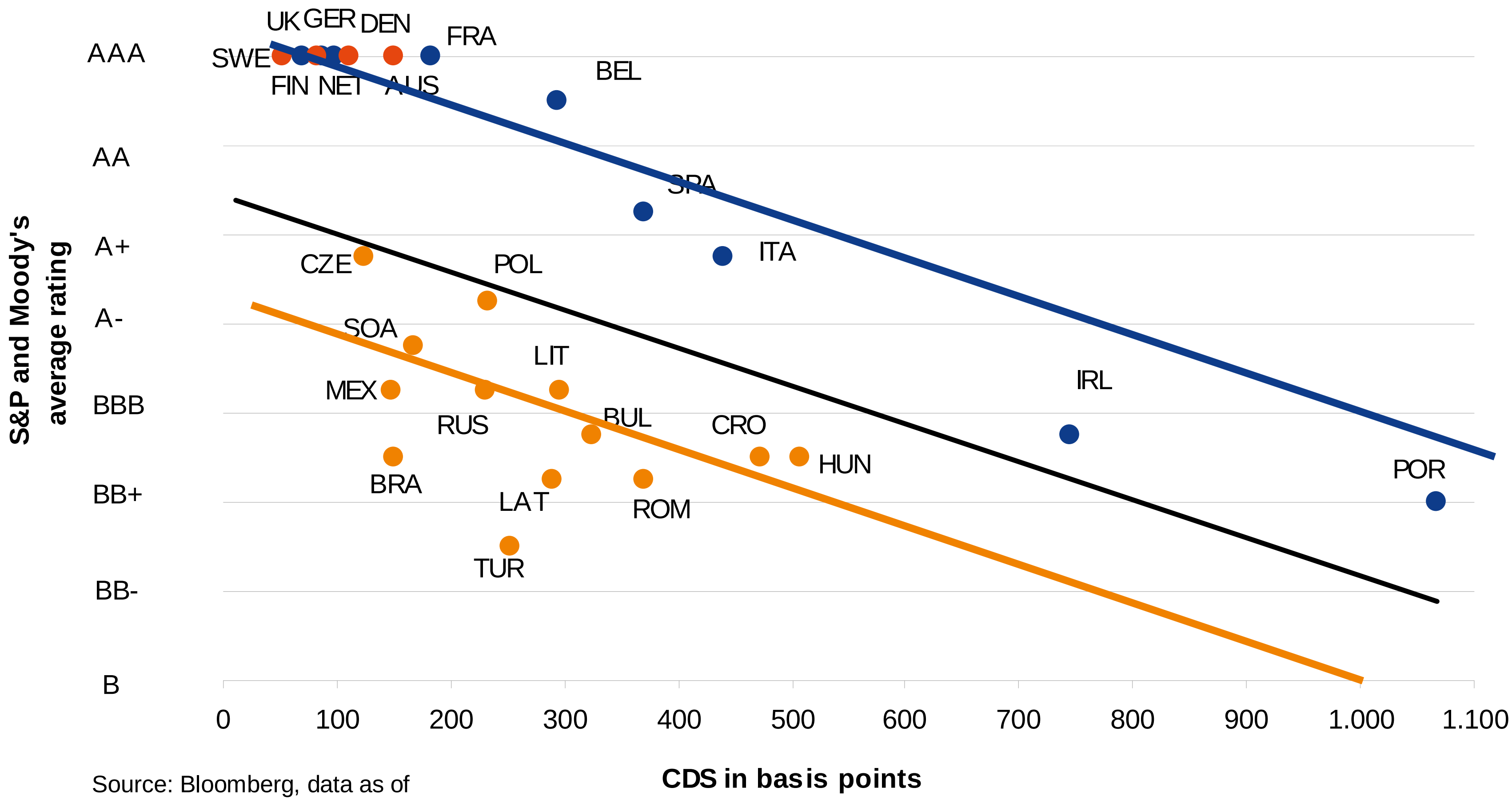
France	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Italy	Aa3	AA	AA-	Aa2	AA-	AA	A2	A	A+
Spain	Aa2	AA+	AA+	Aaa	AAA	AAA	A1	AA-	AA-
Netherlands	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Austria	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Finland	Aaa	AA+	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Denmark	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Sweden	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Norway	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
United Kingdom	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Switzerland	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Japan	Aa2	AA+	AA+	A2	AA-	AA-	Aa3	AA	AA-
United Staates	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AA+	AAA
Canada	Aa1	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
Australia	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AAA	AAA
New Zealand	Aaa	AAA	AAA	Aaa	AAA	AAA	Aaa	AA+	AA+

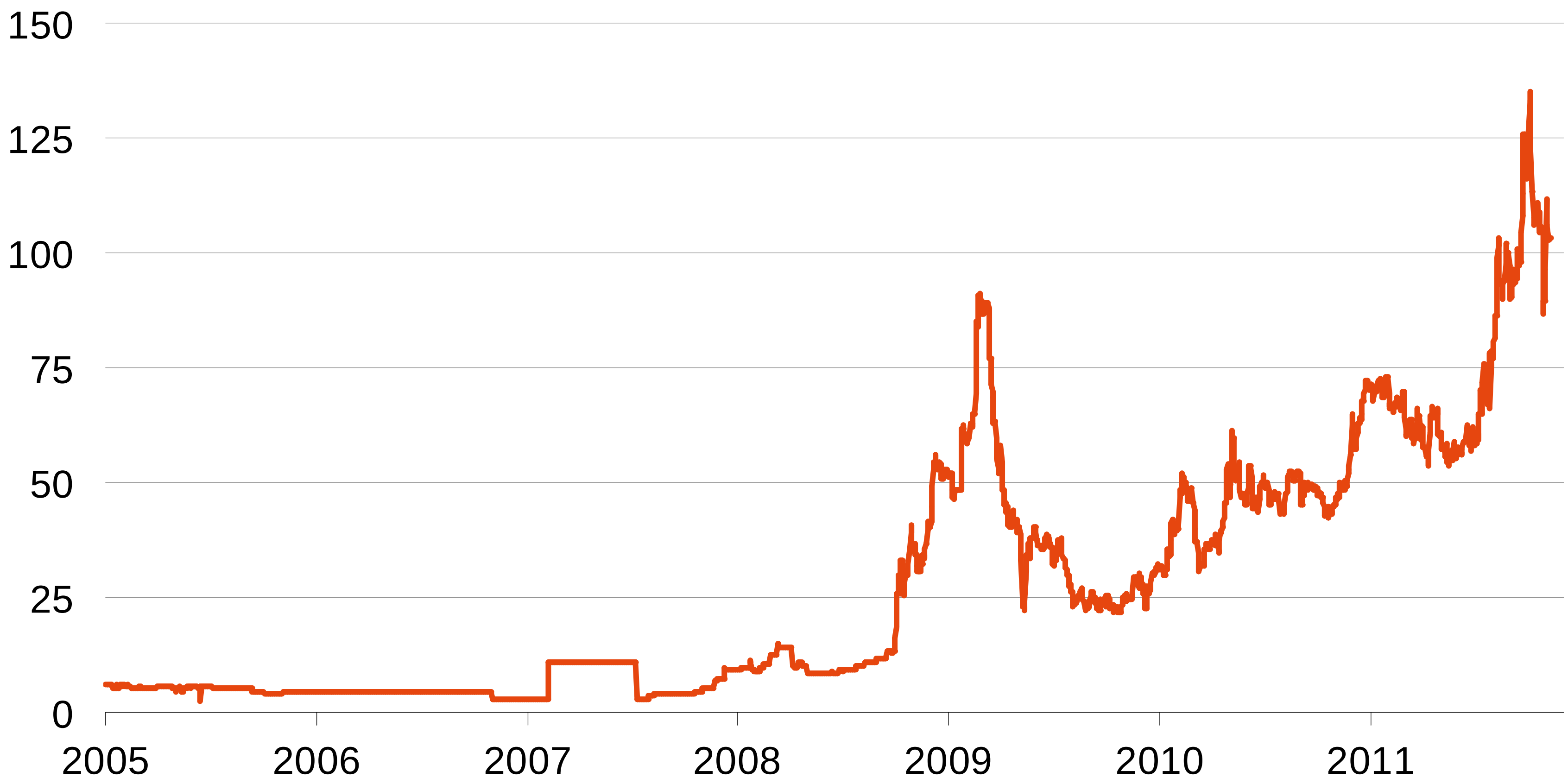
Good to be far away from EMU



Source: Bloomberg, data as of 19.10.2011

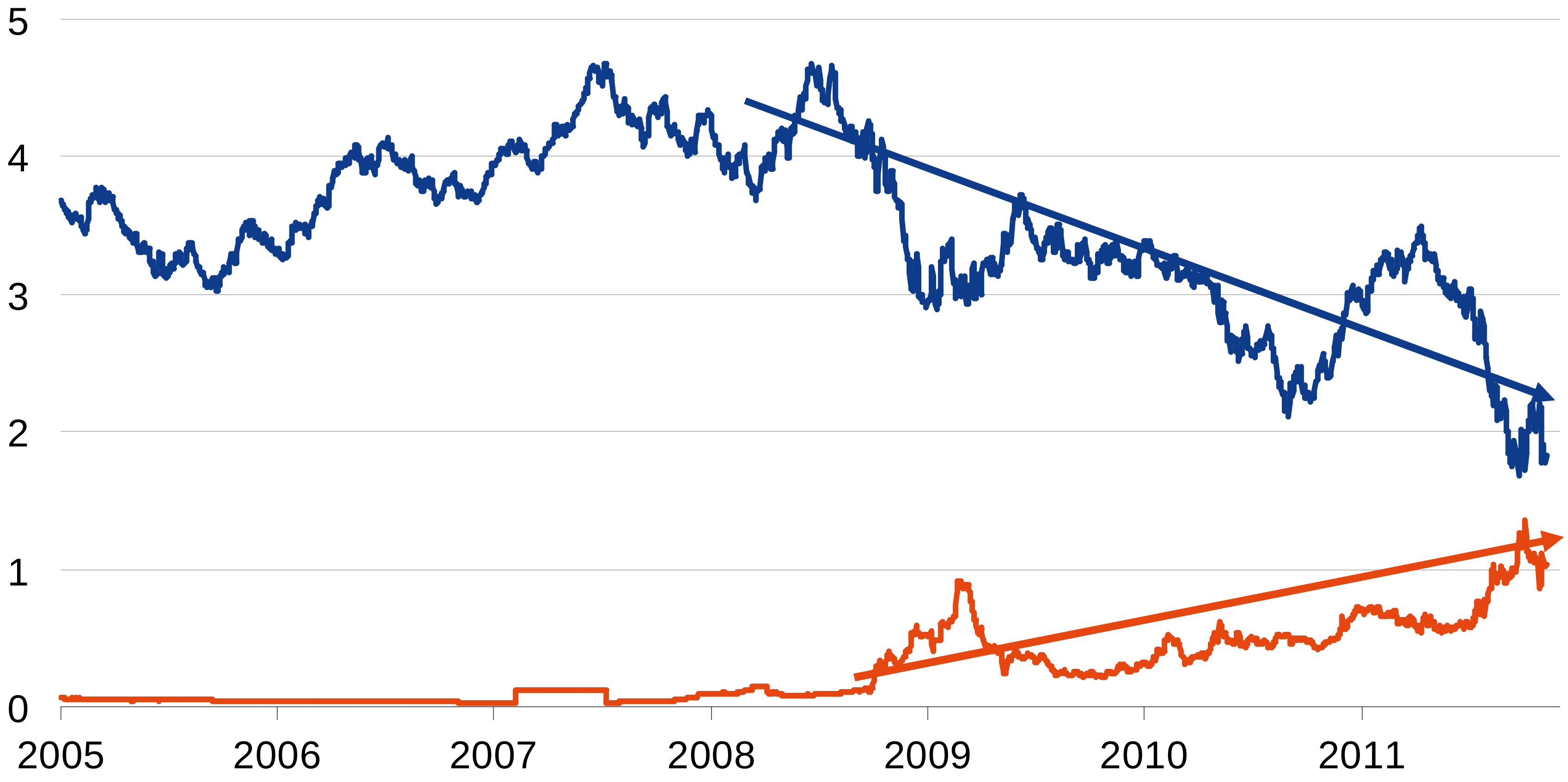
It‘s all credit now

CDS-Spread Germany (10 yrs)



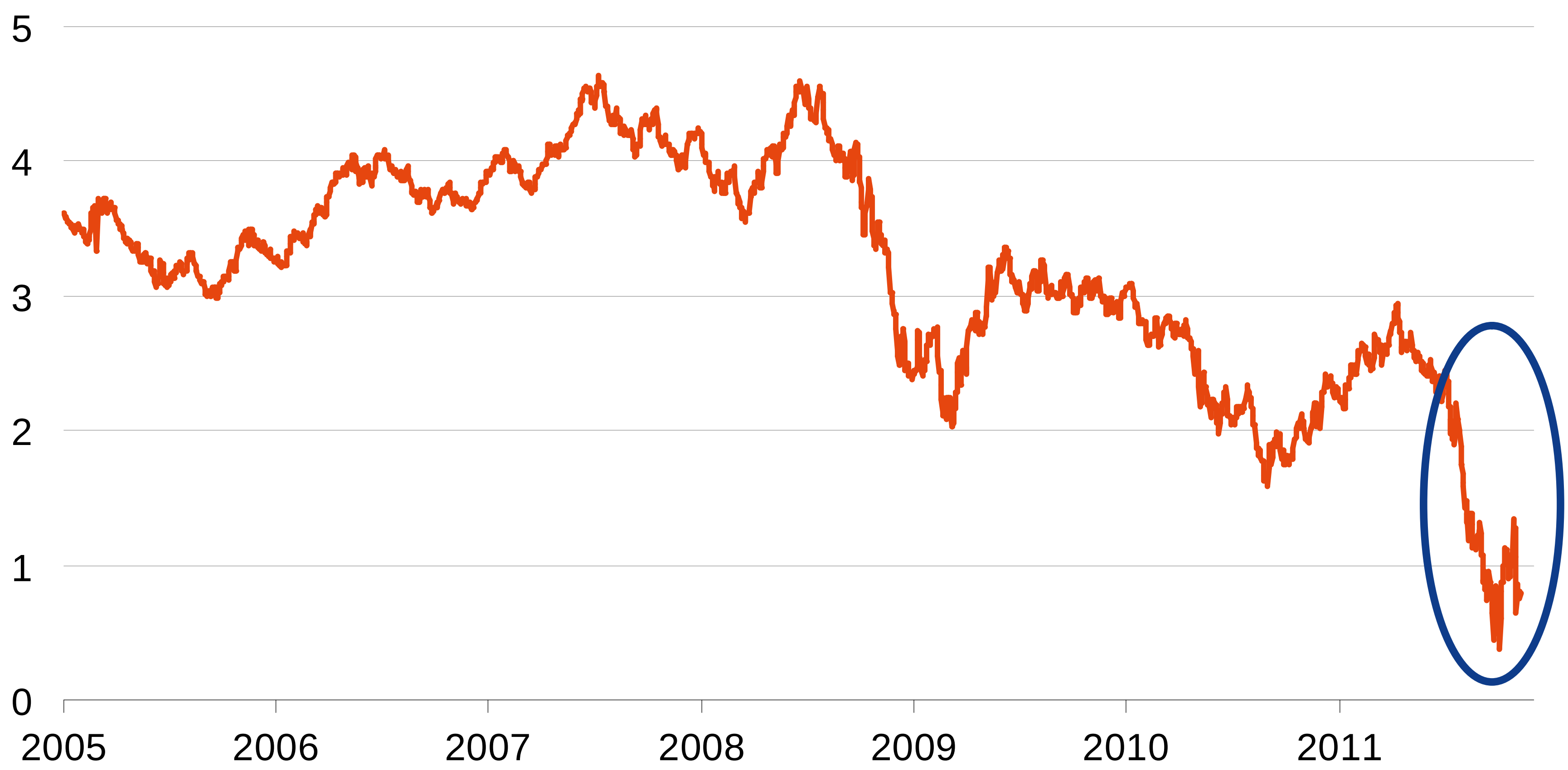
Bund yields and CDS

yield 10yr Bund; CDS spread Germany (10yr)



“Credit adjusted” yield is close to zero

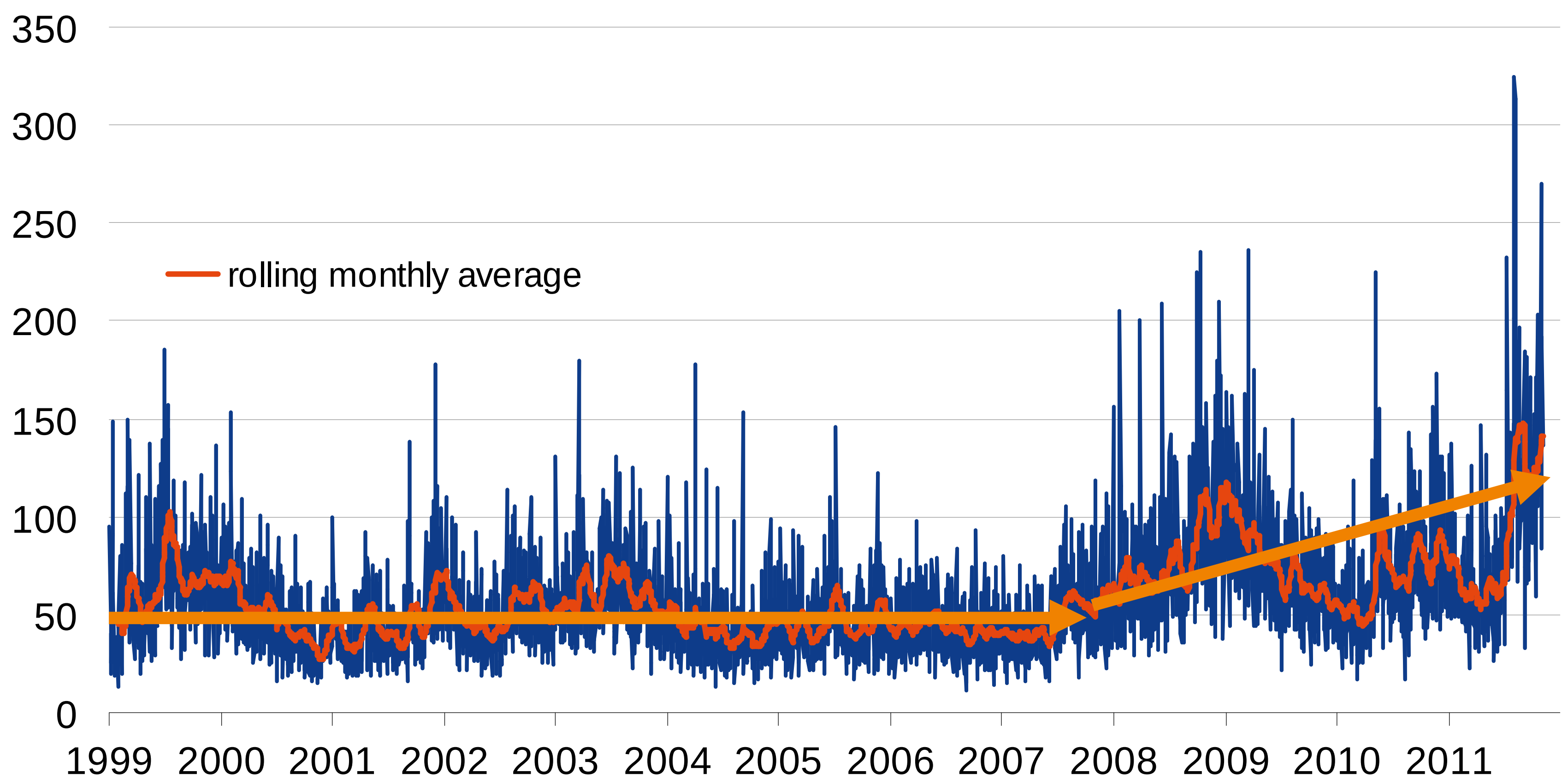
Yield 10yr Bund minus CDS spread Germany (10yrs)



3. Volatility and liquidity

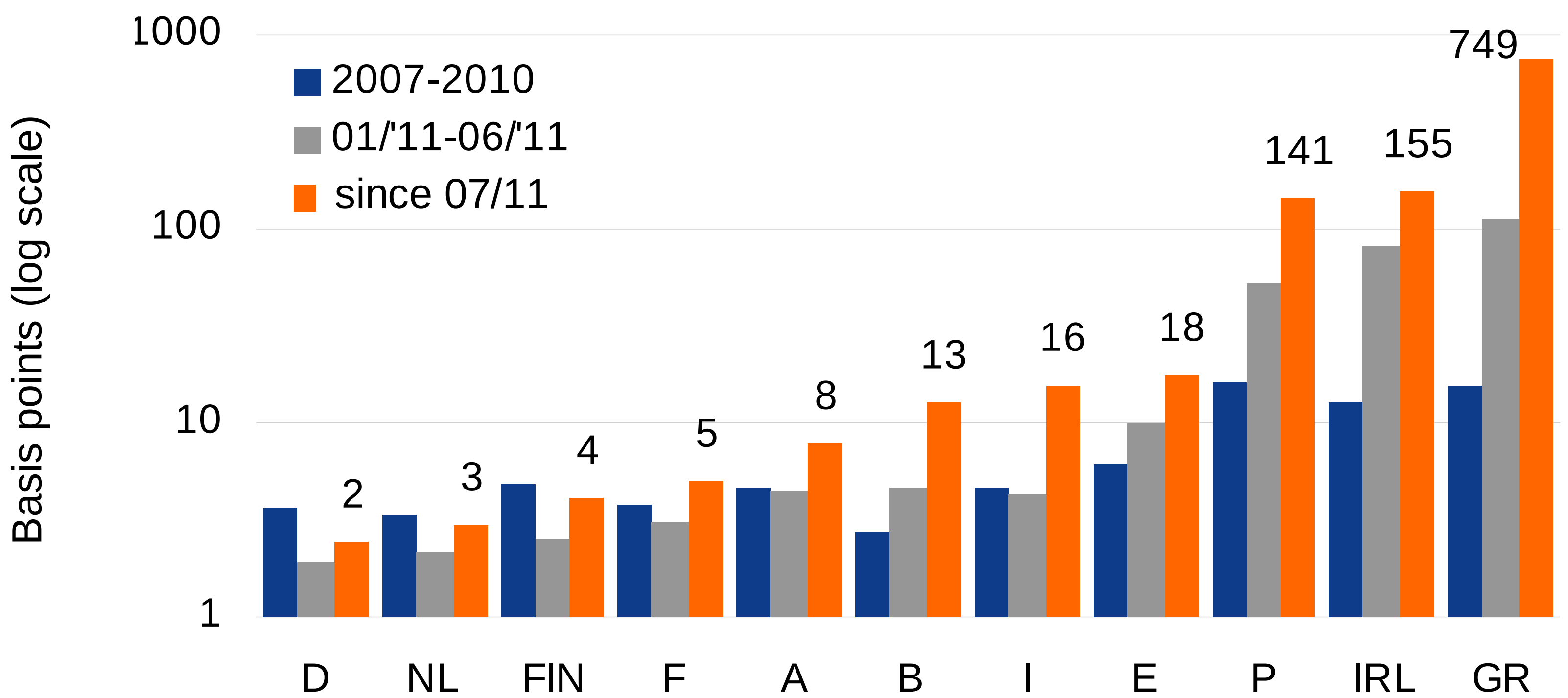
Volatility has risen substantially

Bund-Future (difference between intra-day high and low; basis points)



Several niches among the EMU govie market have become dysfunctional as of late

Bid/Ask yield spreads, Euro-area govies: annual averages across the universe covered

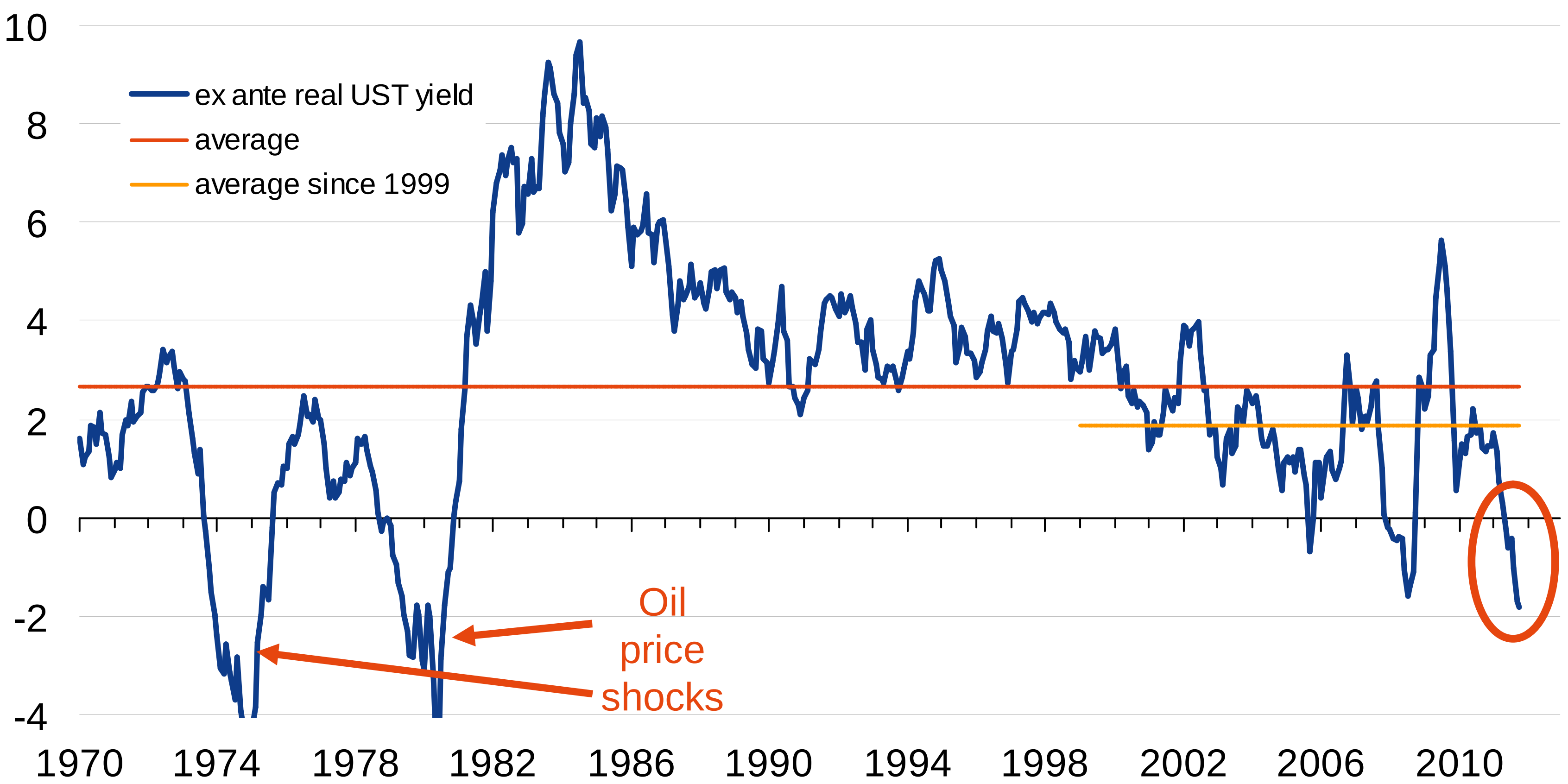


Source: Bloomberg, DZ BANK calculations

4. Real yields and financial repression

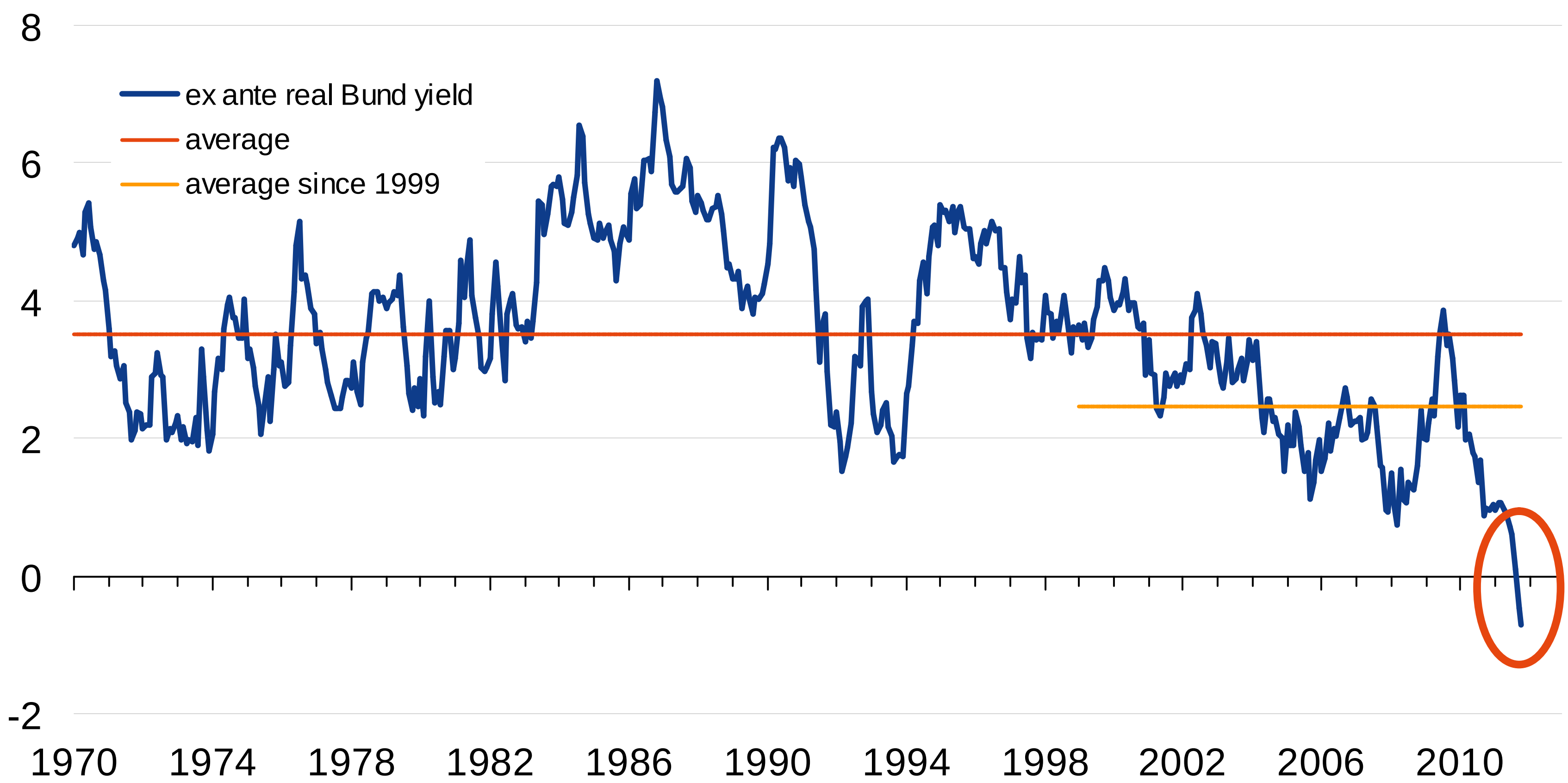
Real UST yields between -4% and 10%

Ex ante real yield (10yr UST yield minus current CPI inflation rate)



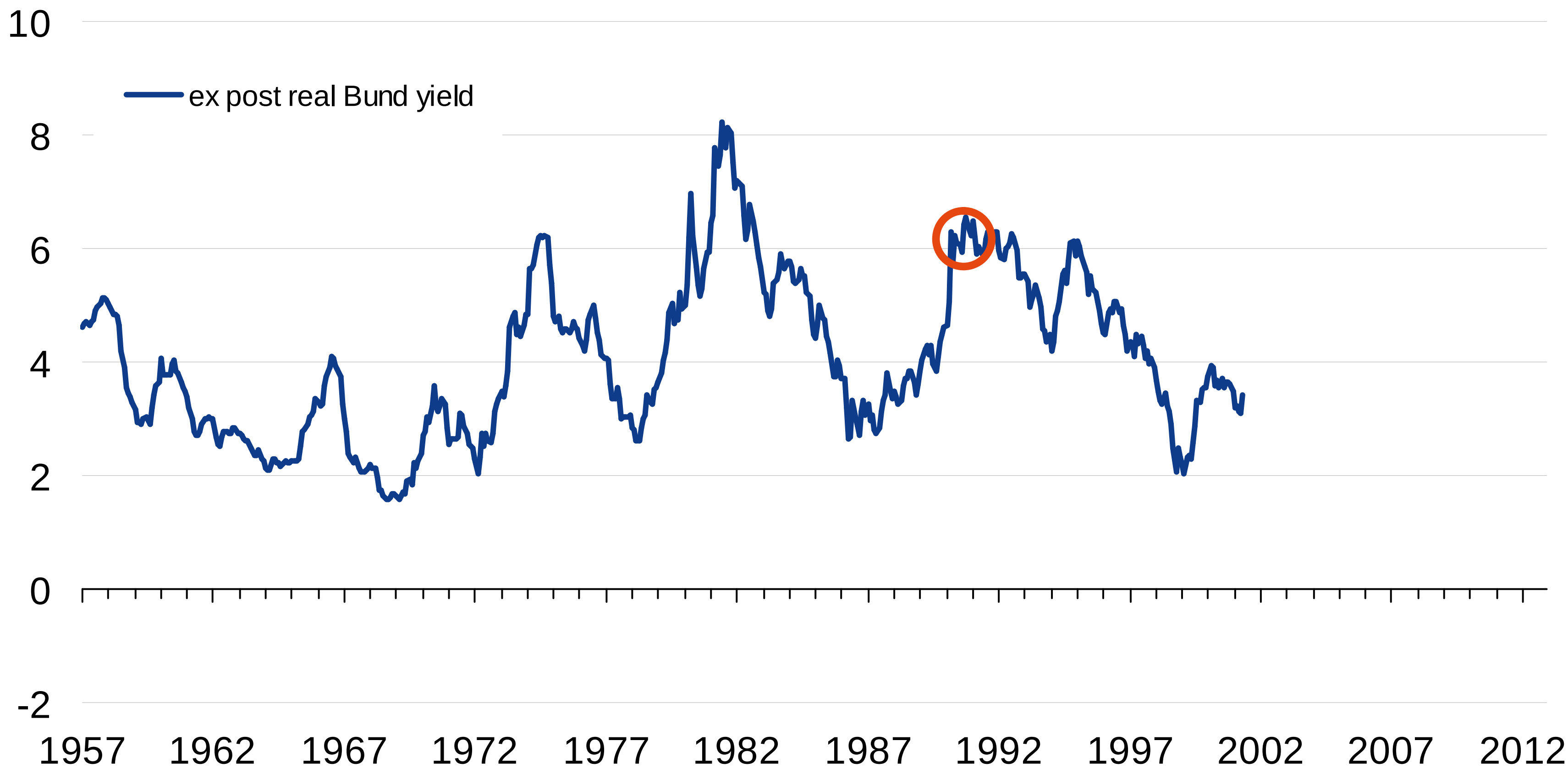
10 yr real Bund yield as low as never before

Ex ante real yield (10yr Bund yield minus actual inflation rate Germany)



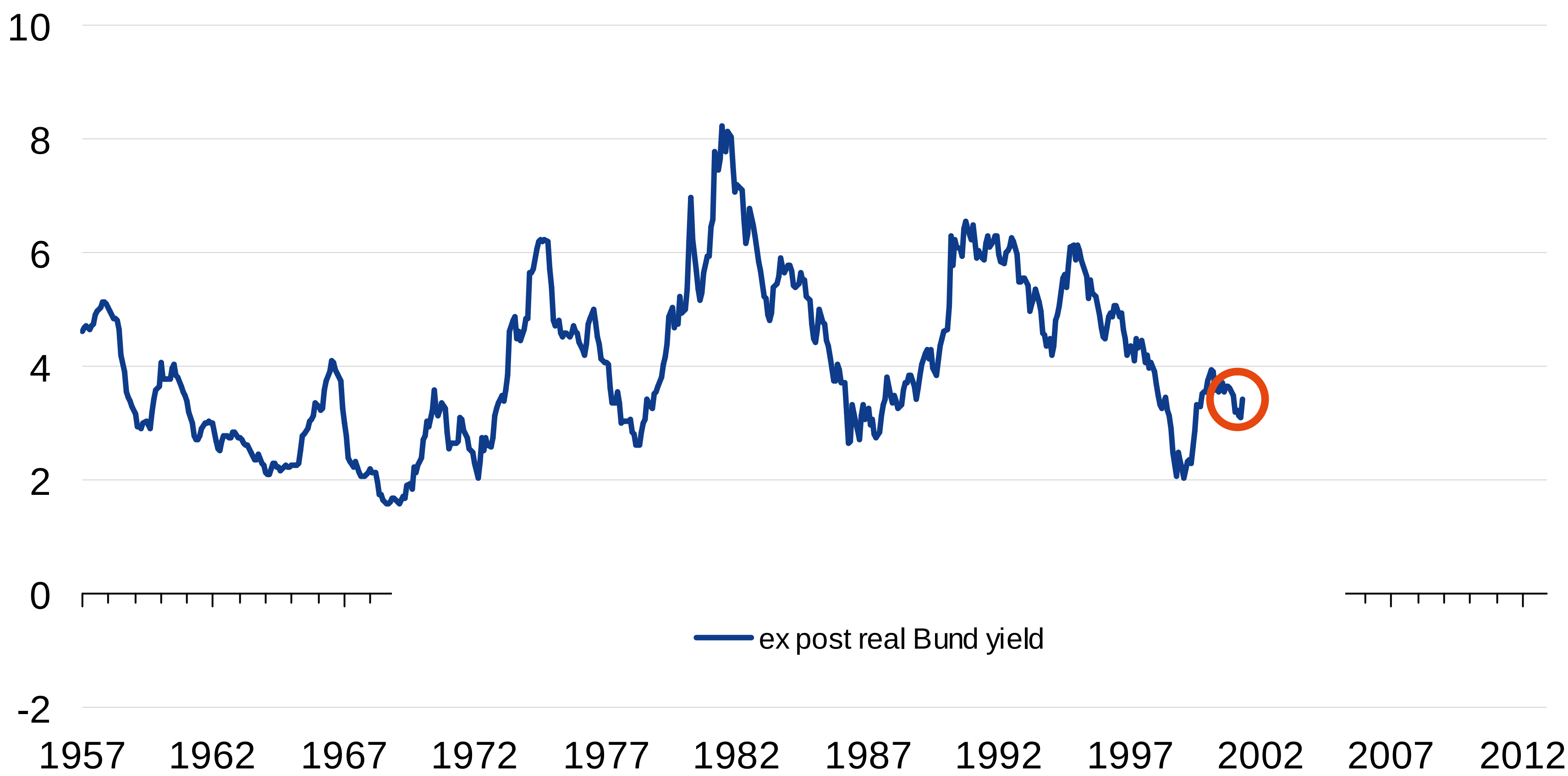
The EX POST real yield matters

10 yr Bund (ex post real yield)



The EX POST real yield matters

10 yr Bund (ex post real yield)



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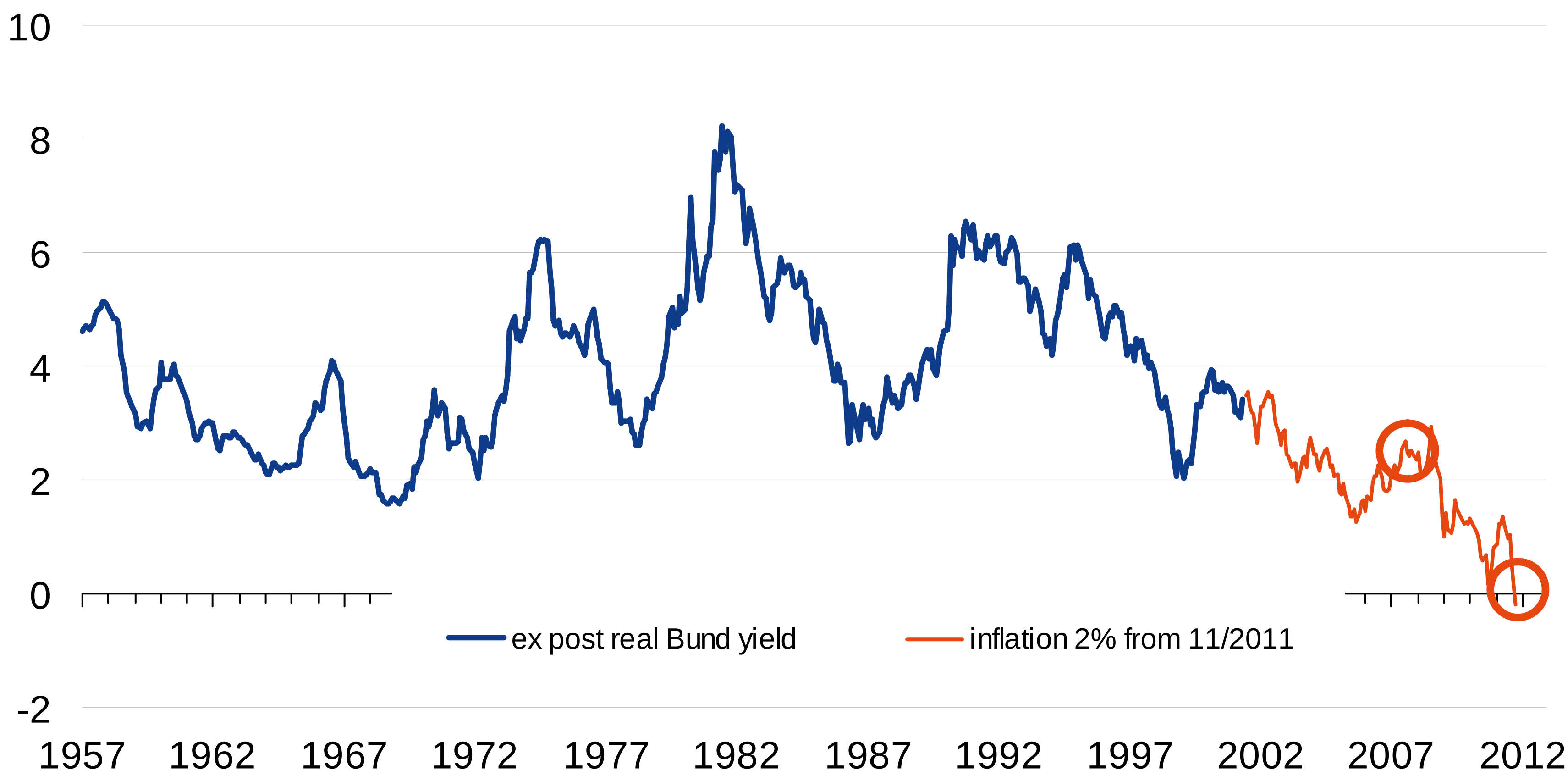
10 yr Bund (ex post real yield)



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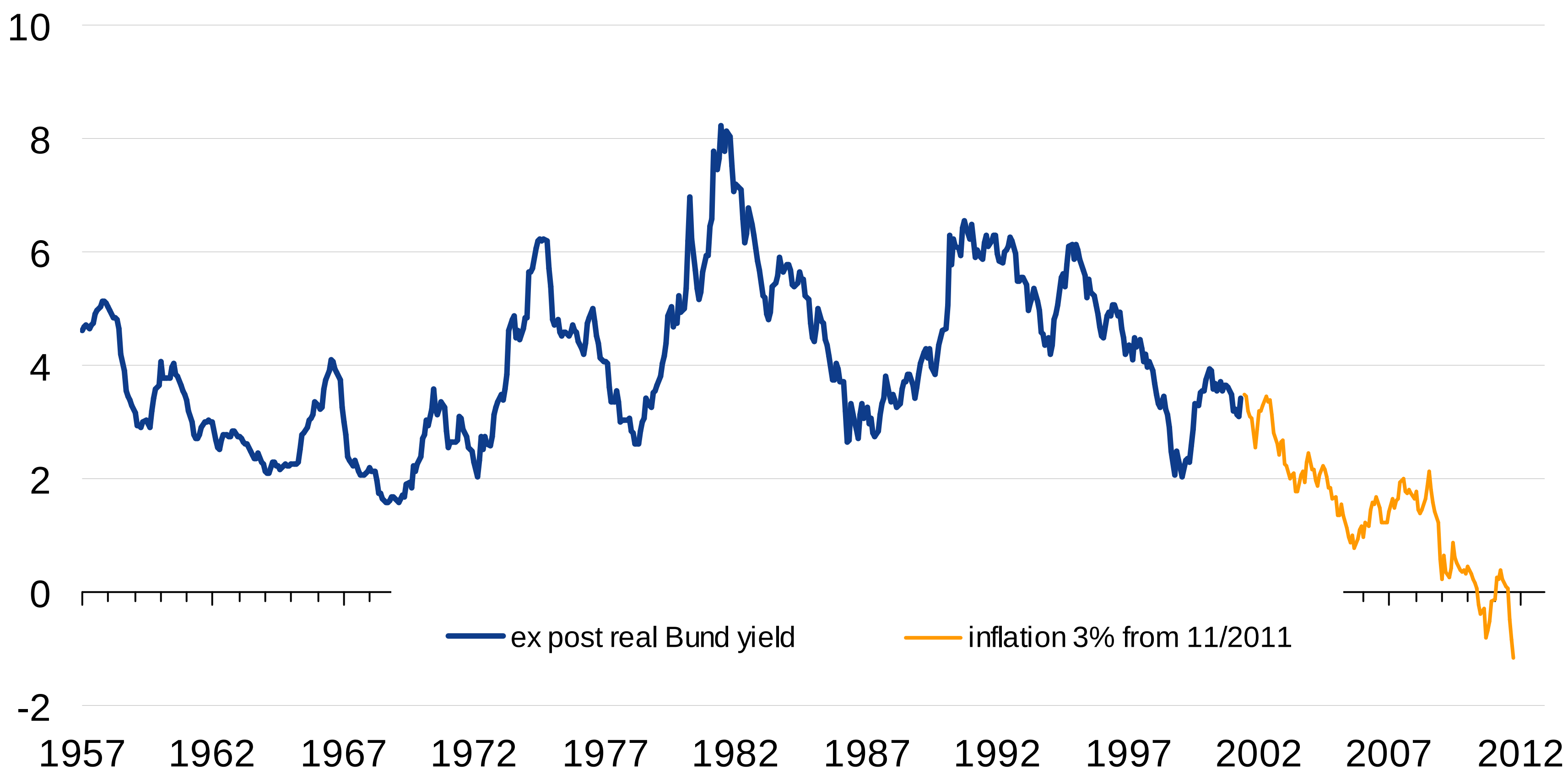
10 yr Bund (ex post real yield)



The EX POST real yield matters

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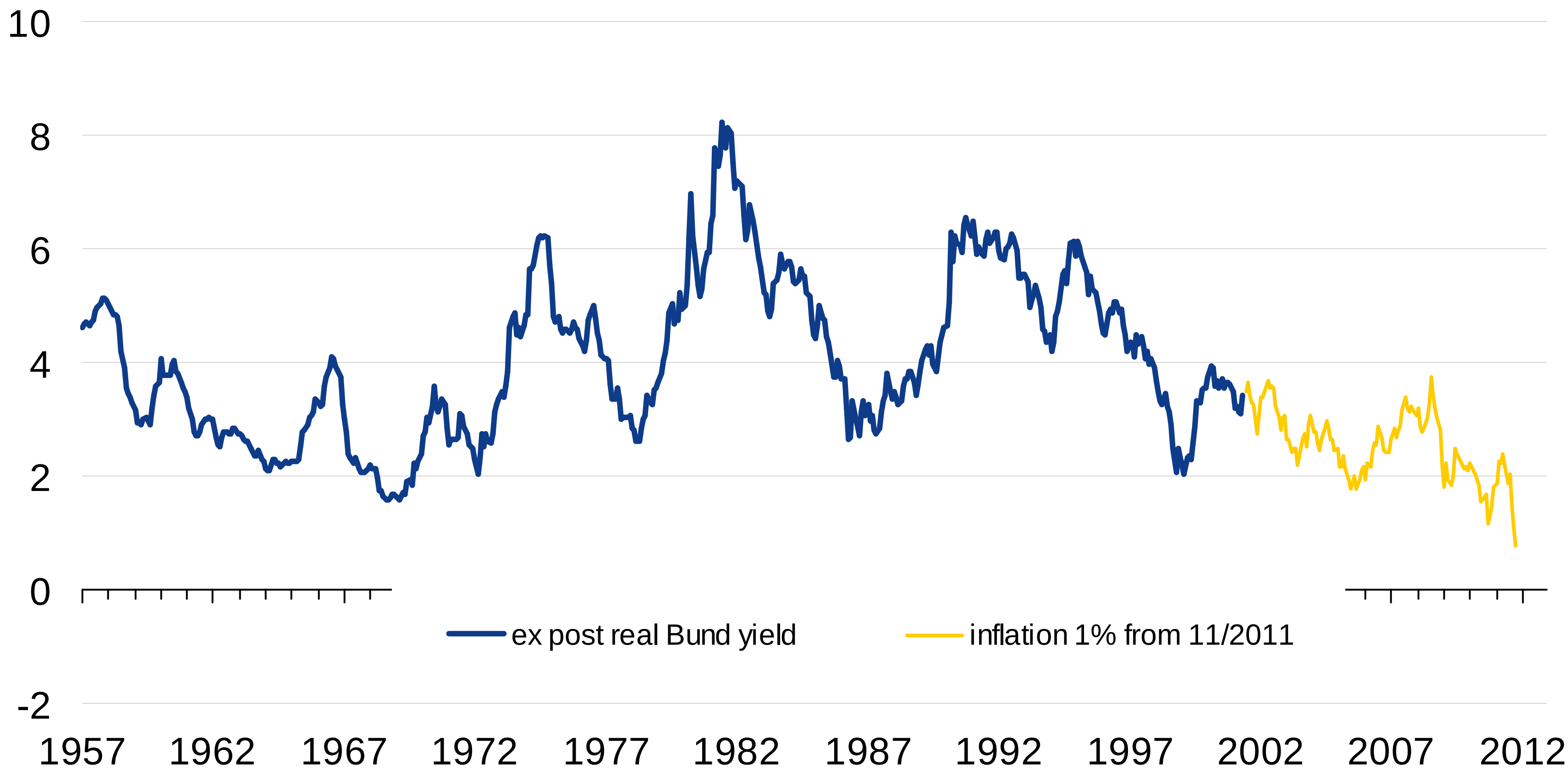

Financial repression as the silver bullet?

NBER WORKING PAPER SERIES

THE LIQUIDATION OF GOVERNMENT DEBT

Carmen M. Reinhart
M. Belen Sbrancia

Working Paper 16893
http://www.nber.org/papers/w16893

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
March 2011

- *„Low nominal interest rates help reduce debt servicing costs while a high incidence of negative real interest rates liquidates or erodes the real value of government debt.“*

- Carmen M. Reinhart / M. Belen Sbranica, The Liquidation of Government Debt, 2011

Conclusions

- “Digital” situation – some countries benefit from record-low yields whilst others groan under the weight of high spreads
- Government bonds bear credit risk – markets will have to cope with this
- Volatility remains high – some market segments have become “dysfunctional”
- Investors have to brace themselves for the problem of low real yields in established markets

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