Market Musings

Global Rates, FX & Commodities Strategy

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▶ EUROZONE ▶ RATES ▶ GLOBAL MARKETS

EUR SSA: Chasing The Finish Line

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- There has been a significant uptick in primary issuance by EUR SSA issuers since the end of August. We estimate that our key European SSA issuers have completed around 75% of their issuance needs for the year.
- Looking ahead to the rest of the month of September and October, we expect to see around €70-75bn global SSA issuance. Of this, around 50% should be skewed to "€". With the ECB ending QE in December, issuers should be incentivized to front-load issuance in the next few weeks.
- While we do see the final leg of ECB's QE programme in Q4 18 , we also see very favorable ECB's reinvestments in the near term. This can keep Bunds and some EUR SSA names well supported. We continue to favour outperformance in German Agencies and EUR Supras vs. peers in near term. In terms of trades, we favour our **5s10s KFW flatteners** and **ESM/EFSF vs Bund Compression** trades.
- With respect to currency, we think October favors issuance activity in "€" space compared to "$" space. Supply pressure could support a **widening bias for the EURUSD XCCY basis.**

Issuance Picked Up, But Has been Well Received

EUR primary issuance in September has kicked-off with issuers chasing to meet their year-end funding targets. Against the backdrop of the improving risk sentiment, most of these issues were well absorbed by the market participants.

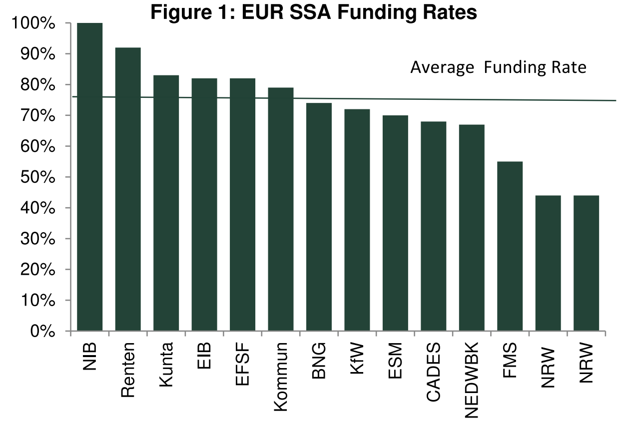
Key New Benchmarks launched since end August:

- **EUR: KFW** (7y), **ESM** (10y and 37y), **Land Berlin** (40y),**KommuneKredit** (5y)
- **GBP**: **ADB** (6y), **IADB** (6y), **Renten** (7y)
- **USD**: **EIB** (3y), **SEK** (2y), **OeKB** (3y)

We estimate that our key European SSA issuers have completed around 75% of their funding needs for 2018 (Figure 1). In particular, we see NIB and Rentenbank leading with their funding rates. Looking at some of the bigger issuers wee have **EIB, KFW and EFSF and ESM completing around 80%, 70%, 82% and 70% of their issuance respectively**.

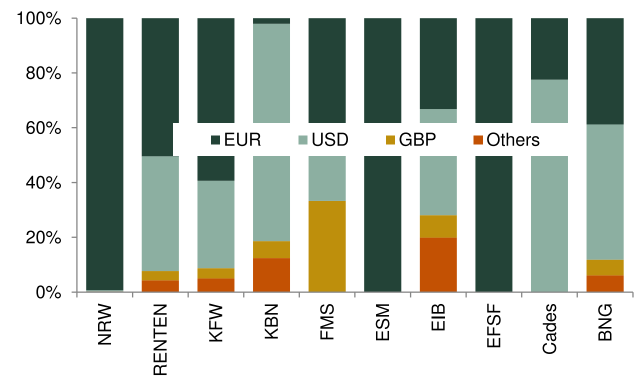
Looking ahead to the rest of the month of September and October, we expect to see around **€70-75bnGlobal SSA issuance of which around 50% should be skewed to "€"**. At this rate, most issuers should be able to reach their funding targets. With the ECB putting an end to its QE programme in December, issuers should be incentivized to front-load issuance in the next few weeks.

Figure 1: EUR SSA Funding Rates



Source: Bloomberg ,TD Securities

Figure 2: 2018 EUR SSA Issuance Profile



Source:Bloomberg, TD Securities

Currency skewed to EUR: So far in Q3 18, we have seen around **51% of issuance in USD, 42% in EUR and 7% in GBP.** This is almost in line with issuance spilt observed in Q2 18. However, it does highlight how supply dynamics have changed since Q3 17. In that period, 69% was issued in USD, 28% in EUR and 3% in GBP. Increasingly global issuers are turning to EUR market to launch their new benchmarks.

Duration issuance slows in EUR: EUR issuance in 2018 has been characterized by a steady decrease in duration risk. Issuance has become skewed to the belly of the curve. This seems reasonable; as the ECB reduces its QE purchases, duration risk is gradually returning back to the private investors. The average volume weighted maturity of issuance in EUR has been 10.7yrs since the beginning of the year. This compares to a duration of 11.8 yrs seen last year. Meanwhile, the average volume weighted maturity of issuance in USD and GBP continues to hover around 4.5 years.

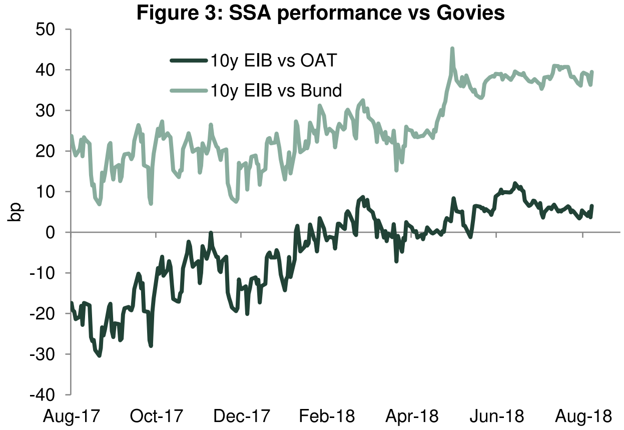
Macro Rate Themes

- **EUR rates:** Bund term premia seem less about fundamentals and more about the **"flight to safety"** and **"scarcity"** components embedded within it. This has prevented Bunds from moving out of the recent trading range of 35-40bp. The end of the ECB's expansive QE programme argues for higher EUR core rates. That said, the move in this direction is likely to be much slower than anticipated. This holds especially amid supportive ECB reinvestment flows in the next 1-2 months. Thus, we maintain our year-end target for **Bund yields at 0.60%.** Meanwhile, normalization of ECB's balance sheet implies an effective widening of long-end rates. This is offset by a more accommodative path for short-term rates. This supports our steepening view for the 5s30s Bund curve (Cross-Currents in EUR Rates).

- **Swap spreads:** Amid vulnerable risk sentiment toward Italy, positioning in swap spreads could remain tactical. From an issuance perspective, the seasonal uptick in September-October supply argues for tighter swap spreads. That said, the short-end Bund ASWs still hold an "Italian risk" premium, in our view. As a result, if the **Italian government is unable to reach an agreement with the EC on its budget, we could see wider swap spreads led by the short-end.** In terms of timeline, the government needs to submit the budget plan to the parliament by September 27th. This will be followed by submission to the EC by mid-October. We also have S&P and Moody's rating review for Italy lined up for end October.

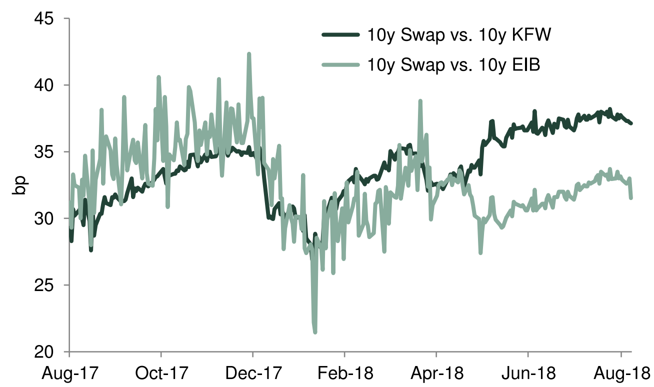
- **SSAs spreads:** The EUR SSA vs. Bund spreads have seen some marginal tightening from levels seen in mid-August. 10y EIB vs Bund spread continues to hover around 35-37bp (Figure 3). This compares to the average of 23bp observed between January to mid-May and highs of 45bp seen during the peak of Italian crisis in May. SSA vs OAT spreads also seem stuck to ranges. Credit spreads have been trading risk around "Italian Budget" risks and not the "end of QE" so far. Meanwhile, in the this week's marginal risk-on tightening move in EUR swap spreads, has seen core SSA ASWs cheapening 1-1.5bps (Figure 4).

Figure 3: SSA performance vs Govies



Source: Bloomberg, TD Securities

Figure 4: SSA performance vs Swaps



Source: Bloomberg, TD Securities

SSA Opportunities

Strategically, we still believe that credit spreads lack the re-pricing of the end of ECB's expansive QE programme. However, in the near term, we could see the potential for further performance in some of the SSA names on the back of supportive year-end cash flows.

Core Agencies: German agencies remain supported

German Sovereign/Agencies/Local government bonds should benefit from the large ECB's reinvestment flows in the month of September/October (ECB QE: A Numbers Game). A scarcity premium in German assets should support the performance of German agencies/munis vs peers in the coming weeks.

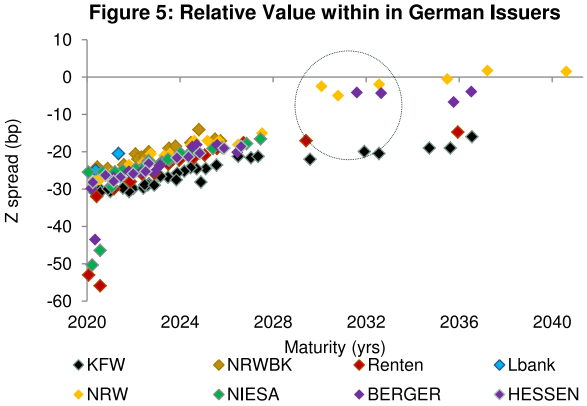
- Among the bigger names, we see **KFW redeeming a total of €12bn in Q4 18**. Against the backdrop of supportive net issuance, we continue to favor our **5s10s KFW Flatteners** in our model portfolio for now.
- Within the German agencies/munis space **NRWBK, State of NRW** and **State of Hesse** are trading relatively cheaper as compared to peers.
- With the ECB downsizing its QE programme, relative value strategies among the various PSPP names, as well against non-PSPP names, should start gaining traction. We believe outright spread levels should now be defined by the fundamentals (LCR weights, ratings, and guarantees) rather than just driven by the ECB s QE flows. In particular, we prefer names like **KBN, SEK, Kommun, ONT, and Q** over the PSPP names like Cades, BNG, Asfing. However, we look for better levels to enter these "QE end " trades.

Supras: Outperform agencies

European Supras see very supportive cash flows into the year-end. In particular, cash flows remain most favorable for ESM. The issuer redeems €7bn in October followed by €6bn in December. We believe nearly a third of these maturing bonds could be held by the ECB. We also note that the ESM has already completed 70% of its funding target for the year. Thus leaving it with net-negative supply until year end. From a trading perspective, we see value in **entering ESM vs Bund/OAT tighteners.**

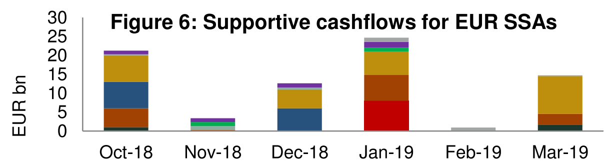
- **Euro ECB SSAs: €20bn German Agencies: €17bn**
- **French Agencies: €3bn Dutch Agencies: €3bn**

Figure 5: Relative Value within in German Issuers



Source: Bloomberg TD Securities

Figure 6: Supportive cashflows for EUR SSAs



	Oct-18	Nov-18	Dec-18	Jan-19	Feb-19	Mar-19
RENTEN	0	0	0	1	1	0
NRWBK	1	1	1	2	0	0
NEDWBK	0	1	0	1	0	0
LBANK	0	1	1	0	0	0
KfW	7	0	5	6	0	10
ESM	7	0	6	0	0	0
EIB	5	0	0	7	0	3
EFSF	0	0	0	8	0	0
BNG	1	0	0	0	0	2

Source: Bloomberg, TD Securities

Cross Currency Plays

XCCY Basis: EUR issuance in "$" more favorable in the +5y sector

Previously, USD-denominated issuance by European names remained favorable in the 2-3y sector. This was due to a wider short end EURUSD basis. However, issuance dynamics have evolved with the significant tightening in the EURUSD front-end basis seen since the beginning of the year.

Figure 7 depicts how global EIB issues swapped into "€" across the curve are distributed. At current levels, XCCY basis does not particularly provide a big yield enhancement for swapping issues. On a relative basis, however, current levels of the XCCY basis suggest that issuers would prefer looking at 5-8y sector to issue their $ benchmarks and then swap them into €.

From an investor perspective, **we have been recommending opportunities to buy shorter-dated "$" issues and swapping them into €** (A Summer SSA Opportunity & Buy CADES $ Feb22 swapped into €). These were attractive ways to create a synthetic cheaper "€" bond. We think these trades now have less performance potential left in them (possibly still work for some second Tier names). Thus we look for better entry levels to reinitiate such cross currency plays.

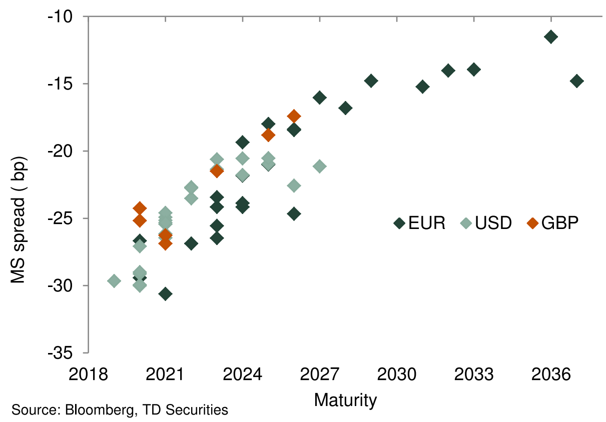
Debt rollover: **Redemption profiles should favor of "€" in October from "$" in September**

Recently, EUR issuers have been incentivized to issue in $. This was due to the heavy dollar-dominated redemption scheduled in August and those upcoming in September. European issuers had a total of €24bn in USD-denominated issues maturing in those months (Figure 8).

In October however, "$" redemptions fall to €5bn. At the same time, however, we see "€" redemption picking up to €27bn (vs €6bn in September). Thus it's less likely to see heavy issuance by EUR issuers in "$" in the near term.

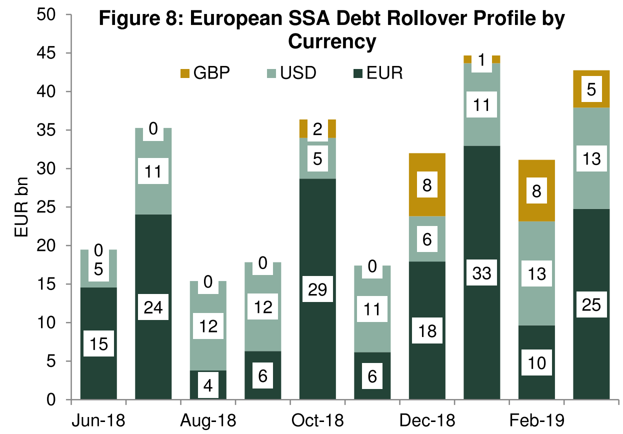
Instead, the incentives to roll over EUR debt is likely to favor "€" issuance. From an **XCCY basis perspective, therefore, this could produce a widening (more negative) EURUSD basis.**

Figure 7: EIB curves in EUR equivalent



Source: Bloomberg, TD Securities

Figure 8: European SSA Debt Rollover Profile by Currency



*Investment grade SSAs -excludes CG, Source: Dealogic, TD Securities

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