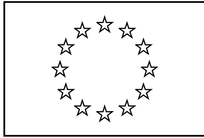


EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS
Treasury and financial operations
Treasury and asset management

Joint Sickness Insurance Scheme

Management of the Reserves

Update/State-of-Play, November 2016

DG ECFIN, Unit L-5 Treasury and Asset Management

Speakers:
Thomas ANSAY, *Portfolio Manager*
Patrick STEIMER, *Head of Unit*
Dimitris PAPAKONSTANTINOU, *Deputy Head of Unit*

European Commission

Main developments since July 2016 (1)

As presented during the CGAM meeting in July 2016, the RCAM portfolio return was **~+1.64% YTD as of June 30 (mid-year)** and the portfolio's duration was ~ 3.23y.

Since then, some of the **key elements** that can be highlighted are the following:

- The **Greek bonds** (EUR 5m or ~2% of the portfolio nominal), which caused a significant part of the portfolio's volatility in 2015, were **fully repaid** on 20 July 2016.
- After the initial turmoil following the June 23 vote, **Brexit** had rather **limited effects so far** on the bond markets – however, as the dust settles and the terms and timeline of the exit become clearer, political and economic implications should unfold.

➢ **Until end September,** overall core rates remained extremely low / negative, and most credit spreads continued to tighten (all periphery except IT, covered & corporates).

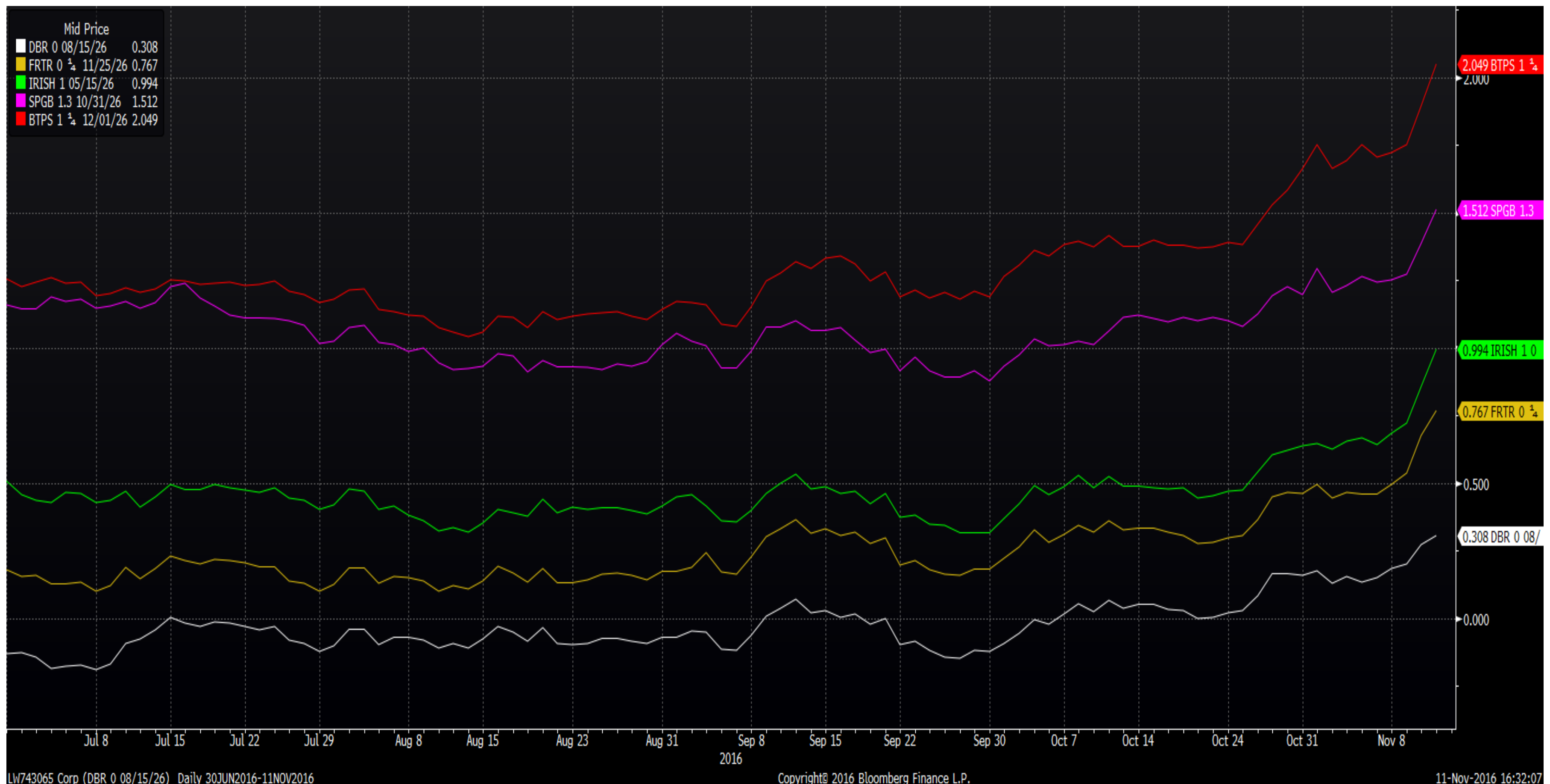
However, **since October the bond market has turned:**

- **Yields started to correct across the board**, in particular for medium to long-dated bonds (short-term remained anchored at – very – negative rates), and the benchmark German 10-year yield turned positive again.
- In November this trend was further exacerbated with the **unexpected election of Donald Trump in the US**, which was digested by the markets as a strong, additional reflation signal.

European Commission

10-year Euro Area Government Bond Yields (YTM)

From end June 2016 to mid November 2016



Economic and Financial Affairs

EUR Benchmark & EUR Swap Curves

From end June 2016 to mid November 2016

S45 EURO SWAPS CURVE 11/11/16 Mid YTM 16:31:28
S45 EURO SWAPS CURVE 06/30/16 Mid YTM
I13 EURO BENCHMARKS CURVE 11/11/16 Mid YTM
I13 EURO BENCHMARKS CURVE 06/30/16 Mid YTM

Change
S45 Mid YTM (11/11/16-06/30/16)
I13 Mid YTM (11/11/16-06/30/16)

1D 1M 2M 3M 6M 8M 10M 1Y 18M 2Y 3Y 4Y 5Y 6Y 7Y 8Y 9Y 10Y

Tenor

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Main developments since July 2016 (2)

This **strong increase in yields since early October** (~+50bp for the reference German 10y Bund vs. its lowest point of ~-20bp in July) can be explained as follows:

- **Inflation in Europe improved** somewhat: since July, the EUR 5y5y inflation swap, a key measure for inflation expectations observed by the ECB, moved from ~1.25% to ~1.55%; while this is still sub-target, this is a noticeable increase.

- Notably for that reason, the **ECB did not announce new monetary policy measures** following the Brexit vote, and forward guidance on QE has been rather vague ever since (even if most analysts expect QE to continue until at least September 2017).

- **Expectations of a Fed rate hike** in December 2016 has strengthened further, as the US economy continued to post robust economic and labor data. This is having some impact on euro rates, since typically both have been – at least partially – correlated.

- Overall, growth, employment and credit lending have in 2016 been relatively resilient across the largest advanced economies (Europe, US and China). This trend has somewhat **reduced the likelihood of broad-based deflation**, at least for the foreseeable future.

- Owing to some announced policies (looser fiscal policy with large infrastructure spending and tax cuts, "re-normalisation" of monetary policy and economic protectionism), **Trump election reinforced reflation expectations**, triggering further yield corrections.

EUR 5y5y Inflation Swap

From end June 2016 to mid November 2016

Mid Price 1.5448
High on 11/11/16 1.5448
Average 1.3530
Low on 07/11/16 1.2500

1.5500
1.5448
1.5000
1.4500
1.4000
1.3500
1.3000
1.2500

Jul 8 Jul 15 Jul 22 Jul 29 Aug 8 Aug 15 Aug 23 Aug 31 Sep 8 Sep 15 Sep 22 Sep 30 Oct 7 Oct 14 Oct 24 Oct 31 Nov 8
2016

FWISEU55 Index (EUR Inflation Swap Forward 5Y5Y) Daily 30JUN2016-11NOV2016

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European Commission

Main developments since July 2016 (3)

Looking at the **RCAM portfolio**, the situation since July can be summarized as follows:

- In the short run, the increase in yields since October has had a negative impact (in line with the market) in terms of marked-to-market value of the portfolio, but this has at least given **better grounds for future reinvestments**.

- In addition, we **used this opportunity to switch** out of some securities with negative yields (hence realizing profits on them) into securities whose yields turned positive again (e.g. Spanish debt, where the eventual formation of a government was also positive).

- We also continued to **diversify into new issuers** (e.g. AAA covered bonds from Canadian, Australian or New Zealand banks). To manage the portfolio's duration, we also opened a few short-term positions in smaller investment-grade sovereigns and corporates.

- On the other hand, we **reduced certain exposures** – e.g. UK banks (only 1 line left, maturing early 2017, due to Brexit uncertainties) and Italian sovereign bonds were decreased (only 2 lines left, of which 1 floater; reduction due to unstable banking sector and uncertainties about outcome of December referendum).

> as of 18 November, the portfolio **YTD return** was ~+1.07%, as further performance from July to September was more than offset by the strong, broad-based yield increases in October and November. In terms of modified duration, the portfolio stood at ~3.25 years.

Looking ahead (1)

Going forward, if slightly higher yields persist, this should

- continue to lift the portfolio's yield to maturity (which turned positive again in November) hence improve the medium-to-long term performance prospects, but also
- help the daily management of the portfolio (e.g. by being able to continue to avoid investing in negative-yielding securities).

However, it should be made clear that **challenges remain ahead:**

- Currently, the vast majority of shorter maturities (i.e. below 3 or 5 years, depending on the asset classes) **continue to offer negative yields**, thereby making it difficult to keep the overall duration of the portfolio in check.
- **Asset scarcity remains an issue**, due to ECB purchases, overall decreasing supply and market-makers' reduced trading books. This forces us to focus on primary market deals, to capture new issue premia but increasingly also simply to find relevant sizes.
- Finally, given the low yield levels and reduced volume available in the market**, trading costs** (approximated by bid-ask i.e. buy vs. sell spreads) need to be taken into account much more than before when analyzing the economics of a transaction.

European Commission

Looking ahead (2)

Further, as highlighted in our note dated 10/10/2016 upon request of the RCAM Management Committee, and as the most recent developments show, the **interest rate risk is and will remain high in the foreseeable future**:

- in case of further strong rate rises, negative performance could be recorded for a certain time – but this would follow years of positive returns which built a certain buffer and it would "only" be a **"marked-to-market" fall in value of current bonds** in the portfolio

- if these bonds do not have to be sold out of the portfolio (= can be held till maturity), **no losses will be "realized"** (i.e. booked in the P&L statement) as the principals shall still be **paid back in full at maturity** (assuming the issuers do not default, which is a reasonable assumption for an investment-grade portfolio).

Potential alternatives would most likely result in worse outcomes:

- selling (all) bonds in the portfolio and placing the monies with banks would, on top of concentration and credit risk issues, imply a gradual drag on the portfolio performance as all banks of satisfactory credit standing offer – deeply – negative rates in the current market;

Looking ahead (3)

- venturing significantly into lower quality bonds by relaxing limit constraints would cater significant **risks of credit events**, i.e. potential non- (or only partial) reimbursements of principal amounts at maturity;

- modifying sizably the portfolio **duration would imply other issues:**
- a significant reduction would reduce interest rate risk but imply investing (heavily) in negative yielding securities;
- an increase would mean a bigger drop in the portfolio's market value in case of rate rises.

Therefore, also given indications of limited liquidity needs in the short/medium term, ECFIN understands that RCAM Management Committee is **aware of such potential marked-to-market valuation losses but accept this risk** as alternatives could mean worse results.

> **In summary**, under present market conditions,

- historical performances do not represent good indicators of future results
- no alternatives can guarantee positive returns (for RCAM or any other portfolio)
- keeping a prudent, diversified and balanced investment policy remains the best approach