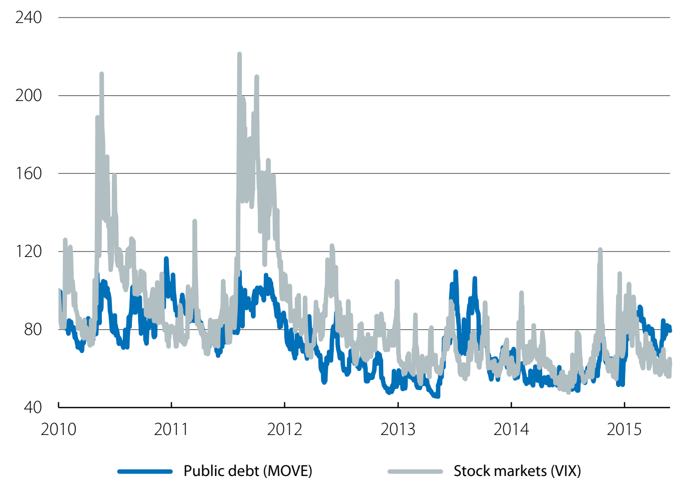
# FINANCIAL OUTLOOK · The government bond market, in the firing line

**Interest rates pick up in the euro area after the lethargy of the last few years.** In a May with few references on the part of the main developed central banks, the sudden rise in yields due to a European sell-off became the main focus of attention on the international financial scene. This episode has accentuated the hesitance shown by developed risk assets over the last few weeks. Given this situation, the most immediate sources of instability faced by financial markets revolve around the monetary normalisation strategy adopted by the Federal Reserve (Fed) and the outcome of negotiations between the Greek government and its lenders. Nonetheless, it is increasingly important to adopt a longer term perspective within the current context of a gradual transition towards a new regime of higher interest rates, especially considering that this new scenario will be one of the main factors affecting the medium-term performance of financial assets.

**Tensions ease in Europe's sovereign debt market although volatility still persists.** The virulent upswing in yield for European public debt between the end of April and mid-May was largely due to the incorporation of greater inflation expectations and growth in the euro area in government bond prices. The intensity of this episode was, in turn, amplified by the readjustment of investor portfolio positions, with a greater effect on the debt of countries in the centre of the euro area. Given these circumstances, the increase in yield was particularly strong for the securities of core euro area countries with long maturities. This was the case of the German bund, whose yield grew by 65 bps over this period compared with the 42 bps rise in the Spanish 10-year bond. Although yields stabilised towards the end of the month, we believe the volatile tone of European debt markets will continue over the coming months and might push up yields again, albeit moderately.

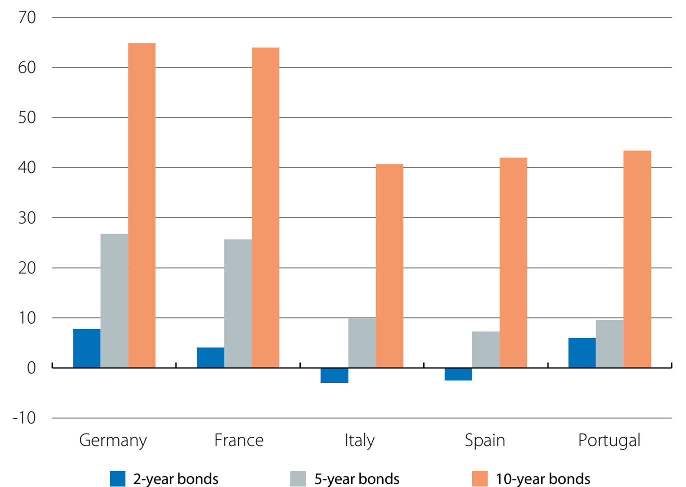
**The European Central Bank (ECB) intensifies its public debt purchase programme before the summer.** The reason given by the monetary authority is to bring forward debt acquisitions due to the lower liquidity in sovereign bond markets that tends to occur in the summer. The most recent data for European sovereign QE are already showing signs of this acceleration. In May purchases of debt securities increased to 51.6 billion euros, 4.1 billion higher than the average level for the previous two months. This faster rate of QE implementation, together with the ECB's manifest intention to complete the public debt purchase programme, confirms the authority's firm commitment to maintaining highly accommodative financial conditions.

### *Implied volatility in financial markets*
*Index (January 2010 = 100)*



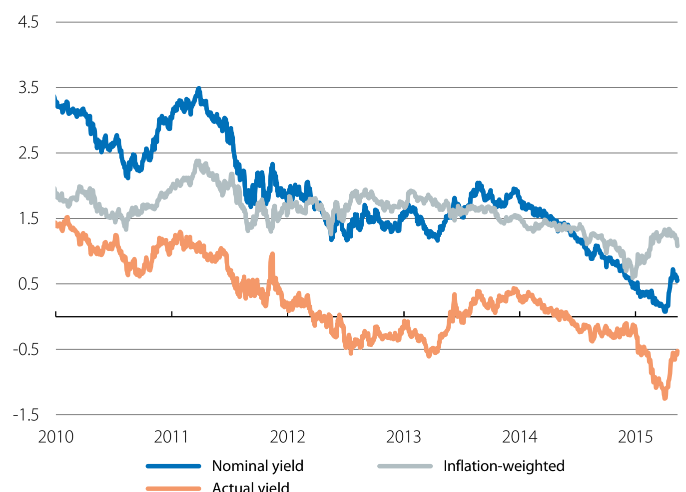

**Source:** *"la Caixa" Research, based on Bloomberg data.*

### *Euro area: yield on public debt*
*Change between 20 April and 15 May (bps)*




**Source:** *"la Caixa" Research, based on Bloomberg data.*

### *Germany: breakdown of the bund's yield*
*(%)*



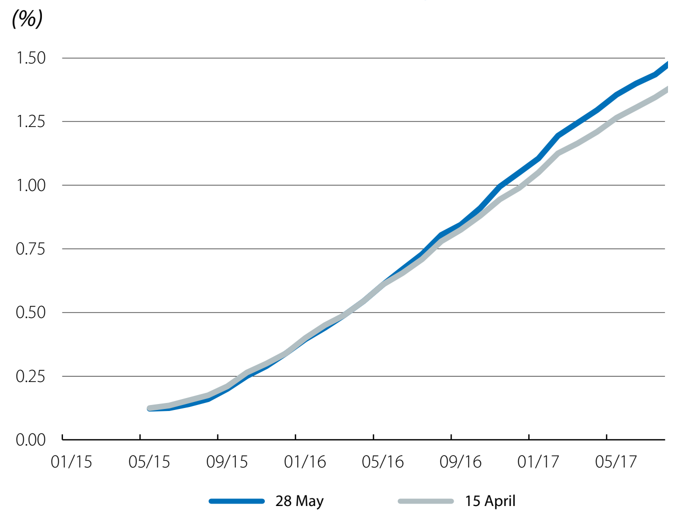

**Source:** *"la Caixa" Research, based on Bloomberg data.*

**Investors await the Fed's messages at its June meeting**. The prudential tone of the last communication by the US monetary authority means we can almost totally rule out any official interest rate hike at the next Fed Open Market Committee in mid-June. This meeting is still causing high expectations, however. The Fed Chairman's press conference and the publication of both economic forecasts and the official interest rate proposed by Federal Committee members are expected to provide further clues regarding the institution's monetary normalisation strategy. Particularly if we consider the more than likely reduction in the 2015 growth forecast after the weak trend in activity in the early part of the year. We expect the solid improvement in indicators for inflation and the labour market over the coming months to place the start of official interest rate hikes in October, earlier than the date assumed by the financial markets. In any case, as the year progresses, debate regarding the first rise for Fed funds is losing some of its interest as analysts examine a broader issue, namely the pace of official interest rate hikes and the long-term equilibrium level being considered.

**The upward trend in Treasury yields gains support**. The rise in US public debt yields in May, in line with expectations, is largely due to two factors that will continue to have some effect over the coming months. Firstly, the Fed's official interest rate hike, which is increasingly imminent. Secondly, the gradual recovery in inflation indicators after a very languid start to the year. In addition, the recent rise in yields was also temporarily supported by the sell-off in European public debt markets, especially in the longer tranche of the US sovereign debt curve. Over the coming months the disappearance of forward guidance by the Fed could expose public debt even more to the trend in activity indicators. This will help volatility in the Treasuries market to reach the higher levels seen in the last few years. However, the increase in yield, together with the relative strength of the dollar against other currencies, will keep US public debt very attractive and might alleviate some of the upward pressure on interest rates.

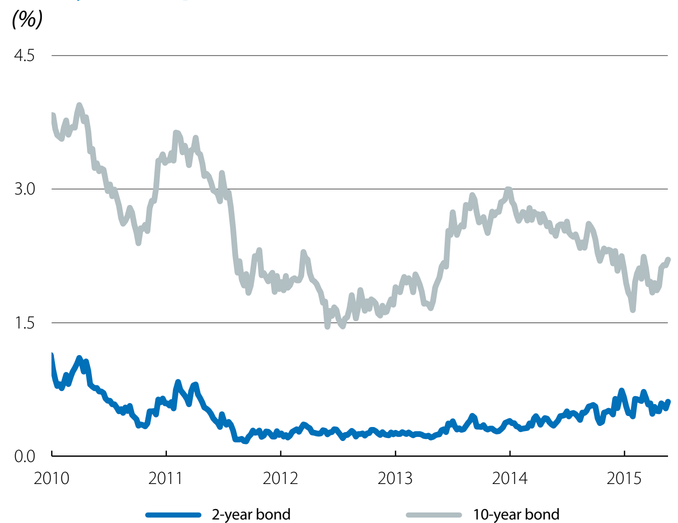
**The sell-off of European public debt has a subdued impact on emerging markets**. One of the positive bits of news in May was the limited effect of tensions in developed public debt markets on the price of emerging assets. Although indicators for foreign portfolio investment suggest a certain slowdown in capital flows towards the emerging countries during May, this has been more localised and less intense than after the turbulences following the pre-announcement of the Fed's tapering in spring 2013. This lessened impact is due, on the one hand, to the significant progress made recently by some emerging countries in reducing their imbalances, both internal and external. On the other hand the prudence shown by the Fed in embarking on its first official interest rate hikes has also had a favourable effect since this gives emerging central banks more margin to adopt expansionary monetary policies. This is the case of the Chinese monetary authority which, given the persistence of weak business indicators, cut

### *USA: Fed official interest rate projections **
*(%)*



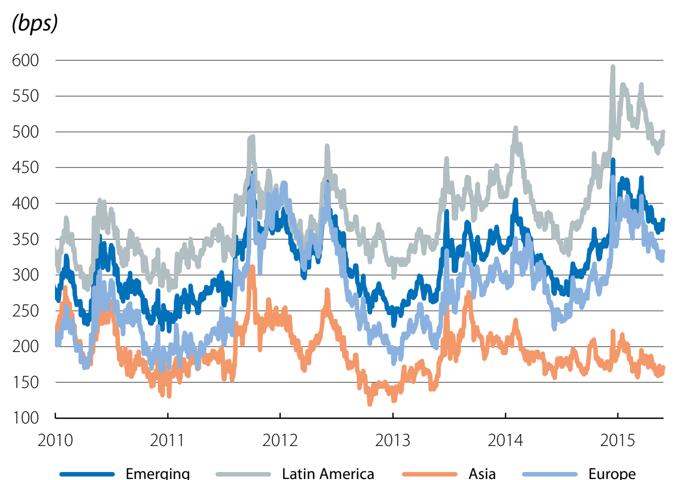

***Note:*** ** Based on Fed funds futures.*
***Source:*** *"la Caixa" Research, based on Bloomberg data.*

### *USA: yield on public debt*
*(%)*




***Source:*** *"la Caixa" Research, based on Bloomberg data.*

### *Spreads of government bonds of the emerging countries **
*(bps)*



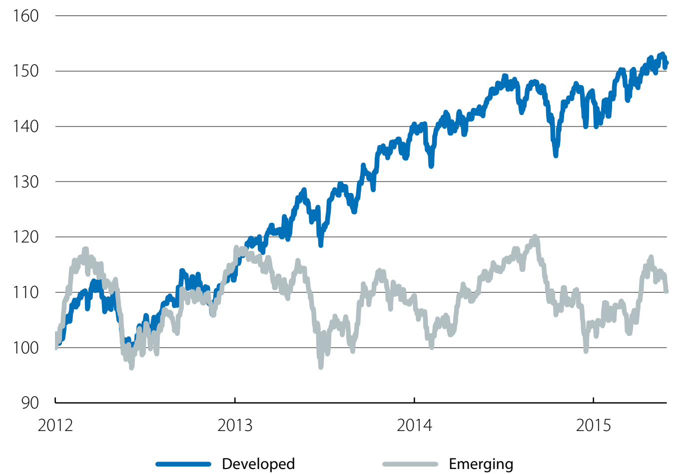

***Note:*** ** Spread compared with a basket of US government bonds.*
***Source:*** *"la Caixa" Research, based on Bloomberg data.*

its official rate for loans for the third time in less than six months, down to 5.10%. However, the loss of dynamism in the Asian economy is still one of the main risks the emerging bloc will be facing over the next few months. Similarly, should the rate of the Fed's monetary normalisation be faster than expected, this would represent another source of instability for the economies of the emerging area.

**Developed stock markets are still immersed in a lull.** Developed stock market indices have failed to show any definite trend over the last few weeks and a cautious climate is building in European stock markets, although losses intensified towards the end of May. There are many different reasons for this turnaround. There has been a gradual disappearance of the factors causing the rally at the beginning of the year (QE and the euro area's better economic prospects) while investor sentiment has deteriorated due to the growing uncertainty surrounding the outcome of negotiations with Greece and the recent upswing in turbulence in government bond markets. At the same time, the US stock market reached an all-time high in May, although the underlying trend is still weak due to the modest corporate earnings campaign. The absence of positive catalysts, high share prices and the closeness of summer all make it unlikely that trends in international stock markets will become any firmer in the short term.

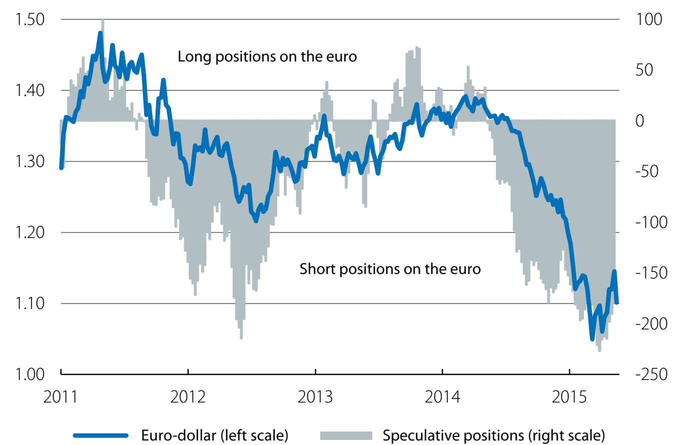
**The value of the euro goes up and down.** The euro's exchange rate oscillated within a range of 1.15 and 1.10 dollars throughout the month of May depending on the messages given by central banks, although the expected improvement in the US economy and the imminent interest rate hike by the Fed should help the dollar to continue appreciating over the coming months. Regarding commodities, the price of crude took a break in May after rising 42% from the minimum reached in January and now stands at approximately 65 dollars per Brent barrel. Given this situation, the OPEC meeting at the beginning of June is not expected to produce any significant change in the supply strategy of the members of the oil cartel. We have therefore maintained our forecast of a gradual rise in the price of crude over the coming months, up to around 70 dollars per barrel by the end of year.

### Stock markets of developed and emerging countries
*Index (January 2012 = 100)*



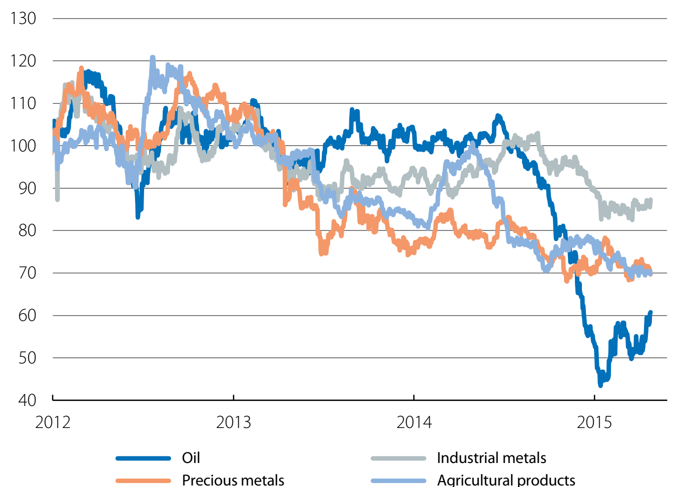

**Source:** *"la Caixa" Research, based on Bloomberg data.*

### Currencies: speculative positions on the euro/dollar
*(Dollars per euro)* *(Thousands of contracts)*




**Source:** *"la Caixa" Research, based on Bloomberg data.*

### Trends in commodities
*Index (January 2012 = 100)*

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