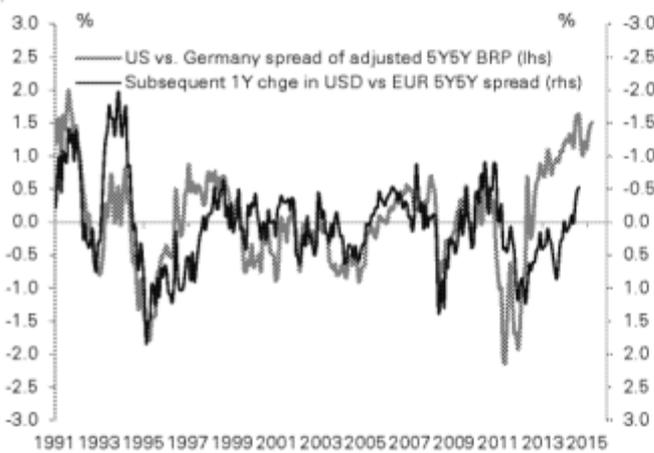




Back-end and swap spreads convergence

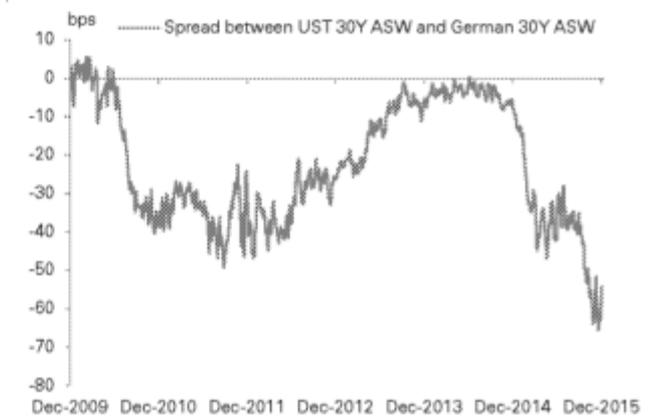
The rationale outlined above would be consistent with a possible underperformance of the European back-end relative to the US. This macro assessment is supported by valuation arguments. Long-term valuation arguments which ignore flow effects such as QE suggest a significant richness of 5Y5Y rates in Europe relative to the US. Accounting for flows, the relative richness is less clear. The corollary however is that any pricing out of flow effect should lead to an underperformance of European fixed income in the long end of the curve. At the same time, the structural drivers of the cheapness of swap spreads in the US are likely to become more prominent in Europe. This should also lead to a relative cheapening of the long end of the German curve vs. USTs.

Figure 12: 5Y5Y adjusted risk premium (which ignores flow effects) indicate some scope for underperformance of European fixed income



Source: Deutsche Bank Research, Bloomberg Finance LP, Federal Reserve, ECB, Consensus Economics

Figure 13: Swap spreads have diverged significantly in the US vs. Germany (cheapening of long UST bonds)



Source: Deutsche Bank Research, Haver Analytics LP, Bloomberg Finance LP, Federal Reserve, ECB

Key risks to the outlook:

As always, there are important risks to this outlook. These include external risks such as China and the dynamics of oil prices, but also domestic risks such as a change in the fiscal policy outlook, political risks in Europe or a turn in the US credit cycle. We summarise the key risks below.

*China:* We argued earlier this year that China rather than Europe was the main disinflationary source at the global level. In contrast to Europe, credit growth remains relatively high, long-term real rates are above 4%, the GDP deflator is in negative territory and the currency has appreciated close to 30% and is now overvalued on some metrics. Our economists are positive on the short-term outlook for growth and China's ability/desire to maintain a relatively stable currency. However, they also recognize the secular decline in growth. Putting it all together, China could continue to exert background disinflationary pressures, but without creating a significant financial shock. Relative to this scenario, the risks would come from a more aggressive adjustment and/or policy response. For instance, a more aggressive devaluation would increase the disinflationary pressures that would be exported to the rest of the world, while enabling a rebuild of FX reserves. Both factors would contribute to a flattening of the curve and would likely lead to more dovish ECB and Fed. Conversely, a more aggressive domestic easing (fiscal and monetary policy) while maintaining the currency stable is likely to reduce disinflationary forces while at the same time putting more pressure on FX reserves. Both factors would lead to steeper core curves.