The Intelligence Report

Our views on the latest investment events - FOR PROFESSIONAL INVESTORS - 17 July 2017

Overview

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The shift in central bank rhetoric at the recent Sintra meeting has refocused market attention on the prospects for higher interest rates. This phenomenon has been particularly marked in the Eurozone, where core 10 year yields have risen 30 basis points on the back of an apparent hawkish shift in the ECB's reaction function. In the first article in this TIR edition, Claude argues that quantitative easing is proving to be reversible, and explores the market implications of ECB tapering.

By contrast, Chi Lo looks at the rise in onshore bond yields in China in our second article, arguing that this process is now mature, and may represent an interesting buying opportunity for contrarian investors.

Russian equities performed extremely strongly in 2016, but have suffered this year as hopes of an early lifting of trade sanctions and weaker oil prices have weighed on investor sentiment. In our third article, Vladimir Tsuprov and Egor Kiselev examine the relationship between oil prices and Russian stocks, finding a more nuanced picture in which other drivers provide grounds for optimism.

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The consequences for the eurozone of unconventional monetary policies becoming conventional

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Over the last decade, central banks have faced economic crises that have required unusual responses. For example, the Bank of England (BoE) cut policy rates to extremely low levels; the US Federal Reserve (Fed) reduced them to zero percent; and in the euro zone, Japan and Switzerland, official rates were even driven below zero. But that didn't appear to be enough. Considerable amounts of cash were injected into the economy through either full allotments on commercial banks' refinancing operations at the central bank, or through the purchase of financial assets (commercial paper, corporate and government bonds, and even shares through ETFs by the Bank of Japan (BoJ)).

As a result, the Fed now holds more than 15% of US government debt, equivalent to 13% of GDP, the BoE owns 23% of the gilt market and the European Central Bank (ECB) owns the equivalent of 18% of eurozone GDP in securities thanks to its asset purchase programme. The BoJ had the largest programme and now holds 76% of GDP equivalent in securities, mainly government bonds.

Given the colossal amounts involved, and the widespread use of these stimulus policies, some believed quantitative easing (QE) had become irreversible.

Impact of quantitative easing

These security purchase policies have had a direct impact on interest rates, causing them to fall sharply, but indirectly, they also improved conditions for issuers. Since central banks purchase this debt on a hold-to-maturity basis (without any provisions for unrealised capital losses at the end of the year) and finance them at the deposit rate (currently set at -0.4% for the eurozone), they can generate a non-negligible profit, with the exception of the Bundesbank. This remains true as long as the interest rate at purchase remains higher than the deposit rate. Any profit is remitted to the state in the form of dividends from the central bank. Taking the case of Italy, the Bank of Italy buys EUR 9 billion of government bonds (BTPs) every month and has been keeping the paper on its books. To date, the gain for the Italian Treasury has amounted to the equivalent of 0.25% of GDP.

Extrapolating this, and assuming that the deposit rate at the ECB will remain low for a long time, Italy's debt-to-GDP ratio can be expected to drop from 133% to less than 120%. Thus, QE indirectly facilitates slow deleveraging even as the direct impact has lowered yields through monetisation.

The Fed has now signalled it will stop reinvesting repayments from maturing government and mortgage-backed securities (MBS) (without specifying the date) and the ECB is preparing the financial markets for the end of its purchasing programme. Consequently, the System Open Market Account (SOMA) of the US Central Bank, where the state securities are held, could drop by more than 30% in the first three years. The Fed thus shows that its purchasing programme is reversible and that the economy is not addicted to asset purchases. Accordingly, QE becomes a normal policy instrument that can be used again later. The success of this approach will require, however, that the economy does not weaken dramatically in the future.

Meanwhile, the ECB has been sending messages to the markets that it would like to begin unwinding its bond purchase programme early next year. Given what the markets have already seen from the Fed, investors should start to anticipate the reversibility of the ECB's programme, which is comparable in size to that of the Fed.

Japan is a different case. The BoJ's asset purchases amount to a much larger percentage of GDP and the size of the government's debt stood at 234% of GDP at the end of 2016. Reversibility does not seem easy. At the annual meeting of central bankers in the Portuguese city of Sintra, the BoJ's representative said that the end of central bank security purchases was still some way off.

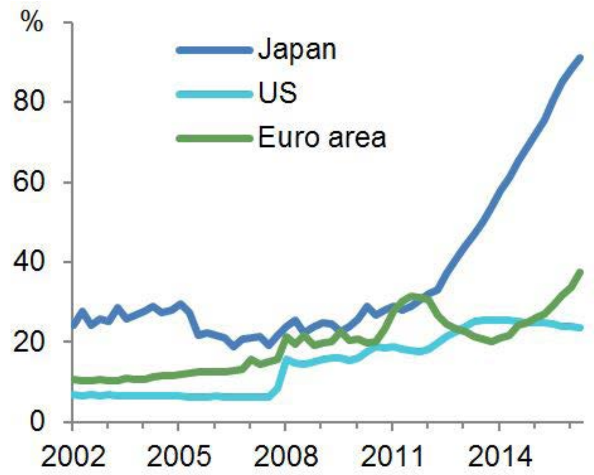
Market expectations of an end to the ECB's purchasing programme, initially led to a rise in interest rates across the entire curve. We expect this rise to continue in a slow and uneven way. The Fed had pre-announced its tapering in May and June 2013, making an official announcement in December 2013 and actually starting in January 2014. The ECB's timetable could be similar. The rise in euro rates, however, should be less given the US experience and the extended period over which the Fed has been raising its key rates. Nevertheless, the yield curve in Germany is less protected than the US curve was in 2013. Consequently, we expect the euro curve to steepen.

As far as BBB-rated eurozone countries are concerned, a reduction in quantitative easing is likely to widen yield spreads over core member state bonds as it reduces debt sustainability. However, this effect could be offset by reasonable economic growth, as long as it is sustained.

Swap spreads can be expected to tighten with the disappearance of a major buyer – the ECB – and 'proxy swaps' such as covered bonds and agency debt are likewise expected to see narrowing spreads. Indeed, the large investors in agency debt with maturities of less than seven years, namely banks managing their liquidity coverage ratio, deal primarily with swaps.

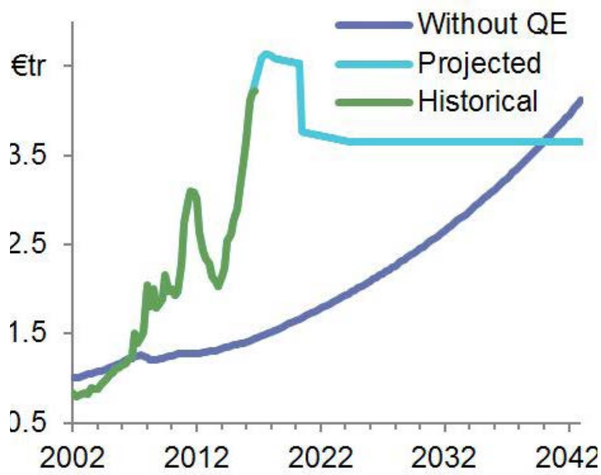
In the run, the addition of quantitative easing to the panoply of conventional monetary policy measures should reassure the markets, while increasing moral hazard" instead of "but at the same time, it increases moral hazard.

Figure 1: Central bank balance sheets as a percentage of GDP



Data as at 31 March 2017. Sources: Bloomberg, BNP Paribas Asset Management.

Figure 2: Simulation of ECB balance sheet



Data as at 31 March 2017. Sources: Bloomberg, BNP Paribas Asset Management.

When bad news becomes good news for Chinese bonds

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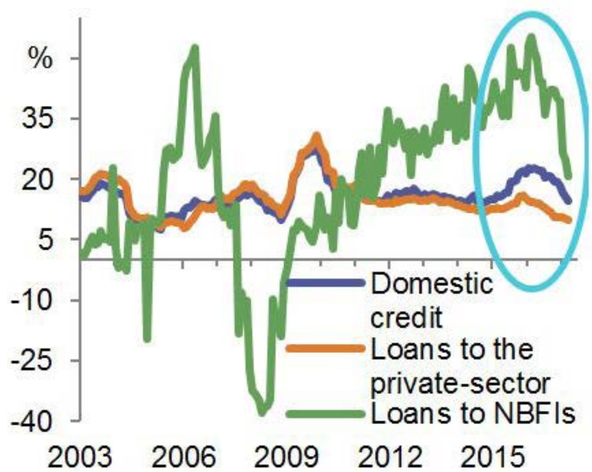
China's onshore bond yields have risen sharply since late 2016 when bond prices started dropping due to inflation fears about a rebound in both commodity prices and the Producer Price Index (PPI). The bond sell-off was part of the global reflation trade as global bond yields also rose. Since early this year, onshore bond yields have had another boost from domestic factors, when in February the People's Bank of China (PBoC) embarked on selective monetary tightening, and in March, Beijing began to impose tighter regulations aimed at forcing the onshore wholesale funding market to reduce its debt levels. These factors have led Chinese bond yields to continue to rise even as global bond yields have stabilised or fallen.

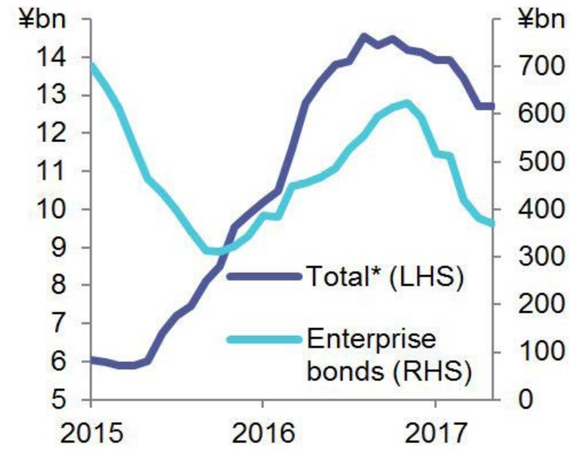
We anticipate China's onshore yields rising further in the near term as the financial crackdown to reduce systemic risk may force more selling by non-bank financial institutions (NBFIs). Should that occur, the resultant liquidity squeeze would likely further slow overall credit growth (Figure 1). The financial clamp-down has also sharply reduced fundraising in the bond market, especially by Chinese enterprises (Figure 2), so the slowdown in bond issuance could continue in the near term. Overall, however, this has not caused major funding problems, largely because bank loan growth has picked up and offset some of the wholesale funding squeeze.

Figure 1. Regulatory tightening causing a slowdown in overall credit



Data as at March 2017. Sources: CEIC, BNP Paribas Asset Management.

Figure 2. Bond issuance has dropped



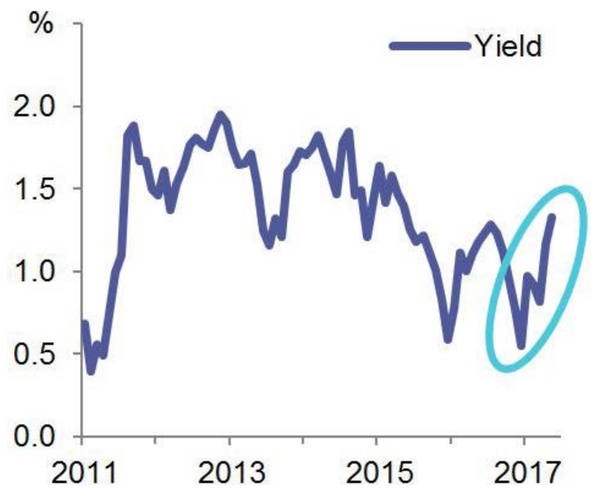
Data as at March 2017. *Includes government, financial and enterprise bonds. Sources: CEIC, BNP Paribas Asset Management.

Should China's GDP growth momentum ease from a robust 6.9% year-on-year (YoY) in the first quarter of 2017 towards 6.5% YoY as we are expecting in the run-up to the 19th Communist Party Congress this autumn, Beijing will likely ease up on its selective liquidity and regulatory tightening measures.

Meanwhile, foreign investors' exposure to the Chinese fixed-income market has remained very low, accounting for less than 2% of the total USD 9 trillion outstanding debt. Beijing has gradually been opening up the onshore bond market to foreign participation by expanding the Qualified Foreign Institutional Investor (QFII) programme, allowing foreign official institutions free access to the China interbank bond market (CIBM) since June 2015, and allowing foreign institutional investors to access the CIBM since February 2016. Recently, it has sanctioned the Bond Connect programme, modelled on the Stock Connect schemes, for foreign institutional investors to invest and trade in the CIBM without having to apply for quotas and open onshore accounts.

It seems that both macroeconomic and regulatory factors are converging to create a positive environment for China's onshore bond market. The forced selling by domestic players due to the financial crackdown has, arguably, made onshore yields attractive, while the spread between Chinese government bonds and US Treasuries widened sharply (Figure 3). The crackdown has likely run its course, with liquidity probably easing soon. Structurally, the CIBM is a market predominantly denominated in local currency and is invested in by local investors, thus shielding China against a debt-currency crisis that pessimistic observers have predicted for many years but still has not happened.

Figure 3. Yield spread between 10-year CGB and US Treasury



Data as at May 2017. Sources: CEIC, BNP Paribas Asset Management.

For foreign investors, a critical factor that hit Chinese bond returns last year was the 8% drop in the renminbi against the US dollar. But renminbi foreign exchange risk has now retreated because of fading capital outflows from China due to improving Chinese fundamentals and US dollar weakness. If the renminbi appreciates against the US dollar later this year, as I have previously argued, it would add to the attractiveness of the CIBM (Chart 4).

Figure 4. Chinese bond yield topping out?

Data as at May 2017. Sources: CEIC, BNP Paribas Asset Management.

The real Russian equities picture is more than just an oil painting

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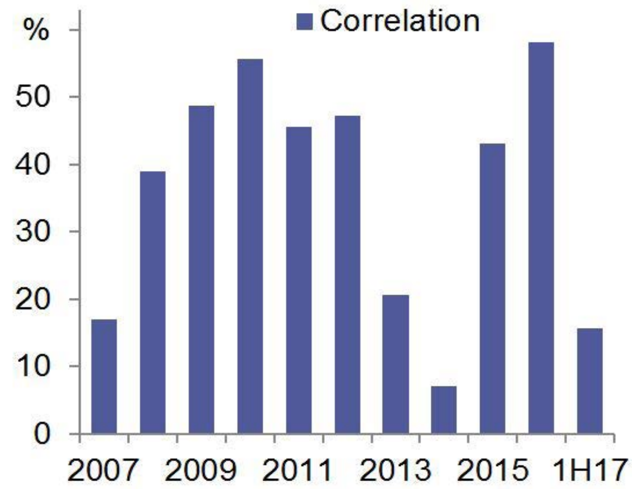
Some investors tend to simplify the connection between crude oil prices and the performance of Russian equities by assuming that oil is the principal force driving the market. For them, it seems reasonable that when the price of oil falls, rises or is stable, Russian equities will move in a copycat fashion. However, statistical analysis shows that the view that a simplistic assumption of the interconnection between oil prices and the Russian equity market over the short term rarely works. The average correlation between the price of Brent crude and the MSCI Russia 10/40 Net Return Index over the 10 year period to June 2017 was only 41%, and in some periods it fell below 20%. Moreover, even when the Russian equity market and oil prices seem to be in perfect harmony, there can be diverse reasons for this.

At first glance, the main reason for the Russian market's decline in the first half of 2017 seems clear given that it contracted by 12.7%[1] while the price of Brent crude dropped by 13%. However, in our view there were other important factors at work here:

- Fading optimism regarding the lifting of sanctions, which put additional pressure on the market. Expectations that sanctions could be lifted rose following Mr. Trump's election as US president in November 2016. However, this optimism almost completely evaporated in the absence of any move on sanctions following Mr. Trump's inauguration in January, the US missile attack in Syria in April, and the US Senate's decision in June for Congress to review any White House attempts to lift sanctions. This disappointment added pressure on the Russian equities market.

- Under normal circumstances, falling oil prices weaken the rouble, which helps the Russian economy and companies withstand the negative impact from lower oil prices. However, this was not the case in the first half of this year, as the rouble strengthened with support from a significant rise in carry trade activity. One of the signs of this carry trade activity was a material rise in the proportion of foreign investors among holders of Russian government bonds, from 26.9% as at the beginning of January 2017 to 30.7% as at the beginning of June 2017.

Figure 1. Correlation between Russian equities and oil prices



Note: figures are based on the daily movements for each period for MSCI Russia 10/40 Net Return index and Brent oil; in USD terms
Sources: Bloomberg, TKB Investment Partners, July 2017

Without these two factors, the Russian equity market would likely have continued to outperform oil price dynamics just as it had done during most of the three-year period since June 2014, regardless of oil market trends.

Medium/long term: sophisticated dependence

The ability of Russian companies to earn money regardless of oil price levels is the critical factor that helps Russian equities outperform across oil market cycles. Russian oil producers are in the first quartile among world oil producers in terms of costs (currently around USD 12-15 per barrel). In addition, around 60% of the market is not directly influenced by oil prices[2]. Consequently, even if oil prices remain more or less flat, the equity market should grow[3], driven by the free cash flow generated by Russian companies. Moreover, a significant portion of this free cash flow goes directly into the pockets of investors as most of the Russian companies distribute between 25% and 75% of it as dividends.

1. In USD terms for MSCI Russia 10/40 Net Return index
2. MSCI Russia 10/40 Net return index structure as at the end of June 2017
3. In the absence of any material change in other crucial Russian equity market factors

Top-10 largest companies in MSCI Russia 10/40 index: Ability to generate free cash flow for shareholders vs. oil price

	Sector	2012	2013	2014	2015	2016
Sustainable free cash flow, USD million						
Lukoil	Oil	7 842	5 507	3 660	3 951	4 376
Magnit	Retail chain	1 127	1 517	1 702	1 298	1 148
Gazprom	Gas	-636	11 265	13 944	4 099	579
Sberbank	Bank	8 484	8 018	1 942	-612	6 179
Novolipetsk Steel	Steel	788	232	920	889	1 184
Novatek	Gas	1 715	1 986	2 505	1 954	1 966
Severstal	Steel	1 049	1 141	1 681	1 638	1 512
Norilsk Nickel	Nickel, palladium, platinum, copper	2 626	2 076	3 945	2 569	2 016
Rosneft	Oil	7 014	7 940	8 770	6 746	5 149
Moscow Exchange	Stock exchange	322	396	406	429	343
Average oil price, USD per barrel						
Brent		112	109	99	52	44

Note: Top-10 companies are selected on the base of their weights in MSCI Russia 10/40 index as at the end of June 2017; Sustainable free cash flow is cash flow from operations adjusted for interest payments and stay-in-business CAPEX (CAPEX needed to maintain current level of production); Sustainable free cash flow for Sberbank is equal to net income adjusted for the sum needed to maintain equity capital at current level in real terms
Sources: company reports, TKB Investment Partners, July 2017

Should the oil market be on a declining trend, Russian companies' ability to generate free cash flow also declines, but the negative impact is cushioned significantly by the rouble weakening. Since November 2014, the Russian rouble has been free-floating. We think the Russian authorities are determined to keep it this way given the five years it took to transition to free-float and their keeping it in place even during the currency crisis in December 2014. The free-floating rouble normally leads to the currency weakening when oil prices drop, and this in turn lowers Russian exporters' costs in US dollar terms given that most of their costs are denominated in roubles. For example, in 2013 the production and transportation costs for Russian oil producers were around USD 20-25 per barrel. These have fallen to USD 12-15 per barrel now, due to rouble depreciation. For Russian exporters in other industries such as steel, fertiliser and diamond production, rouble depreciation can even improve their cash flow generation in US dollar terms as long as their product prices hold up.

Finally, there are other crucial factors for Russian equities which can lead to a divergence between the performance of the Russian equity market and oil price levels, such as monetary/fiscal policies, the perception by international investors of Russia's credit risk, and geopolitical events. However, looking ahead, in our view the most important factor is likely to be further rate cuts by the Central Bank of Russia (CBR). Cumulative rate cuts totalling 700 basis points contributed markedly to the Russian market's 65% rise over 2015-2016. We foresee a further 250-300 basis points cut over the next 12-24 months, which should further support the market. The CBR's current key rate is 9%, which we believe leaves plenty of room for further cuts given that inflation is expected to be in the range of 3.8%-4% over the period.

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