Fixed-Income & Debt Markets

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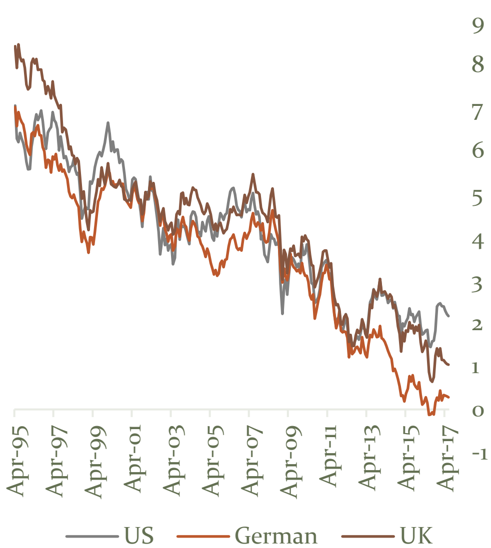
10 Year Government Bond Yields



Introduction: U.S Fed Rate-Hikes

America might be the world's largest economy but "There are no free lunches". These days Uncle Sam pays more than many others to borrow money. Its 10-Year yields are higher than those in Britain, France & even Italy. (See relative generic 10-Year yield comparison below of US, German & British)

The gap between the American & German 10-Year Yields has been more than 200 bps recently. While for the better part of the past 25 years, it was rare for the spread to exceed a single percentage point. (See chart)

A generation ago, you would expect the currency with the higher yield to be the one with the weaker currency, with the investors demanding a higher yield to compensate for the additional risk of further depreciation. Alas, this isn't the case anymore. The investors have developed a better understanding of the correlation of the decisions by the governments & the actual impact.

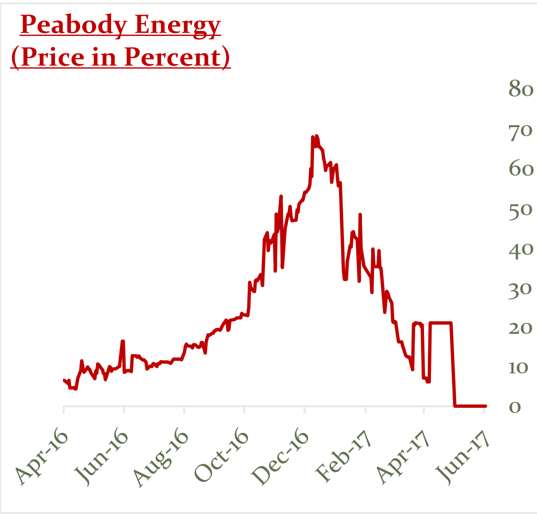
The U.S fed has announced 3 interest rate hikes in 2017 & 3 more the following year. Krishna Memani, CIO of Oppenheimer Funds discussed with Bloomberg, the extent to which the investors have prices in the expected hikes after the first one in March 2017.

The dollar has been strong, relative to the euro, & many people expect it to strengthen further. The higher yield on the American debt is one of the reasons why investors might want to invest in the dollar.

The gap may be a reflection of the differences in both monetary & fiscal policy.

In America, the Federal Reserve stopped buying T-Bonds a while ago & has started raising interest rates since December 2015; while the European Central Bank is still buying bonds as part of its "quantitative easing" program & is paying a negative rate on deposits.

U.S Yield	Date	Yield	Change
3-Month	1st June 2017	0.976	-0.24%
1-Year	1st June 2017	1.158	+0.26%
2-Year	1st June 2017	1.298	+1.54%
5-Year	1st June 2017	1.763	+0.86%
10-Year	1st June 2017	2.213	+0.69%
30-Year	1st June 2017	2.865	+0.28%



Spotlight 1: U.S Government

U.S government debt prices fell on Thursday as investors started to take in the recent economic data. On the data front:

1. The weekly jobless claims came in at 248,000, beating the forecast by 9,000.
2. On Thursday, the ISM manufacturing index for May, came in at 54.9, falling short of the estimate of 55.0 by a fraction.
3. April construction spending fell 1.4% while economists were forecasting a gain of 0.5%.

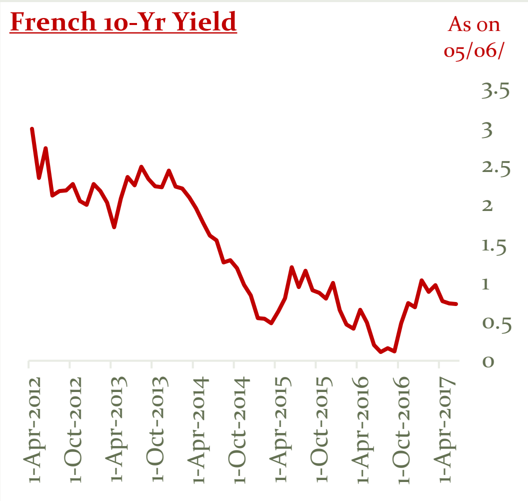
The world of yields has started to evolve into a more investor driven arena. While the short-term rates might be set by the Fed, the long-term rates reflex the true expectations of the investors. If as previously stated, having a permanent difference in yields across regions might be a reality, the world of fixed-income could eventually evolve into something more interesting. Having the government agencies decide on policies while the investors push prices to be more fair and accurate, might start to complicate the system.

Spotlight 2: Goldman Sachs Trading

Goldman Sachs may be one of the insatiable banks when it comes to competition but even they have been affected by the mayhem in the distressed debt (DD) market. Goldman Sachs shows a $50Mn - $60Mn on its distressed-trading desk in 2015. The DD unit generated about 25% of the bank's fixed-income trading revenue over the past five years (About $2.5 billion a year). The DD unit realised it shortcomings then & started recruiting talent e.g. Philip Giordano (Former director, distressed-products division, Deutsche Bank).

Relatively new, Adam Savarese (Goldman Sachs Group top distressed-debt trader in 2016) was determined to make an impact & found his opportunity in Peabody Energy Corp. As the coal miner dwindled near bankruptcy, Savarese acquired its unsecured bonds for pennies on the dollar & rode them to one of 2016's most successful trades. If Savarese had sold or reduced his holding in December, he could've locked in gains. Instead, the bank's position in Peabody fell by $40Mn this year. The current bid-ask spread as of 2nd June 2017 is 2.5% - 21.00%.

Now, of course the big question is, wasn't there a Volcker rule? Which prohibits banks with federally insured deposits from activities like propriety trading. The institutions must prove that the bond inventory is used to meet their clients' needs. To ease the market, a person familiar with the bank's policies said the trades were within the rule's bounds.



Spotlight 3: French Election

One of the biggest news out of the EU is the French election & the way investors will react after analyzing the different economic, social & financial stances of the candidates.

The French 10-Year bond yield rose 2.5 bps in early April trade to 0.93 percent, while German Bund yields moved slightly lower at 0.18%. The gap between the two is used as a "Fear Gauge" by investors on the heel of the French elections & is close to a 6-week high. Daniel Christen at Capital Economics seems to have had a rather interesting view for the rally of the French 10-Year bond yields just before the election results. He mentions, "A key reason for the rally in French OATs has been the diminishing chance of one of his two radical rivals gaining power". He also mentions that the rally is unlikely to persist as the perception of France's creditworthiness has changed and as the ECB starts to unwind the bond-buying programme.

Macrons win will have a contagion effect on the way analysts will view the economy, trade routes & regulations, especially post-Brexit. The markets may be efficient enough to price in the expectations, it is possible that the pricing for events such as this might only include a short-term view. We could still end up waiting to see the full extent to which the investors will absorb the resulting information as Macrons views and policies take effect, however, as of now, it seems that the French 10-Year OAT has reached a state of tranquil, at least temporarily.

Current State of 10-Yr Govt. Yields

(As on 1st June 2017)

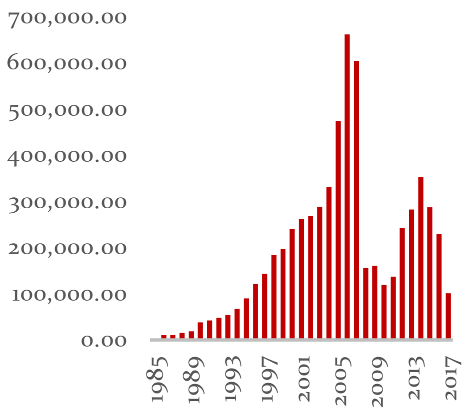
Country	10-Year Yield	1-Month Change (bps)	YTD Change (bps)
USA	2,25%	-2	-20
China	3,69%	+19	+63
Brazil	11,76%	+163	+34
Germany	0,42%	+8	+21
France	0,85%	+2	+17
UK	1,08%	+3	-16
Russia	7,51%	-17	-84
Australia	2,44%	-9	-32

Upcoming Events

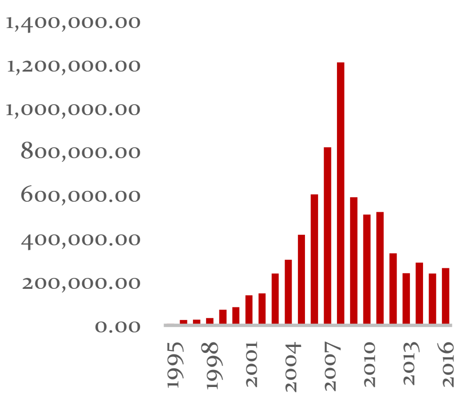
1. There are upcoming FOMC meetings scheduled for 13th & 14th June. All the Reserve Bank presidents attend Committee meetings, participate in discussions, and contribute to the Committee's assessment of the economy & policy options. There are 8 meetings held a year. Investors should guess how much of the policy expectations will be priced into the yield already as some expected information on the rates come to light.
2. The reserve bank of New Zealand implements monetary policy by setting the Official Cash Rate (OCR), which is reviewed eight times a year. The most recent meeting was on 23rd March 2017, where they left Official Cash Rate (OCR) unchanged at 1.75%.
3. The EU forecasts the inflation to rise from 0.3% in 2016 to 1.8% in 2017 & 1.7% in 2018. The investment in the Euro area however is forecasted to grow by 2.9% this year and by 3.4% in 2018

Final Take-Away

U.S. ABS Issuance ($ Mn)



European Securitized Products Issuances ($ Mn)



I have dedicated this section of the report to entice readers to think about the future of Fixed-Income markets, debt trading and the regulatory markets.

As we all know, with the introduction of the Volcker ruling, Dodd–Frank Wall Street Reform, MiFID ruling the markets are being forced to evolve into something more "Transparent". The word is in quotes because it should be taken with a pinch of salt. Anton Kreil, a veteran from Goldman Sachs, Lehman Brothers and J.P Morgan is a person whose views on the market were tracked by analysts. In 2008, we had seen him take a rather bold stance that you will start seeing talent shift from major investment banks to smaller houses.

The biggest reason for the Volcker rule was to avoid making a bank its own biggest client. Although the law focuses on commercial banks, the other reforms focus on the firms which are listed. This means that the banks would have to delist in order to avoid scrutiny, and although this does not seem likely to say the least. The human talent which makes up the companies can start to shift with the fall in bonuses over the past decade. A recent example would be the transfer of Mark Tsesarsky, ex-Citigroup veteran, to the hedge fund Millennium Management LLC. T-Man, as he was known around the bank, was the head of special situations for securitizations at Citigroup. The work behind the fancy title entailed betting on bonds backed by mortgages and other assets, on behalf of Citigroup. Bloomberg aptly calls him "The Alchemist Who Turned Toxic Assets into Gold at Citigroup". Just after the 2008 crisis hit, while other banks were looking to unload the toxic securities and Citigroup itself was taking an $11 billion write-down on its holdings, Citigroup doubled down by buying Collateral Debt Obligations (CDO) and Mark was put in charge to oversee the operation of the desk. Ended in December 2015, Mark the handful of traders notched almost $2 billion in revenue. Their performance was made possible by an unprecedented rescue of the financial system, including a bailout of Citigroup, and a flood of central bank money that lifted asset prices. Now he will help run dozens of traders betting on various bond markets, a business that represents about $7 billion of Millennium's assets under management.

Although some people found Anton Kreil's views to be too early, the markets are shifting and it might be time to re-evaluate where the world of trading (especially with the rising opportunities in the debt market) is heading. We know that securitization can be a profitable business. If the trend comes back, there has to be someone to take advantage of it, no matter when they will work out of.

The vision of the markets might be important but so is the view of the millennials currently reading this article, who will soon dominate the market.

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