Sunset

Friday, 24 June 2016

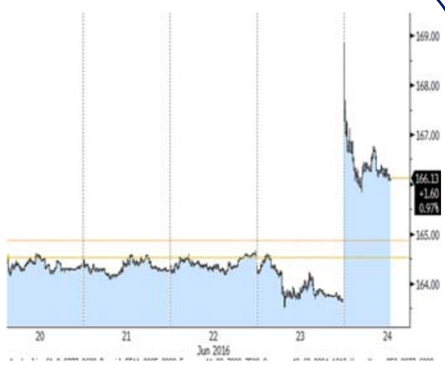
Headlines

- **European shares plunged lower in the opening** with major indices losing approximately 10%. **Part of the losses were being erased later in the session**, although most indices trade still 6-8% down. US Equities opened with losses of 2-3%. The Nasdaq underperforms (-3.5%).
- **UK Prime Minister Cameron announces his resignation in the wake of the referendum** and said a new leader should be in place by October to lead negotiations with the European Union.
- **G7 Finance Ministers vowed to continue to consult closely on market moves and financial stability and cooperate as appropriate**, recognising that excess volatility and disorderly moves in exchange rates can harm economic and financial stability after Britain voted to exit the European Union.
- **The Swiss central bank said it had intervened in the currency market to weaken the Swiss franc** in the wake of Britain's vote to leave the EU and added it will remain active in that market. EUR/CHF trades currently around 1.08, after having dropped to 1.062 early this morning.
- After the Bank of England, also **the ECB said it stands ready to provide additional liquidity**, if needed, in euro and foreign currencies. The **Fed also said it is prepared to provide dollar liquidity through its existing swap lines** with central banks, as necessary, to address pressures in global funding markets. **People's Bank of China pledged to keep the yuan basically stable** and said it would maintain ample liquidity.
- After S&P, also Moody's and Fitch warned that Brexit is a credit negative for the UK. **Fitch said Brexit is moderately negative for the UK sovereign** and added that they will review the sovereign rating shortly. **Moody's said the lasting credit impact of the vote to leave will depend on the nature of the UK's ties with the EU.**
- **Sunday, Spain will hold general elections.**
- .

Rates

Core Bonds surge on surprise "Leave" victory

Core bonds profited from the UK decision to leave the EU. It triggered overall risk-off sentiment and obliged a lot of players to reposition after the market had anticipate a "Remain" victory during the past 6 session. The other side of the coin were heavy losses on equity markets, the sterling and peripheral bonds. Beside core bonds also gold and the yen amongst others profited from the Brexit decision. The BoE, Fed and ECB stated that they closely monitor financial markets and are ready to deliver liquidity, if needed. The Swiss central bank confirmed it had intervened to stem the appreciation of the franc and the Japanese Minister of Finance called for coordinated G7 action.



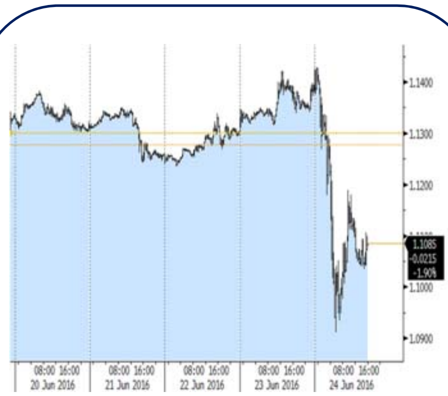
German Bund (black) opens sharply higher on Brexit, lost some ground, but still keeps juicy gains .

After the first wild swings, markets calmed a bit and safe haven assets lost some of the initial gains, while riskier assets regained some ground. It was followed by more sideways trading. However, changes are still very big. At the time of writing, the **German yield curve** bear steepens with yield increases of 8.7 bps (2-yr), 16.6 bps (10-yr) and 25.6 bps (30-yr). Yields across the curve set new all-time lows. Especially the drop of the 30-year is mind-boggling. The market now discounts a 52% chance of a 10 bps rate cut in July and a 25% chance of an additional 10 bps cut by end 2016. We are sceptical whether the ECB will cut rates further, certainly not substantially. Negative rates are heavily criticised and disliked by the population as it endangers the financial health of banking, pension and insurers sectors. Also in UK markets, there was a safety flight to Gilts with yields down between 25 and 33 bps, the belly outperforming. Markets discount now a 68% chance of a rate cut before the end of the year, suggesting that they expect a serious deterioration of the economy. In the **US, yields dropped by 15 to 21 basis points**, the belly outperforming. The market now prices one a 25 basis points rate hike by March 2018. **So, de facto it considers the tightening cycle as being done** (after one single rate hike end 2015).

On intra-EMU bond markets, **peripheral bonds were heavily sold, as were peripheral equities which underperformed core European equities**. 10-yr yield spreads widened 31 basis points (Italy/Spain), 44 bps (Portugal) and 111 bps Greece. Semi-core (Belgium/France) spreads widened 6/7 basis points while non-core German spreads widened 5 basis points. The size spread widening was according to the beta of the concerned credits. The spread widening of Spain and Italian was substantial, but only slightly more than last week's narrowing. It now tests the June 2015 highs though. **On Sunday, Spain holds parliamentary elections**. A victory of the centre left Podemos and centre-right Ciudadanos would be another sign that voters punish governments because of a general unease about the economy and the policies that seem unable to improve it. Observers are undecided whether Brexit will help PM Rajoy or work against him. We side with the latter.

Currencies

EUR/USD and USD/JPY hit hard, but off the Asian lows



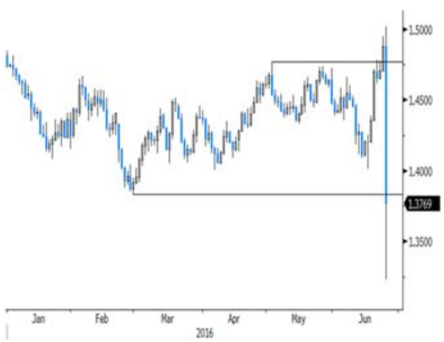
EUR/USD (1w) settles in the 1.10/1.11 area after the initial Brexit sell-off.

Today, **the biggest part of the Brexit repositioning on the currency markets had already occurred before the open of the London and the European markets.** The yen and the dollar were the obvious shelters attracting the safe have flows. The euro and the yen were the most outspoken victims. On a second line, most **smaller currencies also softened as they were hit by an unwinding of carry trades or simply as investors avoided currencies with a lower market liquidity.** USD/JPY dropped temporary below the 100 barrier but had rebounded to the 102.75 area at the start of the European session. EUR/JPY and EUR/USD initially declined in lockstep but basically showed a similar pattern as USD/JPY. EUR/USD initially dropped to low 1.09 area but returned to the 1.11 area ahead of the open the European equity markets. Japan Fin Min Aso indicated several times that authorities will take appropriate steps to safeguard financial stability. **However, we didn't see any aggressive talk on currency intervention at this stage. Major central bankers probably agreed to stay muted on the issue of (individual or coordinated) action even as the G7 openly mentioned that**

excessive volatility and disorderly moves in exchange ranges could destabilize the global economy and the financial system.

During the day European equities and core bond yields settled in sideways ranges, off the opening lows. EUR/USD and USDJ/JPY had more difficulties to find a short-term equilibrium and declined again off the rebound highs going into the open of the US markets. EUR/USD trades currently in the mid 1.10 area even as the 2-year interest rates rate differential between the US and Germany dropped about 7 basis points to 127 bps. USD/JPY trades currently slightly north of 102.

The risk-off trade triggered sharp repositioning on the currency markets with the yen and the dollar gaining and the euro declining. The other way around, it will be interesting to see how much US equities will be hurt by the combination of global uncertainty and a stronger dollar at the same time. Will there be second round effects back to the currency market, e.g. by a further decline of USD/JPY and/or EUR/JPY. **Whether or not this kind of mechanisms/loops can be avoided will be important for global market stability.** Among the smaller currencies, the Swiss central bank admitted interventions to avoid further strength of the franc. EUR/CHF trades at 1.08 off from 1.10 before the start in Asia this morning and with an intraday low of 1.0650 early this morning.



GBP/USD (2016): The (currency) price of Brexit

Sterling short-squeeze continues

The intraday trading pattern of sterling was basically in line with the risk-off trade and with the price pattern in the other major currency cross rates. Cable dropped from the 1.50 area to touch a multi-year low of 1.3239 in Asia, just to settle in a 1.40/1.36 range later in the session. Markets currently price in a probability of 75% of a BoE rate cut by March next year. EUR/GBP gradually also entered calmer waters. The pair settled in the 0.80/81 range after touching a reaction top just north of 0.83 in Asia this morning; So, the losses in EUR/GBP were substantial but not really excessive/disorderly. EUR/GBP 0.85 apparently won't be that evident to break in a sustained way anytime soon.

News

US: Durable goods orders weaken again in May

After robust gains in the previous two months, **US durable goods orders** dropped by 2.2% M/M in May, sharply stronger than expected (-0.5% M/M). Weakness was led by the volatile transportation sector. Excluding transportation, orders fell by 0.3% M/M, also undershooting the market consensus. The drop followed however two consecutive monthly gains. Still, the details are poor with orders falling for all categories of goods. Poor shipments data only added to the negative news. Headline shipments dropped by 0.2% M/M. Shipments of non-defence capital goods excluding aircraft, which is seen as a good proxy for business investments in the GDP data, dropped by 0.5% M/M, reversing most of the previous month's uptick. **These data suggest that for now, business investments remained poor in the second quarter. The pick-up in orders in the previous months was an encouraging sign that the worst might be over in the US manufacturing sector. Today's data however indicate that the sector is not yet out of the woods as business conditions remain tough.**

16:00 CET

Daily EMU spread changes (bps)

	5-yr			10-yr			30-yr		
	Yield	Spread	Change	Yield	Spread	Change	Yield	Spread	Change
Germany	-0.55%			-0.06%			0.49%		
Greece	#VALUE!	#VALUE!	#VALUE!	8.75%	881	112.0	#VALUE!	#VALUE!	#VALUE!
Portugal	2.19%	274	33.9	3.35%	341	40.8	4.19%	369	38.6
Italy	0.49%	104	21.1	1.54%	160	29.2	2.55%	206	28.3
Spain	0.57%	112	21.7	1.60%	166	28.8	2.69%	219	27.7
Ireland	0.00%	56	11.5	0.82%	87	19.2	1.57%	108	18.8
Belgium	-0.31%	25	5.0	0.40%	46	6.5	1.24%	75	6.2
France	-0.26%	29	5.8	0.37%	43	6.4	1.12%	63	6.3
Austria	-0.34%	22	2.6	0.33%	39	4.8	1.00%	51	3.9
Netherlands	-0.34%	21	2.5	0.21%	26	4.3	0.64%	15	3.2
Finland	-0.37%	18	2.2	0.28%	34	4.9	0.68%	18	2.3
US	1.07%	162	-7.1	1.58%	163	-1.9	2.44%	194	11.6
UK	0.58%	113	-19.8	1.10%	116	-12.4	1.94%	145	-1.4

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