

Economic Surprises and US/Europe

Fundamentals may matter more than you might think

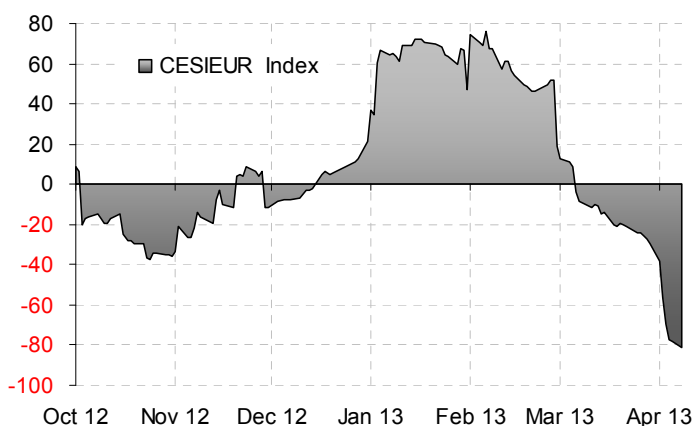
- Fundamentals may be being ignored in peripherals, but they do have a clear role in driving the trend in Bunds and the US/Germany spread.
- Bund yields and the Citi European Economic Surprise Index (ESI):
 - Sustained divergences of Bund yields away from their average require a corresponding trend in the economic surprises. The European ESI moves point to the scope for even lower Bund yields.
- The Treasury/Bund spread and the spread between the Economic Surprise Indices:
 - The US/Germany yield spread has led the spread of ESIs, not the other way round. However, there has been a close relationship between the 1-month change in the spread between the ESIs and the yield spread. Monitor 1-month changes in the spread of the ESIs for changes in direction of the yield spread trend.
 - Given the divergence between the US and European ESIs over the last two weeks, narrowing of the yield spread (Bunds underperforming Treasuries) would be swimming against the tide of short-term market expectations of the relative economics. If the Treasury/Bund spread were to narrow by 5-10bps, ceteris paribus, buying Bunds out of Treasuries would look an interesting proposition on this basis.

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Figure 1. Citi European Economic Surprise Index



Source: Citi Research

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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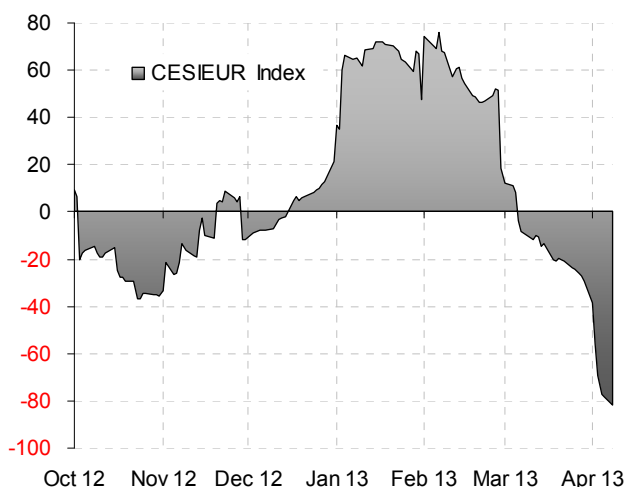
Fundamentals may matter more than we think

With prices seemingly divorced from fundamental in Europe, there is a school of thought that, as a determinant of prices, fundamentals don't matter any more, with the need for yield trumping any rational caution. This may be true of peripherals, but it is not true with respect to Bunds or cross-currency spreads, in our view.

Sustained divergences of Bund yields away from their moving average require a corresponding trend in the economic surprises.

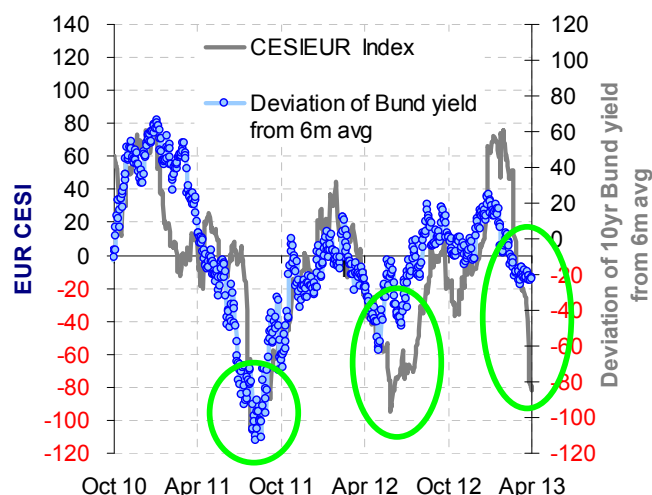
The Citi European Economic Surprise Index (ESI) has attracted a lot of attention recently with the extent and speed of its decline (Figure 2). While there is no direct relationship between ESIs and yields, we have previously written about the relationship between ESIs and the deviation of yields from their (moving) average. Sustained divergences of Bund yields away from their average to require a corresponding trend in the economic surprises. This is shown in Figure 3 below right.

Figure 2. European Citi Economic Surprise Index has moved even deeper into negative territory



Source: Citi Research

Figure 3. Economic surprises provide the fuel for yield trends



Source: Citi Research

There is another aspect of Figure 3 that is important: it points to the scope for even lower Bund yields. Although Bund yields were higher on the previous two occasions¹ when the ESI was so low, the last time the ESI bottomed, in 2012, there was a similar divergence between the ESI and 6m yield deviation and 10yr yields subsequently fell 25bps.

The European ESI moves point to the scope for even lower Bund yields

Alternatively, one could point to the fact that the European ESI has twice bounced from similar levels, and if that were to happen again, then that may allow Bund yields to rise in the medium term. It all boils down to whether you give primacy to the *divergence* between the ESI and the yield divergence, or to the *level* of the ESI. We tend towards the former interpretation. Although the latter interpretation is equally valid, we would point out the scope for the ESI to deteriorate further.

¹ Currently, Bund prices are floating on the tide of liquidity, and being buoyed by the need to insure against EMU uncertainty as peripheral exposure increases.

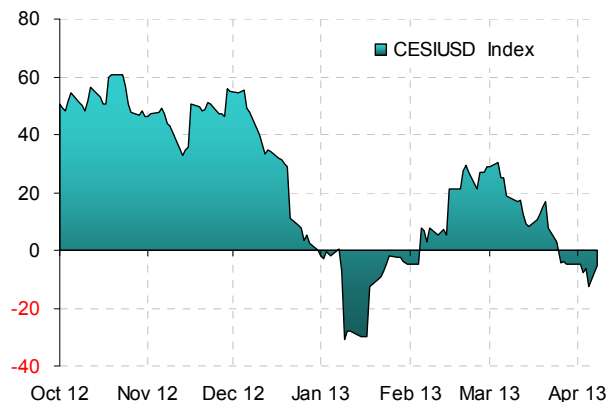
Is there a relationship between relative ESIs and cross-market spreads?

The deterioration in Europe dominates the spreads between ESIs

Given that there is some relationship between economic surprises and yield trends, it would be reasonable to expect some sort of relationship to obtain between cross-market ESI spreads and yield spreads. We explore this below.

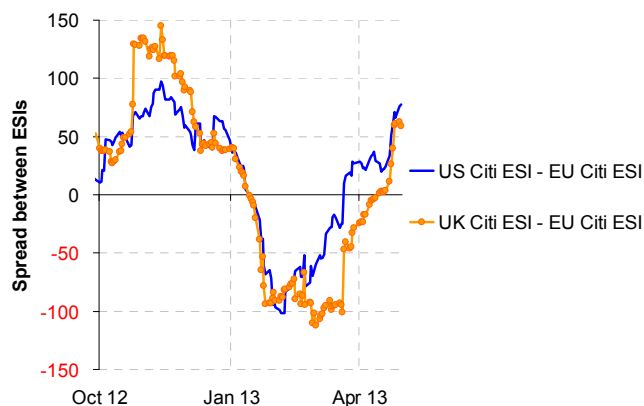
The trajectory of the Citi ESI in Europe is far more dramatic than either in the UK, where it is negative but slowly improving, or the US, where it is trending lower (Figure 4, below left). The two main ESI spreads to Europe are shown in Figure 5 below. The dominant effect of the deterioration in Europe is clear².

Figure 4. US Citi Economic Surprise Index trending lower



Source: Citi Research

Figure 5. Spreads between Citi Economic Surprise Indices

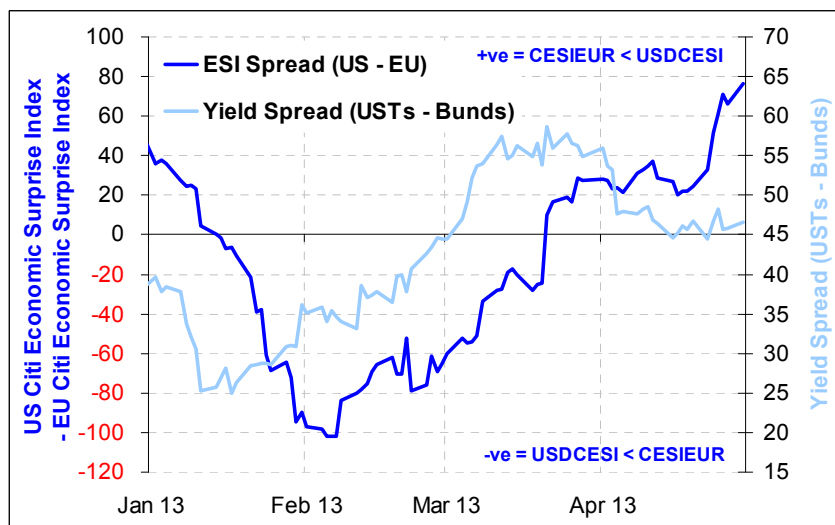


Source: Citi Research

The US/Germany yield spread has led the spread of ESIs in 2013, not the other way round.

If you plot the spread between the economic surprise indices for the US and Europe, and the yield spread you see that there has been some relationship between the two spreads in 2013 (Figure 6 below). The ESI spread has lagged the yield spread, suggesting that the market has been doing a good job of anticipating the relative surprises. If it is not coincidental, it definitely feels oxymoronic. Either way, the lag makes it of little practical use, and we need to look at things differently.

Figure 6. Continued negative surprises in European ESIs relative to US are not being reflected in Treasury-Bund spread



Source: Citi Research

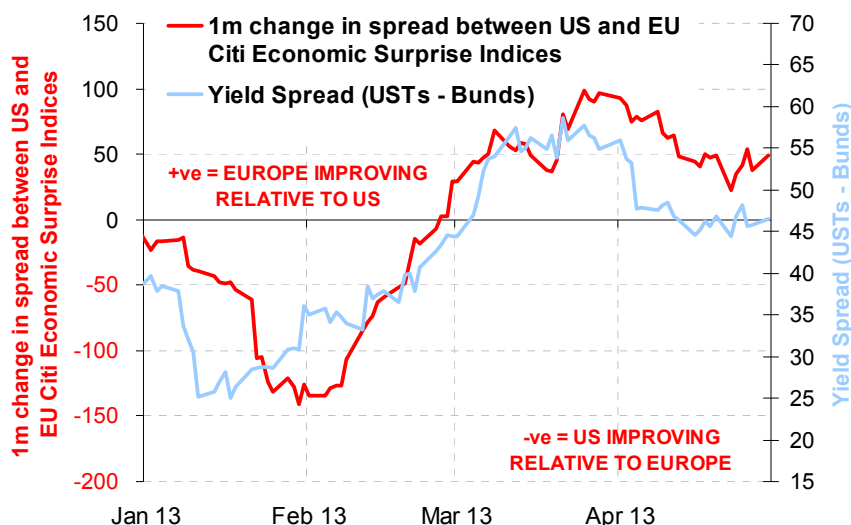
² The spread between the US and UK is close to flat.

A different perspective sheds light on the spread outlook

When you look at the 1-month *change* in the spread between the economic surprise indices, there is a much closer relationship (Figure 7), with some correspondence between reversals in the trend of the ESI spread and reversals in the yield spread.

Figure 7. But when you look at 1-month changes in the US-EU spread there *has* been a close relationship to the yield spread in 2013

Monitor 1-month changes in the spread of the Economic Surprise Indices for changes in direction of the trend

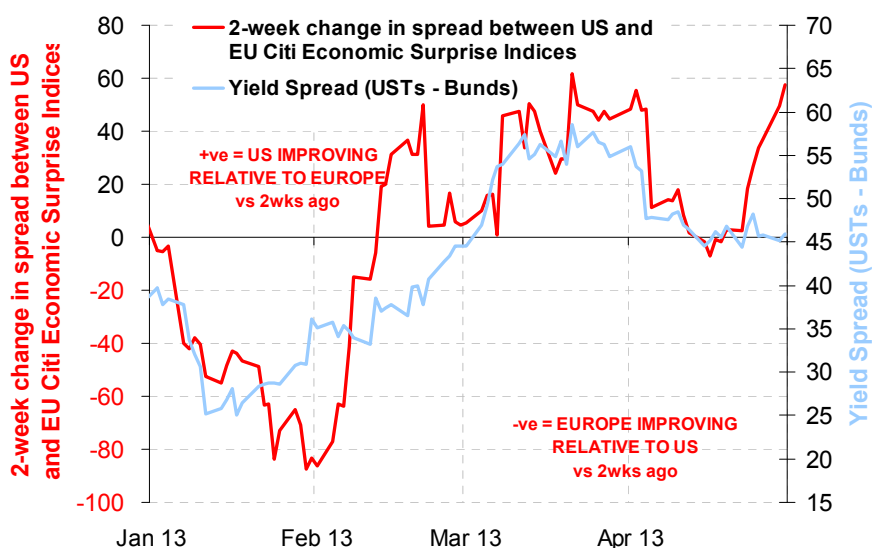


Source: Citi Research

This is worth monitoring but currently both spreads are moving sideways. Of more immediate practical use is looking through a narrower time window of ESI spread changes. Figure 8 below shows the 2-week changes of the US/Europe ESI spread and the yield spread between Bunds and Treasuries.

The divergence in the ESIs over the last two weeks suggests that narrowing of the yield spread (Bunds underperforming Treasuries) would be against the tide of short-term market expectations of the relative economics.

Figure 8. Divergence between the data surprises and the yield spread suggests potential widening pressure on the Treasury-Bund spread

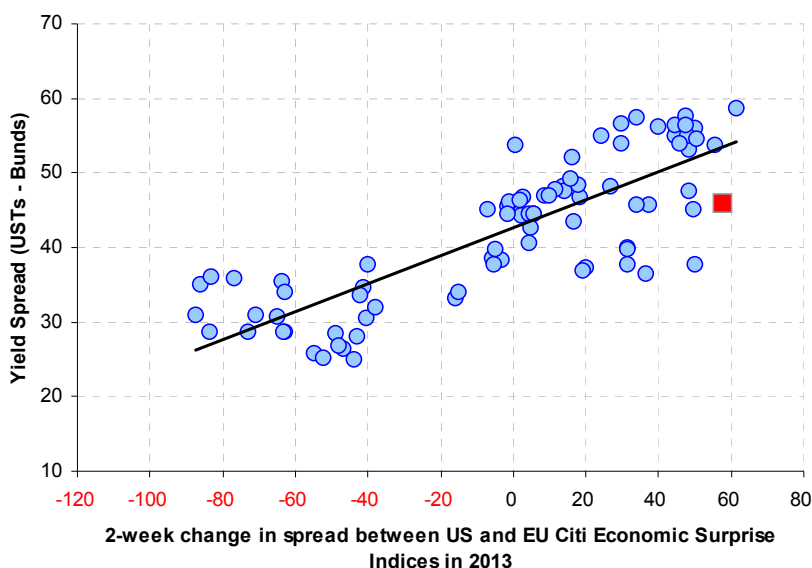


Source: Citi Research

If the Treasury/Bund spread were to narrow by 5-10bps, ceteris paribus, buying Bunds out of Treasuries would look an interesting proposition on this basis

The relationship between the yield and ESI spreads is not perfect (the correlation coefficient is only 0.81) and the current divergence is significant but not extreme. But if the Treasury/Bund spread were to narrow by 5-10bps, ceteris paribus, buying Bunds out of Treasuries would look an interesting proposition on this basis.

Figure 9. The divergence is significant but not extreme, and the correlation coefficient is only 0.81, but it does suggest another 10bps of narrowing, ceteris paribus, would make widening seem much more likely than a continuation of the recent relative Bund underperformance.



Source: Citi Research

Conclusions

Bund yields and the Citi European Economic Surprise Index:

- Sustained divergences of Bund yields away from their average require a corresponding trend in the economic surprises. The European ESI moves point to the scope for even lower Bund yields.

The Treasury/Bund spread and the spread between the Economic Surprise Indices:

- The US/Germany yield spread has led the spread of ESIs, not the other way round. But there is a close relationship between the 1-month change in the spread between the ESIs and the yield spread. Monitor 1-month changes in the spread of the Economic Surprise Indices for changes in direction of the yield spread trend.
- Given the divergence between the US and European ESIs over the last fortnight, narrowing of the yield spread (Bunds underperforming Treasuries) would be swimming against the tide of short term market expectations of the relative economics. If the Treasury/Bund spread were to narrow by 5-10bps, ceteris paribus, buying Bunds out of Treasuries would look an interesting proposition on this basis.

Fundamentals may be being ignored in peripherals, but they do have a clear role in driving the trend in Bunds and the US/Germany spread

Appendix A-1

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