

ECB underwhelms; Latam credit edgy before rate rise

Further monetary stimulus from the ECB fails to meet market expectations, while rising borrowing costs in the US could spell trouble for EM debt.

- 2-yr German government bonds jumped 12bps as ECB underwhelmed market expectations
- In corporate credit, the Markit iTraxx Europe index widened to a six week high
- After strong non-farm payroll number, USD EM debt is eyed on elevated Latam spreads

Draghi disappoints

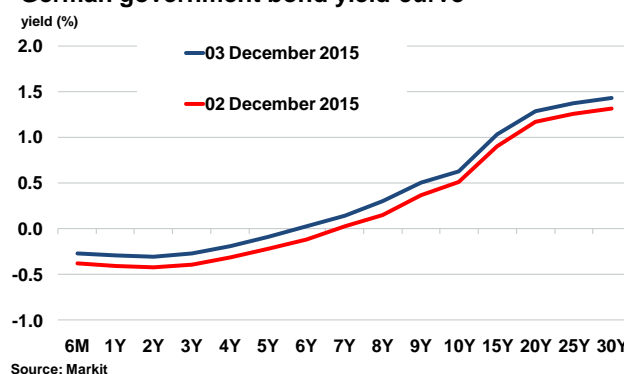
Sky high expectations are sometimes impossible to meet. This was the case yesterday when ECB president Mario Draghi surprised markets, veering away from his usual ultra-dovish monetary policy stance.

	Before ECB Dec 3rd meeting	After ECB
Deposit facility rate (%)	-0.20	-0.30
QE pace per month	€60bn	+ reinvest coupons
QE duration	Sep/16	Mar/17
QE composition	gov, agency, regional, covered, abs	further regional, agency

With latest inflation figures tepid, market participants were expecting the ECB to provide an aggressive easing package to add to the ongoing QE programme. The deposit facility interest rate was indeed cut, but by less markets were expecting. Yields on 2-yr German government bonds rose 12bps on the back of the news, to -0.3%, in line with the new deposit rate. Yields had started the day at -0.42%; highlighting the gap in expectation between the market and the ECB.

But it was the pace of monthly QE purchases that really caught the market, which had expected an increase, off guard. In FX markets euro/dollar surged while government bond markets in Europe saw significant shifts.

German government bond yield curve



The one day move in the German government bond yield curve was across the term structure, with the 10-yr rate widening by 11bps to 0.62% according to Markit's bond pricing service. These have continued their ascent this morning.

Markit iTraxx main index (spread)



The reaction was also negative in corporate credit, with the Markit iTraxx Main Europe index widening 5bps since the announcement; hitting a six week high as the market re-priced the added credit risk.

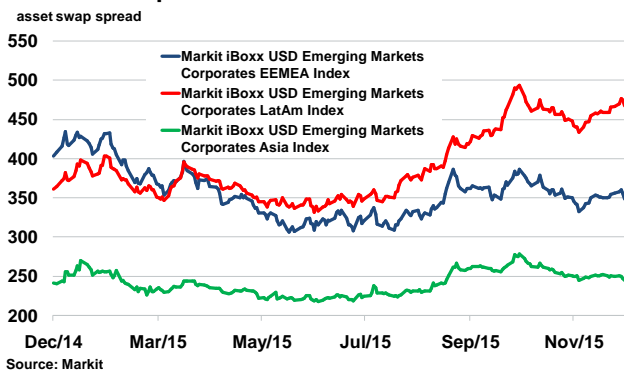
Whether the package delivered by the ECB will be effective remains to be seen, but with unemployment still above 10% and bank lending relatively weak, the market's high expectations felt justified.

EM eyes rate rise

Latest non-farm payrolls came in better than expected (+211k), clearing the final hurdle for the Fed's anticipated interest rate hike on December 16th. But while the US economy and unemployment are in a healthy situation, the same cannot be said for emerging market (EM) economies. There is around \$4tn of US dollar denominated corporate debt outstanding outside the US, a figure that has doubled since 2008.

treasury yields rise above 1%, and the rising borrowing rates could make servicing US dollar denominated debt in the Latam region more difficult as further rate increases ensue in 2016.

USD EM corporate bond risk



According to the Markit iBoxx USD Emerging Markets Corporates LatAm Index, US dollar denominated corporate debt in the Latam region has seen swap spreads widen 26bps over the last month. Today's non-farm payrolls announcement has already sent 2-yr

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