14 December 2012 │ 31 pages

Australia/NZ

APAC Developed Markets Rates Strategy

Prospects for 2013 – a Year of Snakes and Ladders

- The prospect of weaker growth in Australia should see the RBA continue to relax policy. This in conjunction with still attractive yield levels should see ACGBs outperform on a cross-market basis, particularly versus the US.
- Spread and curve trades offer better potential returns than outright duration risk in AUD, although we do expect benchmark yields to gravitate lower next year. We also see value in receiving the belly of AUD and NZD curves versus the wings and re-positioning a relative flattening of the swap curve versus bonds via the 3s10s box.
- We expect 2013 to be the year for semis given simmering foreign demand for high yields and high quality. Our ratings risk scorecard highlights Queensland debt as the value pick based on the fiscal outlook and balance of risks, and we recommend buying 10y QTC vs NSWTC.
- In Japan, we continue to expect a shift of policy focus from fiscal discipline to growth strategies, with fiscal and monetary policies tilted towards more a reflationary bias. Long-term sector JGBs (7-10 years) will lead the yield curve changes in both bull and bear markets. An increase of bond supply is expected across the curve as refunding bond issuance balloons which may lead to additional burden for market.
- If the LDP returns to the power, growth focus policies to tackle deflation will likely support an equity rally and yen depreciation. The BoJ is expected to remain under pressure to cooperate with the government on additional easing programs which should anchor the medium-term sector in JGBs.

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With thanks to
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Figure 1. Strategy Summary Table

APAC Developed Markets	View	Strategies
Direction	AUD rates markets should remain highly correlated to offshore markets. Headline risks make outright duration unattractive still, but we expect to witness lower yields going forward. JGBs are likely to underperform as growth strategies are deployed in Japan.	Keep duration exposure light but look to buy ACGBs (3.4% or better in 10yr) or receive longer dated AUD swaps on dips
Yield Curve	AUD curve could re-steepen on rate cuts before flattening takes hold. JGB curve looks relatively anchored out to 5yrs	Front-end flatteners on bullish RBA outlook. Buy 5s and 7s versus the wings in Aussie and Kiwi respectively.
Cross-market	Long AUD vs US	Receive AUD 5y5y vs USD or 10yr cash spread.
Spreads	Swap spread box close to end of re-steepening move, with potential for reversal early in the New Year. Semi spreads should consolidate first before compressing further	Hold QTC versus SAFA and NSWTC. Look to re-position 3s10s EFP box flattener in Q1.
Inflation	Neutral on AUD inflation risk currently	Look to pay fixed on 10y ZCS on any dip towards the 2.70% level
Volatility	Gamma looks to have found a base and now looks better medium-term value than vega, on selected tenors.	Sell AUD vega to buy gamma on 10yr tails. Keep calendar spreads (2m10yr vs 6m10yr)
Risk Allocation	Spread and curve trades are likely to fare better than outright duration exposure in 2013.	

Source: Citi Research

Australia and New Zealand

Aussie Bonds: License to Thrill

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Next year promises to be another year of modest global growth, with Australia facing the challenge of rebalancing its economy against a backdrop of deleveraging and global uncertainty. This is likely to require further monetary easing, with growth expected to slow quite sharply to around 2.4%. We expect the front-end of the curve to remain well supported, with the RBA likely to ease rates again in the first quarter, with risks skewed towards further cuts later in the year. Importantly, we doubt that the market would begin to price in a reversal in the policy rate cycle over the coming 12 months given a benign inflation outlook and soft labour market outlook. Our economists also expect the New Zealand economy to grow below par, with the high exchange rate dampening aggregate demand. Further deleveraging is likely in the housing sector, with the RBNZ now likely to be sidelined until well into 2014.

Figure 2. Key macroeconomic forecasts

y/y% or % of GDP	GDP Growth		CPI Inflation		Fiscal Balance		Government Debt	
	2013	2014	2013	2014	2013	2014	2013	2014
Global	2.6	3.1	2.8	3	-3.8	-3.2	90	89
Industrial Countries	0.9	1.5	1.7	1.8	-4.8	-3.8	121	122
Australia	2.4	3	2.8	2.2	-0.8	0	30	28
New Zealand	2.2	2.3	1.8	2.1	-3.2	-1.1	38	42
Japan	0.7	0.7	-0.3	1.6	-8.1	-6.6	243	244
China	7.8	7.3	2.8	3.6	-2	-2	43	41

All data from GEOS, 26 November 2012 and Australia and NZ Economics w eekly, 14 Dec 2012

Source: Citi Investment Research and Analysis

The global outlook is likely to continue to exert a significant influence on local market performance. The immediate concern is the US fiscal cliff, where we now see moderate cause for optimism that an agreement to avert disaster (i.e. most of the fiscal cliff) may be brokered before year-end. But even if it is not, our central view is that agreement will be achieved early in the New Year. However, our US political analysts believe that this is unlikely to resolve the question of US political uncertainty, as a grand bargain to address wide-ranging fiscal reform is unlikely to be seen (see Global Political Insights - US Fiscal Cliff Negotiations: The Art of Noise). For local markets, we would view a positive fiscal cliff outcome as a dip-buying opportunity,

With central banks continuing to supply liquidity via extended or new QE or via further traditional policy easing (the ECB is expected to cut the deposit rate to -0.25% by mid year), a key theme for 2013 will be the search for yield. At the same time, we see the risk of further negative rating actions over the medium-term as Europe is likely to remain mired in recession for at least the next two years and the US and UK are both failing to stabilise debt burdens. In 2013 we expect both the UK and the US to be placed on negative watch/outlook although both will probably avoid an actual downgrade next year. Even if further sovereign downgrades are postponed in Europe, by access to the OMT and a delayed Grexit scenario, we expect market participants to remain very wary over future debt restructuring risks. If history is our guide, investors are likely to view such risks as good cause for further diversification into more stable currency areas (for a full discussion of such risks see Global Economic Outlook and Strategy - Prospects for Economies and Financial Markets in 2013 and Beyond).

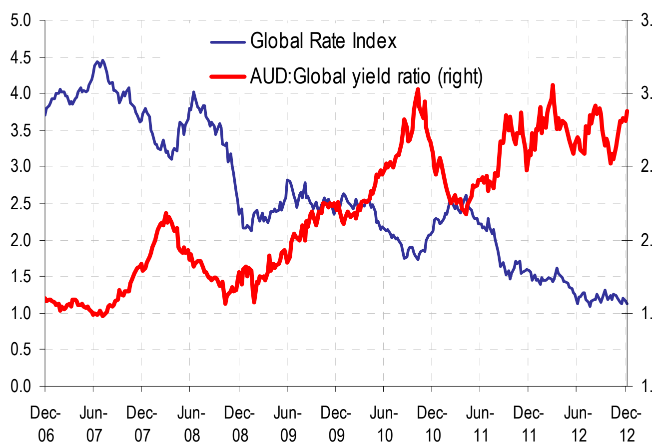
We expect investors to increase exposure to those markets where underlying fundamentals remain relatively sound or where there is still potential for a sizeable policy response should global growth risks intensify to the downside. In Australia

policy rates and the term structure still remain elevated by international standards. To a lesser degree the same is also true for New Zealand.

Although our Australian growth outlook shows a material slowdown, our economists expect monetary policy easing to provide an adequate cushion. Given the extent of moderation in growth that we anticipate, we do not believe that the stability of Australia's sovereign credit outlook will be brought into question over the course of 2013. We expect to witness a modest increase in ACGB issuance in FY13 (around A$13bn compared to FY12) as the government fails to deliver a budget surplus. However, this is unlikely to weigh on bonds given that it will add much needed liquidity to the market, while the offshore bid for bonds should remain strong throughout. We think it is a fair judgment to view Australian bonds as an ongoing safe-haven investment, against the far more adverse global economic backdrop that we envisage. Figure 4 highlights the point that local markets have been consistent beneficiaries of adverse credit events in European markets over the past two years.

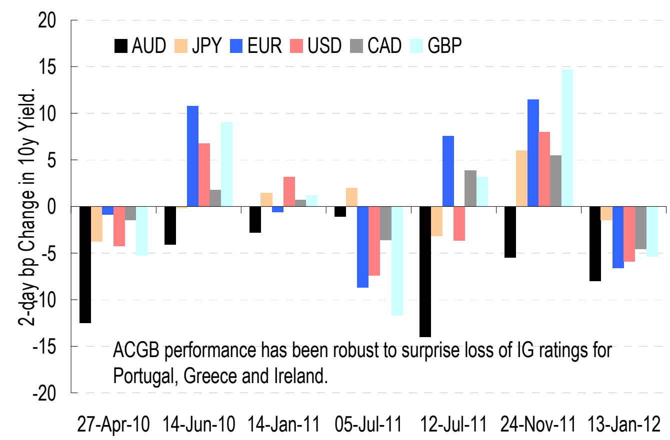
The still significant yield premium in local markets compared to global averages (Figure 3) is likely to serve as a compelling draw to offshore investors, particularly in global yield levels continue to remain pinned at historically low levels. Our global yield forecasts envisage a progressive increase in yields in developed markets, but as we discuss below there are likely to be increasingly divergent growth patterns in major economies, leading to a potentially significant decoupling of interest rate markets. This consideration is likely to be a key factor shaping the duration view for local markets.

Figure 3. Average AUD yields as a ratio of global yields



Source: Citi Research

Figure 4. From Downgrades to Down Under: 2 day BP yield moves following EMU IG rating losses



Source: Citi Research

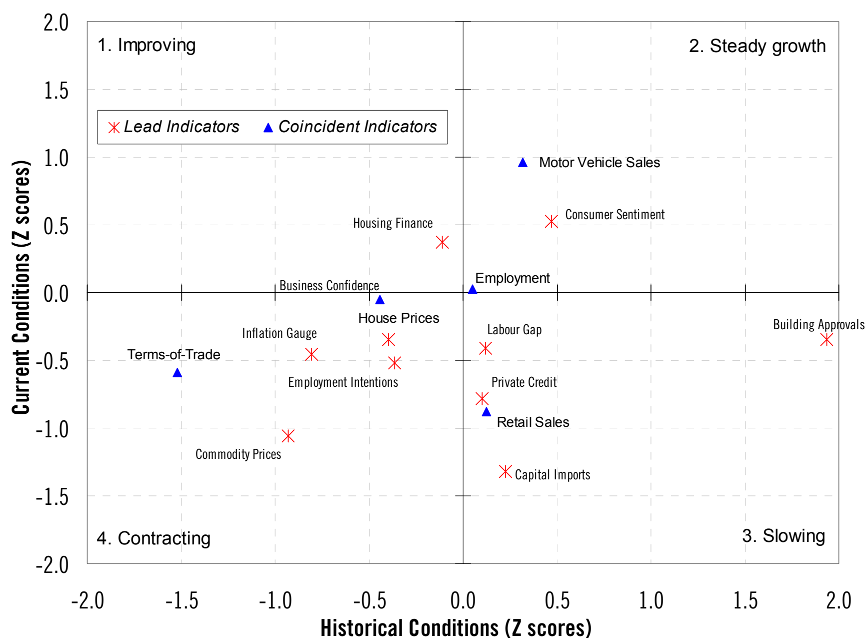
Our Duration View: Buy the Dips

With the potential exception of JGBs, major developed markets have now been in a range trade since mid year (post the Spanish banking crisis). In the near-term this seems likely to be maintained and we have therefore continued to recommend a neutral duration stance, with a buy on dip strategy should yields test the upper bounds of established ranges.

A key question going forward is whether the prospect of further monetary easing, in conjunction with the boost to global liquidity (potentially supplemented by the BoJ) is capable of re-defining yield ranges in local markets. Given the extent of the

slowdown in Australian growth that our economists now predict, in conjunction with the more bullish outlook for policy rates that this entails (the base case is now for two further RBA cuts early in Q1, with the possibility of more to follow), we think the risk is clearly skewed for benchmark 10yr ACGB yields to trade back through 3% - potentially by a significant margin. The following chart illustrates the current state of the Australian economic barometer (courtesy of our Australian economics team). Of note, there is a clear bias towards increasing weakness in house prices, hiring intentions and business confidence, with more coincident and leading indicators now falling into the contracting or slowing zone.

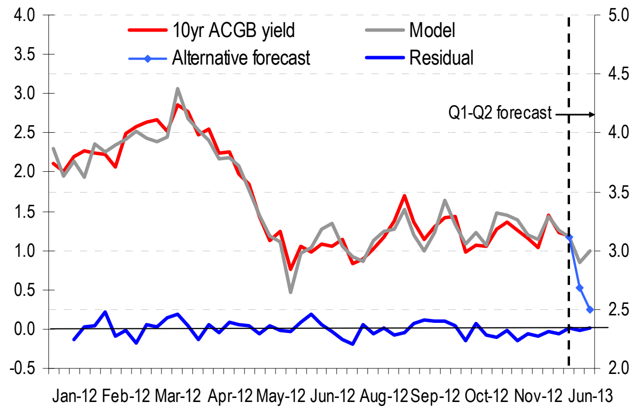
Figure 5. Australian economic barometer: further signs of weakness



Source: Citi Research

Figure 6 shows our fair value model for 10yr yields in conjunction with our baseline forecast, plus an alternative forecast that reflects a further moderate drop in global yields and market expectations for a 2% terminal cash rate in Australia. This provides a graphic example of how benchmark yields may potentially trade significantly through current forward rates, which are still pinned around 3.30-3.35% for 10yr bonds over the next 3-6 month horizon. At a minimum, we believe that beating these forward rates should be easily achieved if our RBA call proves to be correct.

Figure 6. Citi 10yr ACGB model vs actual and forecast



Source: Citi Research

Figure 7. Implied risk free real rate comparisons

	Funding	5y5y Implied CDS	5y5y Fwd Yield	5y5y Inflation	"Risk Free" Real Rate
USA	0.25	0.55	2.78	2.92	-0.68
Japan	0.10	2.00	1.25	-0.05	-0.70
Germany	0.00	1.09	2.41	2.16	-0.85
UK	0.50	0.86	2.90	3.10	-1.05
Australia	3.00	1.15	3.76	2.75	-0.14

Source: Citi Research

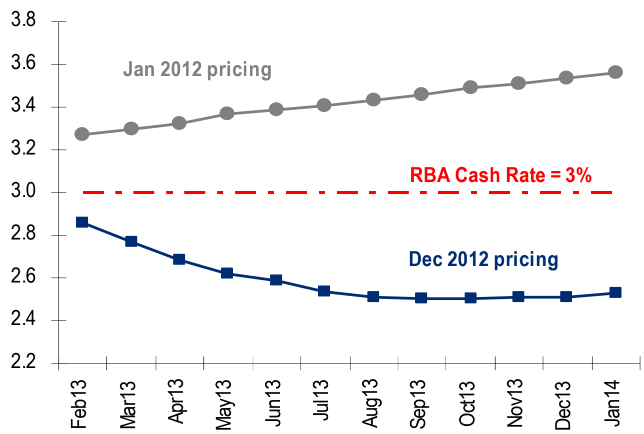
One particular challenge for 2013 will be determining which major developed market is in the driving seat. While US fiscal cliff concerns dominate sentiment currently, our international strategists believe that European debt concerns are likely to re-assert themselves, particularly over the second half of the year (when the risk of Grexit is likely to reassert itself as a key market concern). This will manifest itself in terms of a re-widening of EMU spreads and a renewed flight to quality in the Bund market (this could of course come sooner, around the time of February's Italian elections for example). We expect the 10yr US-Euro yield spread to widen sharply as a result and this poses the question of whether Australian bonds track bund yields lower or merely track US Treasury yields progressively higher, should the US growth cycle strengthens as our economists expect (see our latest GEOS publication for full details of the global macro forecast)

Our best answer is that any spike in US yields in the near-term that is not accompanied by clear evidence of stronger growth should still be considered as a dip buying opportunity. Over the medium term, should European debt market concerns come back to the fore then we would anticipate local markets to become increasingly sensitive to these risks. In our view, this all points in the direction of local market outperformance on a cross-market basis. On an inflation and risk adjusted basis, all markets look historically very rich, but local markets are still the better choice, particularly in view of the greater fiscal risks in other markets (see Figure 7). We consider how best to reflect this view in a subsequent section.

Curve: a more complicated question

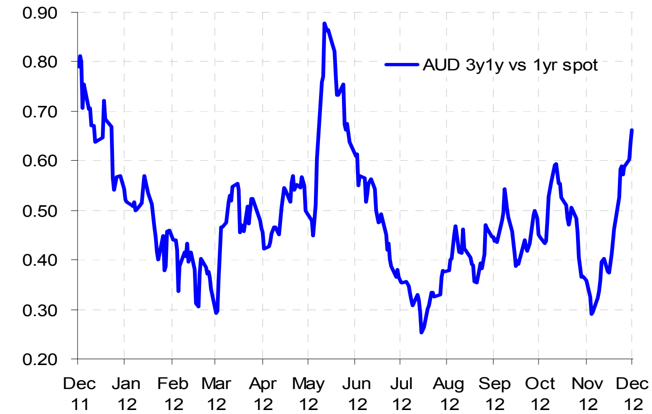
There is now less than 50bp of residual easing priced into the AUD OIS curve, which for the first time in a long while looks modest compared to our economist's baseline view (2 cuts in Q1). Moreover, this pricing expectation is largely concentrated into the first half of next year. While there may be some re-acceleration in GDP growth in the second half of the year as interest rate sensitive sectors respond to prior stimulus, we would be surprised if the market did not move to price is more significant easing risks in the interim, particularly if global conditions remain as challenging as we expect. We think that an effective way to express this view is in terms of flattening trades at the short-end of the curve. Our current recommendation is to receive 3y1y versus 3m1y. As highlighted, the longer dated forward has recently cheapened quite considerably versus spot, which seems incongruous with the recent run of weaker economic data and the widespread flattening of global money market curves, as central banks seek to pin short-term rates at ultra low levels.

Figure 8. The changing pattern of OIS pricing



Source: Citi Research

Figure 9. Front-end re-steepening is likely to reverse



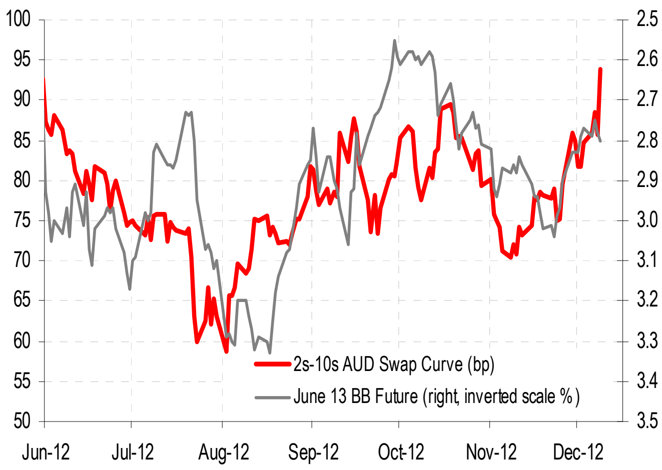
Source: Citi Research

A view that we have held for much of the current year has been that the AUD curve would behave directionally throughout periods where the RBA was either on hold or in fine-tuning mode. This is clearly not likely to be the case during the early months of the New Year, in our base case view. We think the ACGB curve is potentially subject to further steepening pressure in this environment, a move that would be accentuated should global yields initially correct higher on any post fiscal cliff resolution relief trade, for example. We would look to reposition flattening risk should the curve re-test former highs (a level between 65-70bp on 3s-10s), but for the moment the risk reward on outright curve positioning looks quite poor in our opinion.

Here we would draw a distinction between cash and swap curves, where the latter has already re-steepened close to former wides on end-year corporate paying and asset swap activity. This move that has resulted in a pronounced re-widening of the asset swap spread curve, close to former highs (see following discussion of the 3s10s swap spread box). The swap curve now looks somewhat extended relative to short-term yields and the box therefore offers a relatively safe means of expressing relative curve views in the current environment.

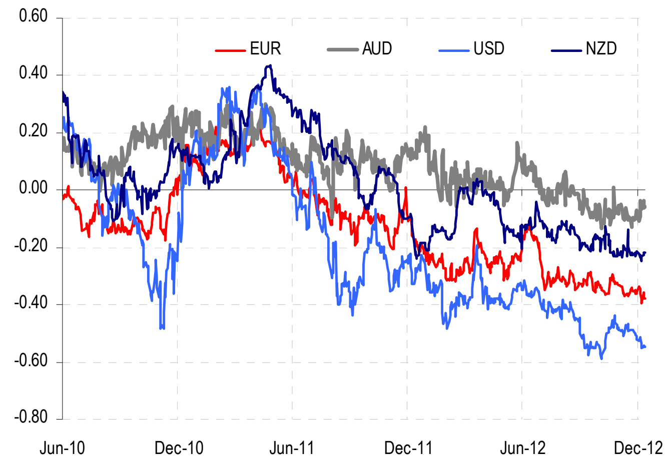
We would expect the belly of the curve in local markets to continue to richen, in tandem with the trend moves seen in other markets. Both AUD and NZ markets still have some way to catch up with the moves witnessed in major developed markets, as reflected in the relative valuations of 2s5s10s butterflies (see Figure 11). Receiving the belly of local market curves is a preferable strategy to outright curve positioning at this juncture in our view.

Figure 10. 2s10s AUD curve and short-term futures



Source: Citi Research

Figure 11. Curvature: the belly of AUD and NZD can richen further

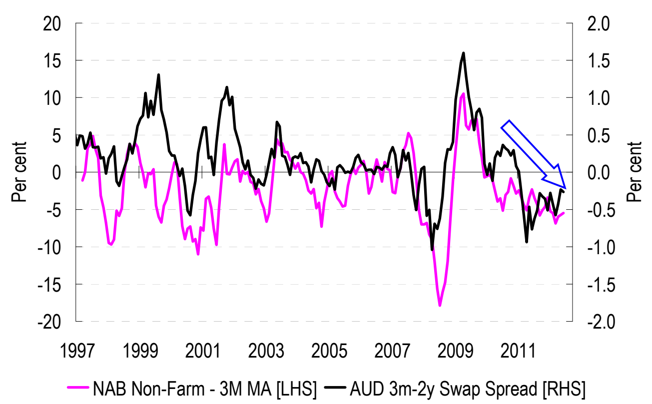


Source: Citi Research

Kiwi Rates: Stay the Course

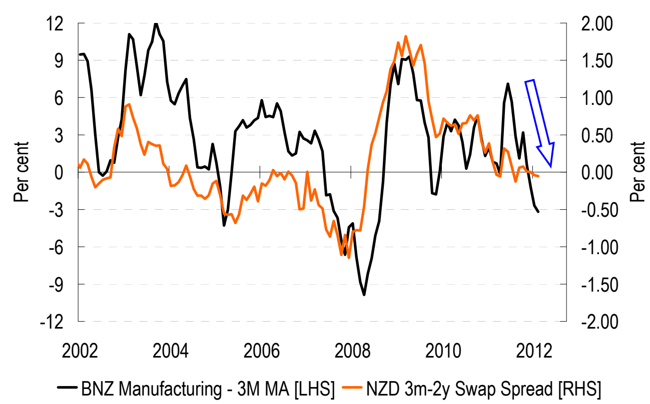
More generally, business conditions in the Antipodes are likely to remain challenging heading into 2013. Indeed, we are expecting a prolonged policy easing cycle in Australia which is New Zealand's largest export market. This was supported by the recent NAB survey of non-farm businesses where we constructed our activity indicator for AU based on the spread between the 'forward orders' and 'stocks' sub-indices (see Figure 12). The activity indicator is still trending downwards which suggests rate cut expectations are likely to persist particularly against a backdrop of sluggish demand and a stubbornly high currency (see 'Business confidence collapses: what about consumer sentiment?'). Likewise in New Zealand, the NZ activity indicator from the BNZ manufacturing PMI slipped further which should add to expectations for policy easing by the RBNZ as proxied by the tighter NZD 3m-2y swap spread (see Figure 13).

Figure 12. AUD Non-Farm Activity Indicator vs 3m-2y Swap Spread



Source: Citi Research, Business NZ

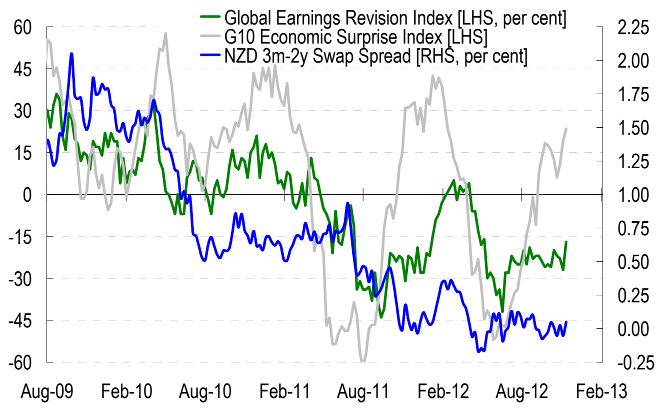
Figure 13. NZD Manufacturing Activity Indicator vs 3m-2y Swap Spread



Source: Citi Research, Bloomberg

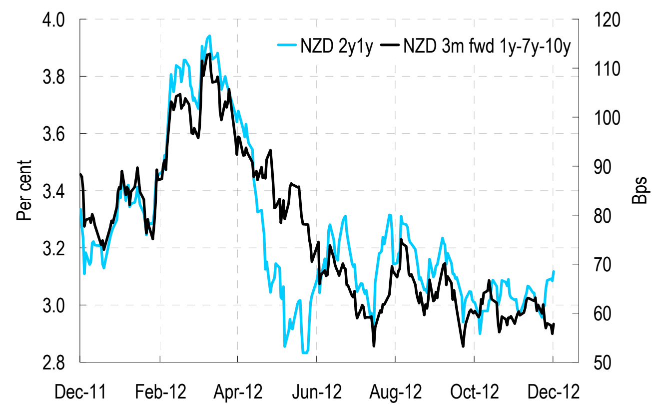
Macro and micro level expectations for firms also look vulnerable on a global basis. As shown in Figure 14, the positive surge in the G10 economic surprise index has shown some slippage while the global earnings revision index is still firmly in downgrade territory with more downgrades expected by our global equity strategy team (see 'ERI Remains an Anchor'). All in all, this supports our bearish positioning in NZD for 2013 through received positions in NZD 2y1y outright as well the belly of the NZD 3m forward 1y-7y-10y fly (see Figure 15).

Figure 14. Vulnerable economic surprise and earnings revision indices



Source: Citi Research

Figure 15. NZD 2y1y & NZD 3m fwd 1y-7y-10y Butterfly

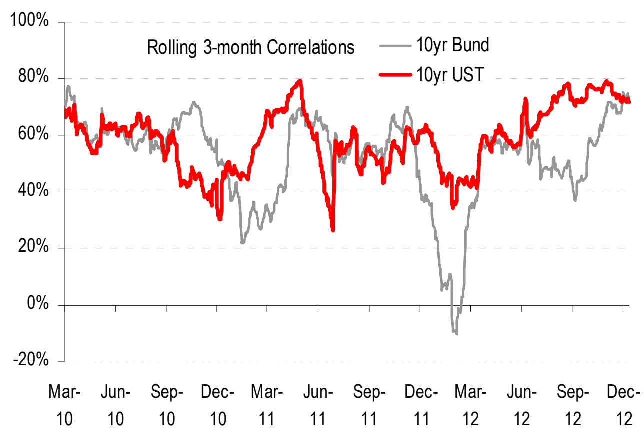


Source: Citi Research

Cross market Opportunities: long Aussie versus the US

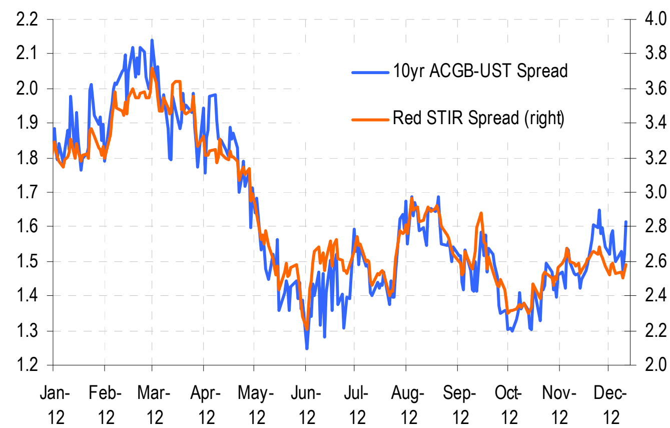
As highlighted above we believe that cross-market positioning offers a better risk reward than outright duration risk currently. This is reflected in the persistently strong correlation between markets (Figure 16), which is currently close to historical highs, both for Bunds and USTs. The second observation worth making is that term spreads are now consistently priced with relative short-term policy rate expectations, as embodied in STIR spreads. With the Fed having confirmed forward rate guidance until the achievement of an unemployment rate target (our economists believe this will take until 2015 to achieve a 6.5% jobless rate), the prime mover in short-term spreads is now the RBA. If our short-end expectations are correct, we can see scope for relative policy rate expectations to progressively shift in favour of ACGB outperformance. Our central forecast is for 10yr ACGB-UST spreads to trade below 100bp by the second half of the year, which is a significant compression on prevailing spread levels of close to 160bp and far outweighs the modest negative carry involved (around -5bp per quarter).

Figure 16. Rolling 3m correlations:10yr ACGBs vs USTs and Bunds



Source: Citi Research

Figure 17. ACGB-UST spreads track relative short-term rate expectations

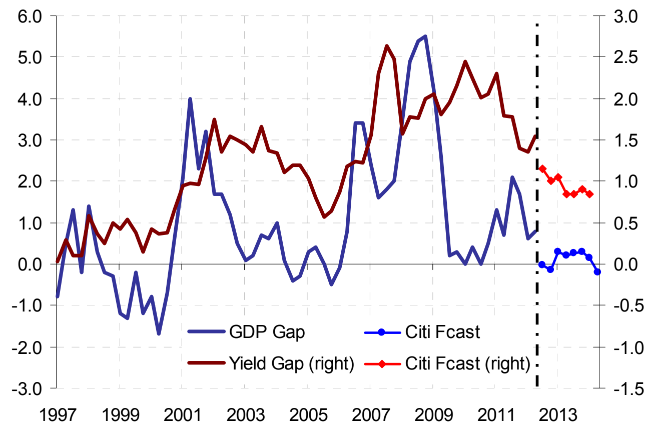


Source: Citi Research

This spread view is also consistent with our relative growth expectations for the two economies, as highlighted in Figure 18. While yield spreads and GDP growth differentials have only been loosely correlated over recent years (primarily a function of specific climatic growth shocks in Australia), our expectation is that the relative slowing of the Australian economy over the forecast horizon will be consistent with relative outperformance of the bond market. This would be more consistent with the period experienced in the early to mid years of the previous decade, as shown in the chart.

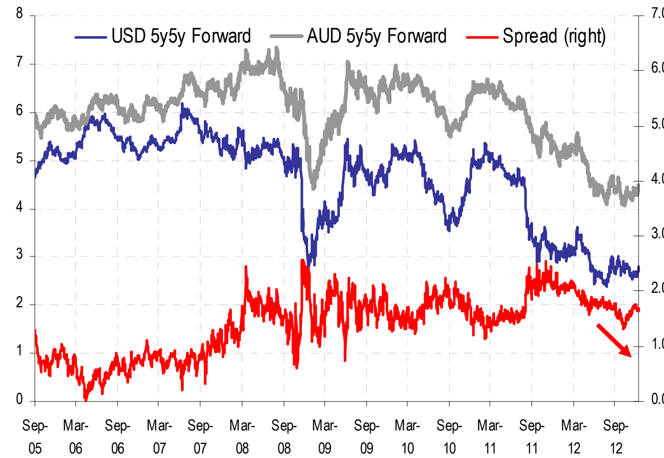
Our favoured expression of the cross-market trade is in terms of forward spreads, where the extent of retracement has been even more marked than in cash. Figure 19 shows this in terms of AUD versus USD 5y5y forward spreads, which have now retraced by around 40bp from early October lows, to close to 170bp. For those investors concerned about the risk of a more pronounced flight to quality move in US rates markets surrounding fiscal cliff negotiations, we have an existing AUD versus USD cross market position via payers, as detailed in our *Tradesheet* section. Selling a DV01 and FX weighted amount of 6m10yr AUD payers into USD equivalents should profit if US yields rise on a successful resolution to fiscal cliff negotiations, but provide protection in the event that US yields fall if the cliff is not averted.

Figure 18. US vs Aus: Real GDP growth and 10yr yield gap (%)



Source: Citi Research

Figure 19. AUD vs USD 5y5y spread history

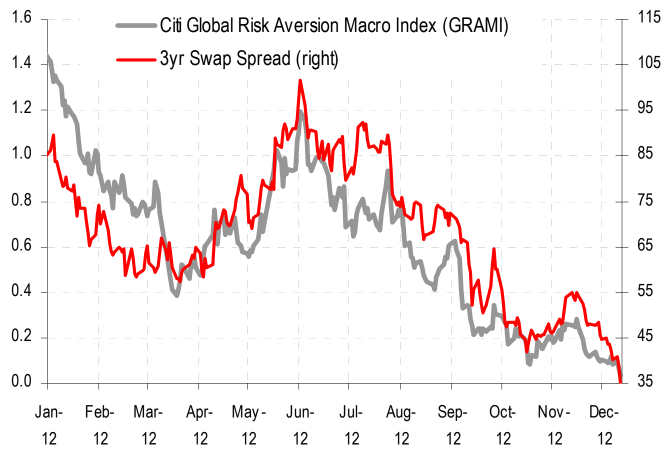


Source: Citi Research

Swap Spreads

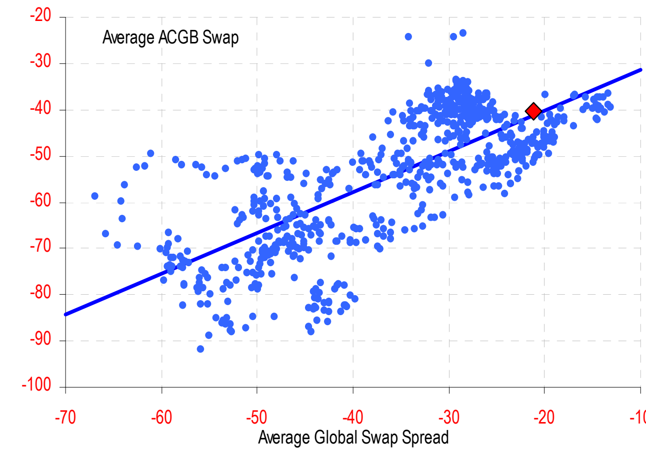
Swap spreads are still moving in tandem with barometers of market risk, which continue to reflect a benign outlook (as reflected in the Citi Global Risk Aversion Macro Index – see Figure 20). This may turn out to be overly complacent given looming event risks in the US and Europe; as such we would not be surprised to see renewed volatility in swap spreads as we enter the New Year. This would be more likely to bear on the short-end of the AUD swap spread curve and could be a catalyst for a reversal in the 3s10s EFP box, which has widened sharply into the close of the current year, contrary to our expectations. In terms of average ACGB swap spread levels, they are no longer trading wide to average global spread levels, which was the case around the middle of the year, since when spreads in local markets have contracted sharply before consolidating. Allowing for the potential for spreads to enter a more volatile period surrounding upcoming event risks, we doubt that a reversal in the spread tightening trend lies in store. The prime drivers for spreads over the medium term are likely to be the direction of policy rates and the search for yield, which should see increasing demand for spread product (and a healthy pipeline of swapped issuance that will pressure spreads tighter across the term structure).

Figure 20. 3yr EFPs and Citi GRAMI Index



Source: Citi Research

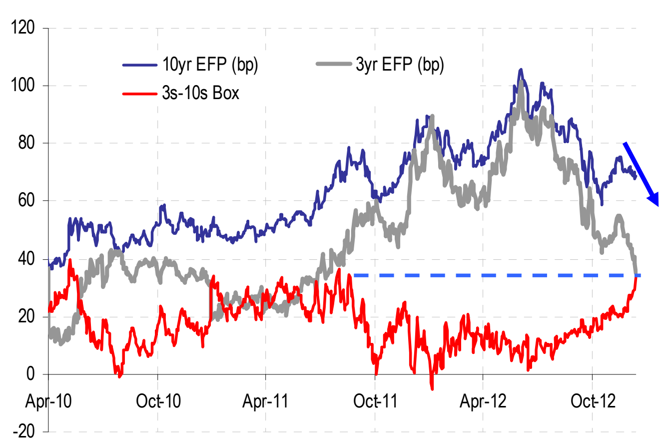
Figure 21. Average ACGB Swap Spreads vs Global Average



Source: Citi Research

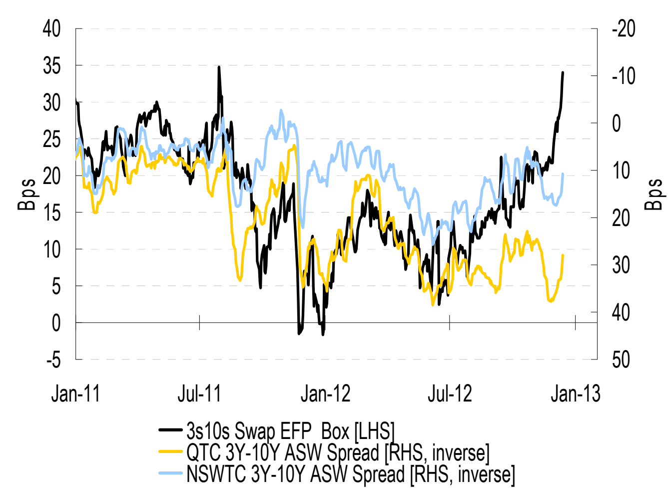
There does not seem to be a clear direction for spreads in the near-term, but we are doubtful that the recent sharp move tighter in short-end spreads will be maintained without a catch up in longer-term spreads. As shown, the 3s-10s swap spread curve has now retraced to levels that have previously signaled turning points. As identified in last week's 'Christmas carry-rolls', we think the long-end asset swapping flows by domestic bank liquidity portfolios have been mostly exhausted as they have simultaneously flattened semi ASW curves to previous lows (see Figure 23). As such, we think the steepening in 3s10s swap EFP box is likely to unwind soon after the holiday period when market liquidity returns.

Figure 22. 3s-10s EFP spreads and box



Source: Citi Research

Figure 23. 3s10s swap EFP box vs 3s10s QTC/NSWTC ASW spread



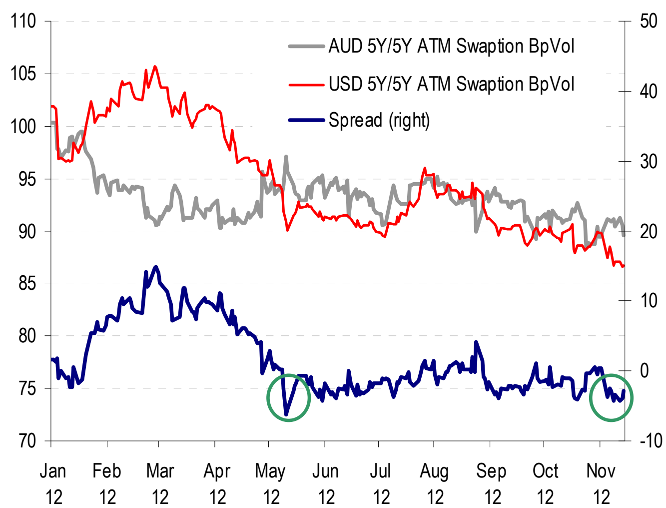
Source: Citi Research

Vapourising Vol – Turning Japanese

We look to fade any spike in vol in local markets associated with offshore event risks, as we expect the huge increase in global central bank liquidity/attempts to contain tail risks to reflect both in a further loss of yield curvature (as discussed above) and a trend slide in volatility.

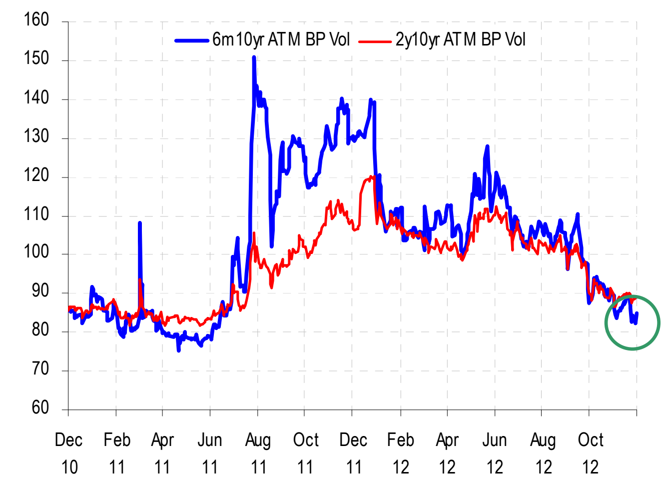
In AUD gamma has continued to be pressured lower, but may be close to forming a base if central bank policy is no longer perceived to be in gradualist mode. In fact gamma has continued to be under more selling pressure than vega and this provides an opportunity to buy protection against an adverse US fiscal cliff outcome, or a more volatile global economic outlook over the course of 2013 in our view. We have previously recommended long 6m10y AUD straddles (financed by selling shorter, 2m expiry options - see *Tradesheet*). The following chart illustrate the relative richness of vega, with AUD 5y5y straddles now trading close to USD equivalents and with 6m10yr now trading modestly through 2y10yr BP vol. We can see the case for owning parts of the gamma surface, but we are far less convinced that vega will remain supported given the global policy backdrop.

Figure 24. AUD 5y5y Vol – now higher than USD



Source: Citi Research

Figure 25. AUD 6m10yr now cheap versus 2y10yr BP Vol



Source: Citi Research

Year of the Snake (and Semis): Warming up to Sunshine State Bonds

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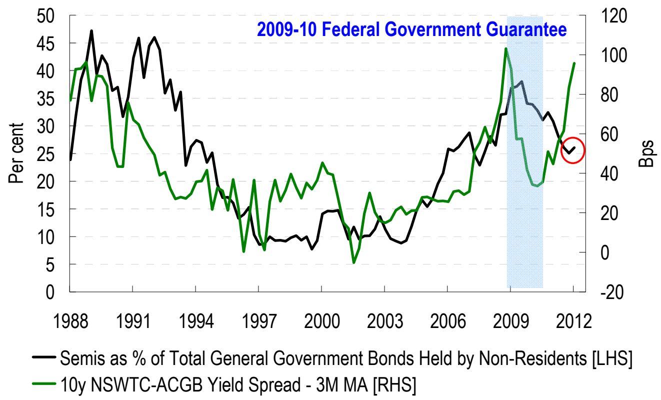
We expect the Year of the Snake to herald further offshore interest in semis as investors reach for higher yields within the universe of high quality and highly liquid bonds. As we can see from Figure 26, the Q2 12 Financial Accounts data from the ABS showed an increase in the allocation to semis over ACGBs amongst non-resident holders of general government debt. Historically this has coincided with wide semi-ACGB yield spreads which remain attractive as the majority of issuers are within one notch of the triple-A rated sovereign who is an implicit guarantor for the states' debt. For example, QTC 21s to 24s now offer a yield pickup over ACGBs in excess of 1%. A more positive ratings outlook on the largest issuer QTC has also enhanced overall liquidity in the semis market (see 'Stable Queensland Ratings Outlook Eases Uncertainty'). Indeed, when viewed through the prism of a leading rating agency's rating methodology, QTC bonds look like the value buy amongst the semis given the fiscal outlook and balance of risks. One of our strategic recommendations for 2013 is to buy 10y QTC bonds against NSWTC as we see scope for the yield spread to compress by a further +20bps.

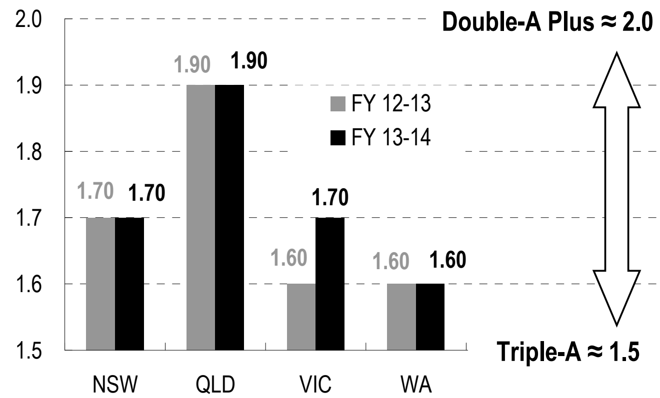
TRADE – Buy QTC 22 vs NSWTC 22. Entry +31bps. Target +11bps. Stop +41bps.

Figure 26. Non-resident allocation to semis increases relative to ACGBs when semi-ACGB yield spreads are wide



Source: Citi Research, ABS, RBA

Figure 27. Difference in risk scores for the major states are marginal under our base case with some downside risk for VIC

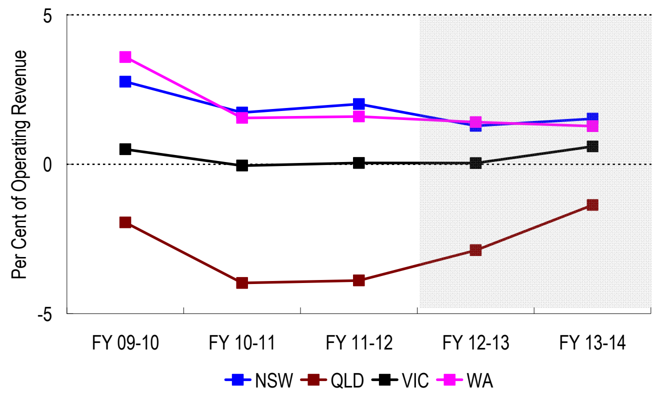


Source: Citi Research

We reviewed the ratings methodology of a leading ratings agency which is based on a scorecard of quantitative and qualitative criteria for local and regional government finances. In our opinion, around 80% of the score weightings are for risk factors which are relatively stable and similar across the states. For example, we remain positive on factors like ‘financial management’ and ‘liquidity’ across the major states like NSW, QLD, VIC and WA. The remaining 20% of the weighting focuses on more quantitative factors including ‘budgetary performance’ and ‘debt burden’ which are based on key financial ratios. We consider these to be more critical for the fiscal outlook and risks.

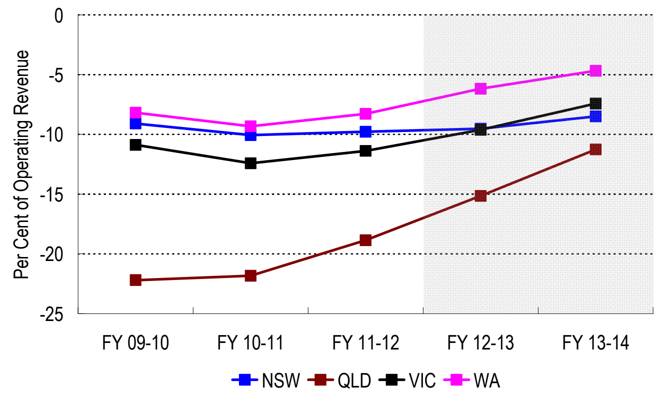
In Figure 27 we show our base case risk scores for FY 12-13 and FY 13-14 free from any qualitative adjustments. This is based on the accounts for the state non-financial public sector. We have used the highest quality data sources available such as the audited state finance reports for actual results as well as budget papers and mid-year reviews for forecasts. By our estimates the risk scores are in line with the states’ current ratings and look to be stable over the next 2 years. For example, QLD has the highest risk score of 1.9 points which reflects the higher risk to its fiscal outlook and supports the lower credit rating. By this measure VIC also looks vulnerable as its risk score is expected to be on par with NSW in FY 13-14. However, the tight scale means that the differences between states are relatively marginal given that the risk scores can easily be adjusted by increments of 0.1 points or more.

Figure 28. Operating balance – 5Y moving averages



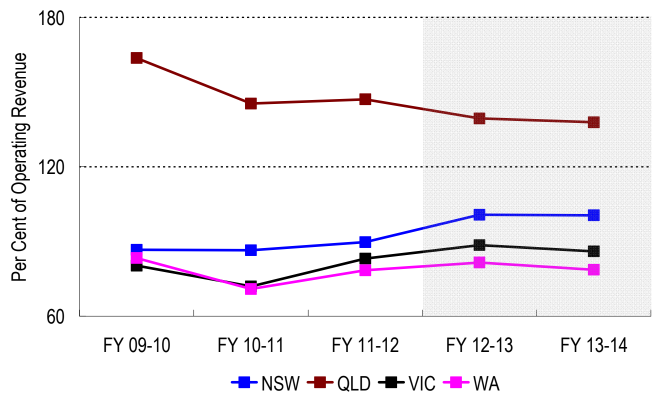
Source: Citi Research, NSW Treasury, QLD Treasury, VIC Treasury, WA Treasury

Figure 29. Fiscal balance – 5Y moving averages



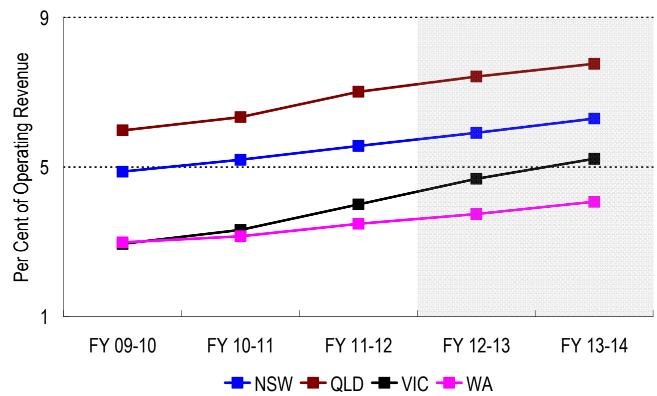
Source: Citi Research, NSW Treasury, QLD Treasury, VIC Treasury, WA Treasury

Figure 30. Gross debt – 2Y forward forecasts



Source: Citi Research, NSW Treasury, QLD Treasury, VIC Treasury, WA Treasury

Figure 31. Gross interest – 3Y moving averages



Source: Citi Research, NSW Treasury, QLD Treasury, VIC Treasury, WA Treasury

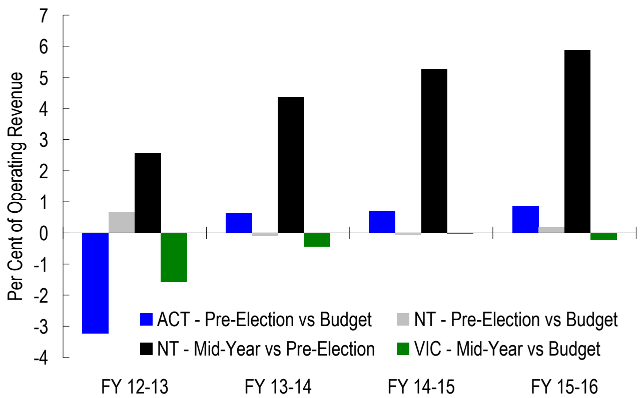
Pigeonholing financial ratios into scorecard bands understates some of the trends within the band for several of the key indicators which are closely monitored to assess ‘budgetary performance’ and ‘debt burden’. To refine our judgement around the scores we examined trends in the four key financial ratios underlying these areas.

- Operating balance – operating balance as a % of adjusted operating revenues (centred 5y moving average of actual results and forecasts)
- Fiscal balance – balance after capital accounts as a % of total adjusted revenues (centred 5y moving average of actual results and forecasts)
- Gross debt – tax-supported debt as % of consolidated operating revenues (2y forward forecast)
- Gross interest – interest as % of adjusted operating revenues (centred 3y moving average of actual results and forecasts)

In Figure 28 to Figure 31, we outline the trends in the abovementioned ratios with the horizontal lines in the charts defining score thresholds. The key observation is that although the ratios for NSW have stayed within their score bands they have showed increasing signs of deterioration in indicators like the operating balance and

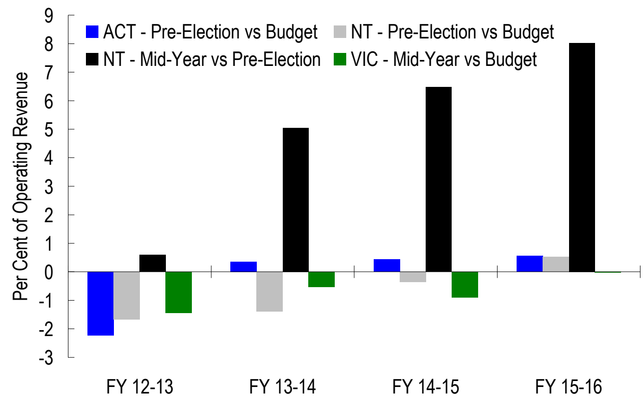
gross debt. By comparison QLD indicators have consistently improved in areas like the fiscal balance and gross debt. This suggests there is some scope for upgrades to the QLD score and downgrades to the NSW score both in the order of 0.1 points, particularly if the mid-year budget review results maintain the trend. With the gap between the QLD and NSW risk scores standing at only 0.2 points, we expect a narrowing in risk scores to support tighter QTC-NSWTC yield spreads.

Figure 32. Operating balance – change in forward estimates



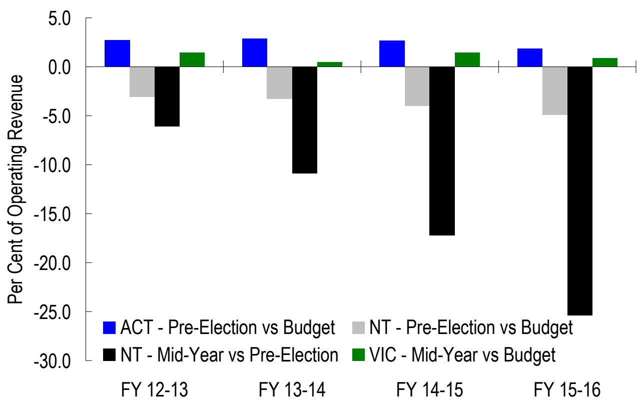
Source: Citi Research, ACT Treasury, NT Treasury

Figure 33. Fiscal balance – change in forward estimates



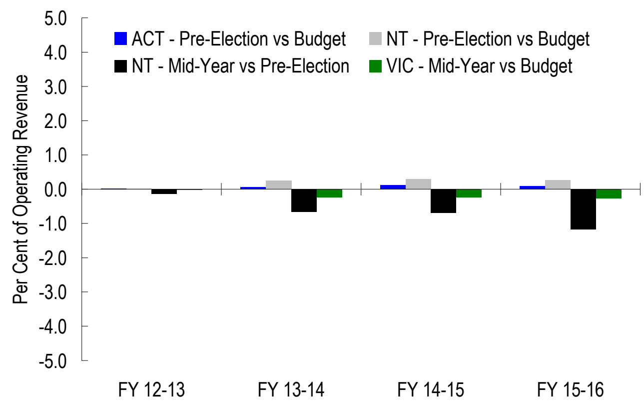
Source: Citi Research, ACT Treasury, NT Treasury

Figure 34. Gross debt – change in forward estimates



Source: Citi Research, ACT Treasury, NT Treasury

Figure 35. Gross interest – change in forward estimates

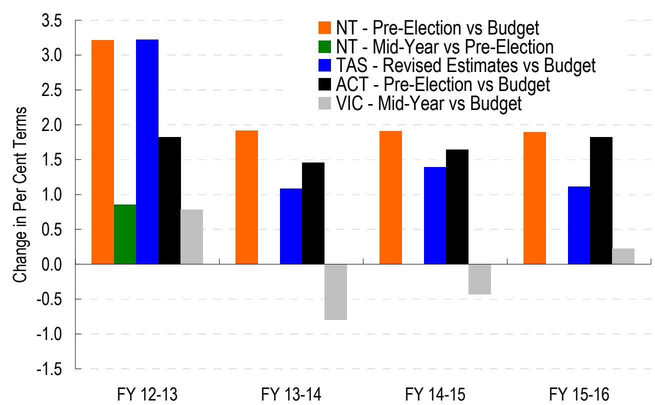


Source: Citi Research, ACT Treasury, NT Treasury

We think the risks to our outlook are tilted slightly to the upside across all the semis with the ratings outlook to be updated following the release of the mid-year reviews. Revenue and expense risks can be gauged from the sensitivity estimates provided in budget papers but these papers tend to focus on only a few items for the current fiscal year only which may give an incomplete picture. Revisions to earnings forecasts are a closely watched lead indicator in the equities market, and we have adopted a similar approach in considering revisions to budget forecasts recently published in the latest ACT, NT and VIC budget updates. Across the four key ratios the budget revisions have been stable or to the upside based on the mid-year reviews and pre-election updates (see Figure 32 to Figure 35). For example, the forecast changes in ACT's pre-election update and VIC's mid-year review were relatively modest when compared to NT's mid-year review which experienced a strong lift in budget balances and a fall in gross debt. Indeed, a lift in actual GST revenues for FY 11-12 has supported more neutral to hawkish GST revenue forecasts for TAS, ACT, NT and VIC (see Figure 36). This also raises prospects for NSW and QLD as GST revenues are not only a common revenue source but are

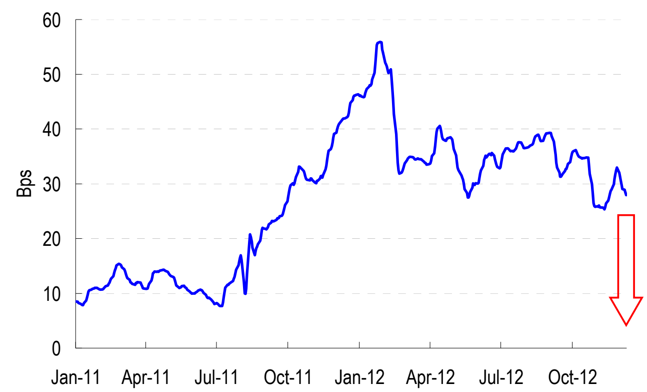
also one the largest revenue streams for each of the states. As we enter a new policy easing cycle we expect collections for key interest rate sensitive taxes like property transfer duty and GST to be well supported in the states' forward estimates and we will be looking towards the NSW mid-year review due next week for confirmation. We think the well publicized risks around mining royalties and Commonwealth grants are already embedded in market prices and these early indicators suggest some potential for upside surprise. Under this scenario we would expect QTC spreads to outperform NSWTC (see Figure 37).

Figure 36. Synchronized upgrades to GST revenue forecasts



Source: Citi Research, NT Treasury, TAS Treasury, ACT Treasury

Figure 37. Constant Maturity 10y Yield Spread – QTC vs NSWTC



Source: Citi Research

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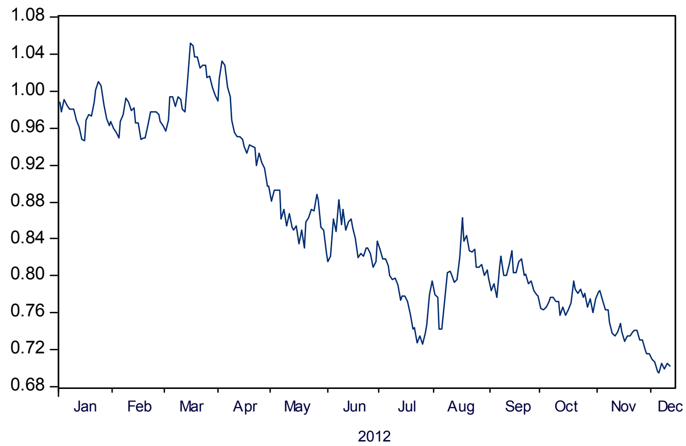
JGB yields are expected to rise gradually through 2013 in our base scenario. We forecast 10yr JGB yield to be 0.85% in January-March (quarterly average), 1.00% in April-June, 0.90% in July-September, and 1.10% in October-December. There is likely to be a paradigm shift from fiscal consolidation to an emphasis on growth, and a shift in fiscal and monetary policy towards a more reflationary bias. Specific catalysts include 1) an increase in JGB issuance, 2) greater preference for risk, 3) decreased confidence in fiscal discipline, and 4) receding flight-to-quality flows. As a coalition of LDP and New Komei Party is broadly expected to win the majority in the Lower House, which is also a consensus in the market, we will base our rates scenario on this possible outcome of the election. In case the two parties fail to capture the majority, we will then revise our forecast in January.

Figure 38. JGB Interest Rate Forecast (quarterly average, %)

	Current	→ Forecast Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
O/N Call Rate	0～0.10	0～0.10	0～0.10	0～0.10	0～0.10
2yr JGB	0.095	0.10	0.10	0.10	0.15
5yr JGB	0.160	0.20	0.25	0.20	0.30
10yr JGB	0.700	0.85	1.00	0.90	1.10
30yr JGB	1.895	2.10	2.20	2.10	2.25

Source: Citi Research

Figure 39. 10yr JGB Yield (%)



Source: Citi Research

An increase in JGB issuance is likely when the new government starts drafting an FY2012 supplementary budget after the election and the FY2013 budget in January next year. In our view, a new government under LDP leader Shinzo Abe would not be bound by the medium-term fiscal framework passed by the Noda cabinet in August, a framework that requires “best efforts” to ensure that FY2013 issuance of new financing government bonds (excluding special pension bonds and other bonds with redemption funding guaranteed by legislation) not exceed the level of FY2012 (around ¥44trn). We would expect an Abe government to prioritize policies aimed at ending deflation and weakening the yen ahead of next summer’s Upper House election. Not only the supplementary FY2012 budget, but also the FY2013 budget is likely to contain significant fiscal stimulus, particularly public works spending.

There is a risk that JGB issuance next fiscal year, when there will be a significant increase in refunding bonds, could expand by more than expected. The market consensus appears to be for increase in monthly issuance of between ¥0-300bn, but this could be as high as ¥600-700bn if issuance of new financing JGBs, particularly construction bonds, exceeds the ¥44trn (Figure 40). We would expect increase in issuance of 2yr, 5yr, 10yr, 20yr and 30yr JGBs. If 30yr bond is to be increased, the frequency will be changed to monthly from 8 times per year, which will result in ¥400bn increases of an aggregate supply and a reduction of the size per auction (from ¥700bn to ¥500bn). Another possibility that we should keep in mind is that an increase in bond issuance may start from as early as February by considering the supplementary FY2012 and the main FY2013 budgets together, in the MoF’s effort to lighten monthly supply burden on the market. A steepening trend

on the yield curve is likely to continue into spring in response to heightening supply pressure. The resumption of JGB issuance may also be considered in the FY2013 JGB issuance plan. We do not rule out the risk that the size of issuance could be beyond our forecast to the upside rather than downside.

Figure 40. JGB Issuance Plan (¥ trn)

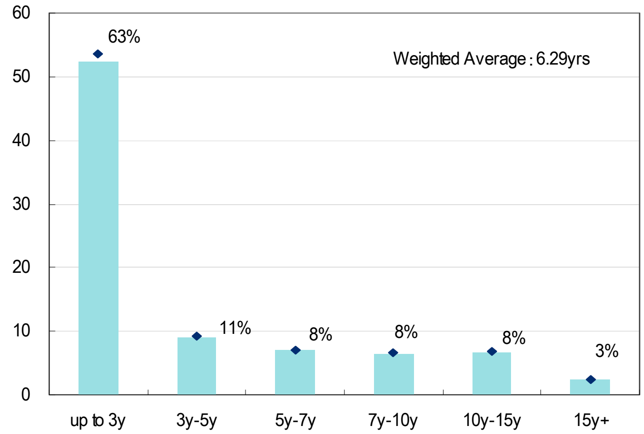
		JGB40	JGB30	JGB20	JGB10	JGB5	JGB2	TB1Y	TB6M	JGBi	Liquidity Supply
	Apr		0.7	1.2	2.3	2.5	2.7	2.5			0.6
	May	0.4		1.2	2.3	2.5	2.7	2.5			0.6
	Jun		0.7	1.2	2.3	2.5	2.7	2.5			0.6
	Jul		0.7	1.2	2.3	2.5	2.7	2.5			0.6
	Aug	0.4		1.2	2.3	2.5	2.7	2.5			0.6
	Sep		0.7	1.2	2.3	2.5	2.7	2.5			0.6
2012	Oct		0.7	1.2	2.3	2.5	2.7	2.5	0.9	0.0	0.6
	Nov	0.4		1.2	2.3	2.5	2.7	2.5			0.6
	Dec		0.7	1.2	2.3	2.5	2.7	2.5			0.6
	Jan		0.7	1.2	2.3	2.5	2.7	2.5			0.6
	Feb	0.4		1.2	2.3	2.5	2.7	2.5			0.6
	Mar		0.7	1.2	2.3	2.5	2.7	2.5			0.6
										Total	**149.7**
	Apr		0.5	1.3	2.4	2.7	2.9	2.5			0.6
	May	0.4	0.5	1.3	2.4	2.7	2.9	2.5			0.6
	Jun		0.5	1.3	2.4	2.7	2.9	2.5			0.6
	Jul		0.5	1.3	2.4	2.7	2.9	2.5			0.6
	Aug	0.4	0.5	1.3	2.4	2.7	2.9	2.5			0.6
	Sep		0.5	1.3	2.4	2.7	2.9	2.5			0.6
2013	Oct		0.5	1.3	2.4	2.7	2.9	2.5	0.9	0.0	0.6
	Nov	0.4	0.5	1.3	2.4	2.7	2.9	2.5			0.6
	Dec		0.5	1.3	2.4	2.7	2.9	2.5			0.6
	Jan		0.5	1.3	2.4	2.7	2.9	2.5			0.6
	Feb	0.4	0.5	1.3	2.4	2.7	2.9	2.5			0.6
	Mar		0.5	1.3	2.4	2.7	2.9	2.5			0.6
										Total	**157.3**

Source: MoF, Citi Research

Greater preference for risk could result in the exchange rate testing USD/JPY85 on the view that BoJ monetary policy would be more dramatic if an Abe government were formed. Citi projects an average exchange rate of USD/JPY84 in January-March and USD/JPY85 in April-June 2013. This would likely push up equities, as a weaker yen would be expected to drive improved profitability at exporters, while increased public works spending would also likely be. LDP Abe seems to be negative about existing schemes of the price stability 'goal' and the BoJ's Asset Purchase Program (APP) in which only the bonds with 1-3yrs to maturity are bought back (Figure 41). Politicians seem to be calling for an explicit inflation 'target' of 2%, which is higher and clearer than the current price stability 'goal' of 1%, as well as an expansion of the long-term JGB purchase operations (so-called, 'Rimban') by removing 'the banknote rule.' In addition, risk asset purchases by the BoJ can be enhanced for credit supplementation by increasing the size of equity and corporate bond purchases under APP or even direct/indirect purchase of credit loans (Figure 42). The BoJ governor and deputies are going to retire next spring and those who agree with an inflation target may be chosen for successors. Increased risk tolerance would reduce latent demand for JGBs. In order to improve investment returns with continued low yields, investors will be faced with the choice of by adding duration risks by extending bond portfolio maturity or taking more credit and currency risks. Pension funds could revise their asset allocations, lowering the weighting of Japanese bonds and increasing those of equities and foreign bonds.

Comprehensive measures to facilitate financing for SMEs, etc.[1] are set to expire in March 2013. If they are extended, it may heighten banks' risk appetite.

Figure 41. BoJ's JGB Holding by Maturity Segment [¥ trn as of end-Nov]



Source: BoJ, Citi Research

Figure 42. BoJ's asset holding [as of Nov 30]

	Target Size			Number of Operation	Amount Outstanding	Progress
Asset Purchases	Dec-2012 40trn	By Jun-2012 53trn	By Dec-2013 66trn			
JGB	24.0	31.5	39.0	46 times	22.1	92%
T-Bills	9.5	14.5	19.5	45 times	9.0	94%
CP	2.1	2.1	2.2	50 times	1.9	92%
Corporate Bond	2.9	2.9	3.2	19 times	3.0	104%
ETFs	1.6	1.6	2.1	64 times	1.5	92%
J-REITs	0.12	0.12	0.13	64 times	0.11	92%
Fund-Supplying Operation	25.0	25.0	25.0		27.0	108%
Total	65	78	91		64.6	99%

Source: BoJ, Citi Research

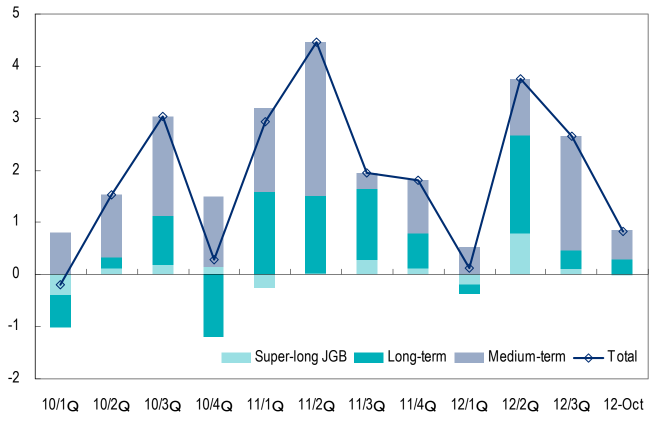
We are most concerned by declining confidence in fiscal discipline. The Noda government passed legislation to raise the consumption tax but put off reform of social welfare. Also, once this month's general election is over, there will be an Upper House election next summer. So cuts to social welfare benefits that hurt voters are unlikely, it would seem. Indeed, benefits are more likely to increase. Moreover, expenditures for public works will likely be compiled in the FY2012 supplementary and FY2013 main budgets. LDP Leader Shinzo Abe is likely to oppose a rise in the consumption tax until the end to deflation is clearly within sight. A final decision on whether to go ahead with the scheduled rise in the consumption tax from 5% to 8% in April 2014 will be made around October 2013, so April-June GDP growth and other economic indicators will be important, as will share prices and the exchange rate. One of the reasons why Japan has been able to retain its credibility for fiscal discipline is ample margin for tax hike from 5% consumption tax, which is lower than VAT rates in US and European countries. If the consumption tax is not raised, there will be an increased risk of downgrades to Japan's sovereign rating, when investors will likely hold off on purchases of JGBs.

On the last factor regarding flight-to-quality flows, we watch for the pace of yen depreciation. In the past two years, overseas investors increased JGB investments in light of deepening European debt problems and expectations for further yen's strength. The main tenors of their investment concentrated in the medium-term and refrained from buying long-tenor bonds for persistent fiscal concerns (Figure 43). If these positions are unwound, particularly if yen's weakening picks up the pace, selling pressure may accelerate in the JGB market. European debt issues seem to be less influential these days than earlier this year and flight-to-quality trades seem to have calmed for now. In FX markets, "the Abe trade" on back of the Lower House dissolution ignited market expectations for the Yen's continued weakening. Also, the market keeps an eye on entrenching trade deficit as well as a contraction of current account surplus. A chance of the BoJ Act revision following the change of power and the BoJ's personnel changes in spring will be important market themes in 1Q, both of which are generally expected to be negative for JPY against USD. We

[1] A framework implemented by FSA for setting up the credit guarantee system to help improve the financial health of SMEs etc.: http://www.fsa.go.jp/en/refer/diet/173/01.pdf

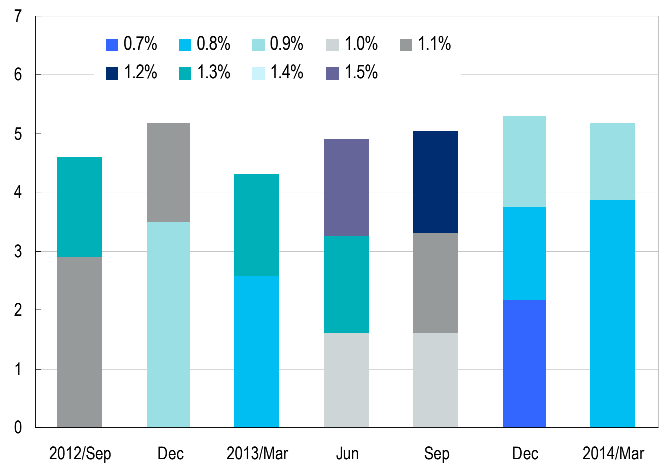
caution of a risk that excessive speculation could result in a negative feedback loop of yen depreciation and JGB yield risks

Figure 43. Yen Bond Investment by Foreigners[¥ trn, quarterly]



Source: JSDA, Citi Research

Figure 44. 5yrJGB Redemption In FY2012-13 By Coupon[¥ trn]

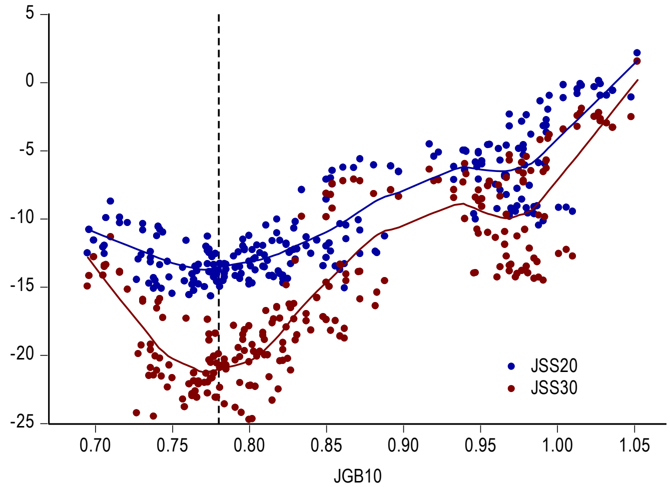


Source: BoJ, MoF, Citi Research

The risk-balance for our base case scenario is on the downside for rates. As we have discussed in this report before, high-coupon JGBs, mainly 5yr bonds, will continue to mature, so average yields on remaining bond portfolios will decline further (Figure 44). Interest rates are unlikely to rise in the medium-term sector, given the effectiveness of BoJ's duration commitment and large purchases of JGBs. So we believe investors will continue to find it difficult to identify profitable investments and to hold excess funds. Legislation that facilitates financing for SMEs is due to expire at end-March 2013, and this will boost latent demand for JGBs from regional financial institutions. Given concern over an increase in provisioning and other credit costs, JGBs will likely be seen as a good investment as they carry zero risk weight. Banks that operate under domestic capital adequacy standards currently do not have to exclude net unrealized losses on marketable securities from Tier I capital, but this exemption expires on March 30, 2014. Many investors buy JGBs not only in expectations of carry, but also capital gains. If the LDP-New Komeito alliance fails to win a majority at the election, there may be an unwinding of the "Abe trade," causing the yen to strengthen, equities to weaken, and bond prices to rise.

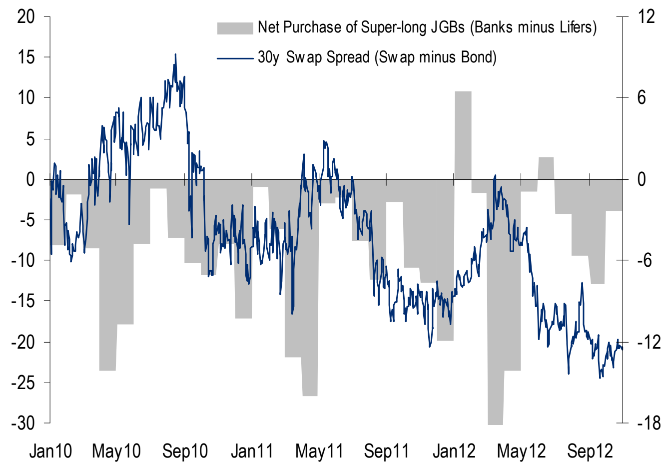
Historically long-end yen swaps tend to underperform bonds (i.e. less negative swap spreads) as yields rise and vice versa. However, as yields stay at suppressed levels, banks are increasingly shifting into the super-long sector and buying on asset swap terms to reduce the duration risk. Indeed, when 10-year JGB dips below 0.8, which we estimate to be the funding cost for major banks, 20-year and 30-year swap spread start to compress rather than trending further negative (Figure 45). The pattern is also reflected in the monthly turnover of JGBs reported by JSDA – as banks purchased more super-long JGBs relative to lifers, who normally buy outright rather than on an asset-swap basis in order to match with their long-term liabilities, the super-long swaps cheapened against bonds (Figure 46).

Figure 45. Long-end JPY Swap Spreads versus 10-year JGB Yield



Source: JSDA, Citi Research

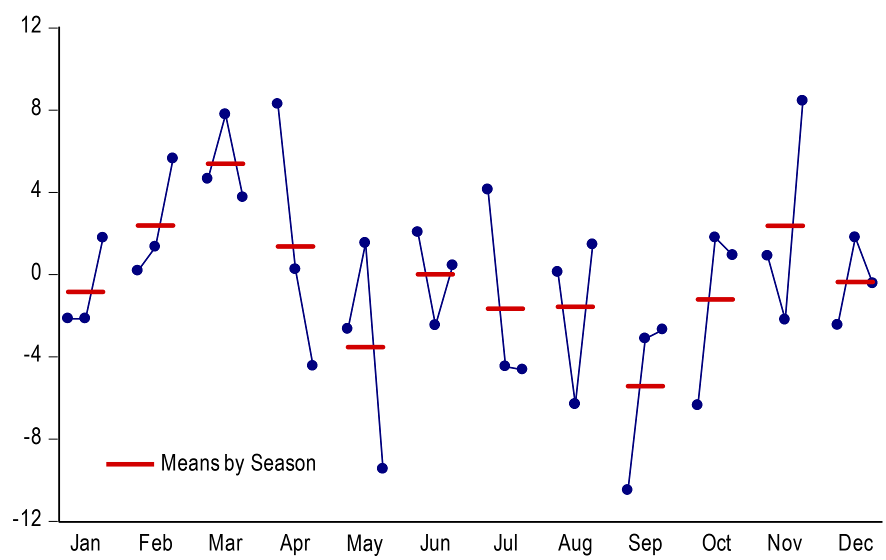
Figure 46. Relative Bank Purchase of Super-long JGB and Swap Spread



Source: JSDA, Bloomberg, Citi Research

The recent upward pressure on the long-end swap spreads is further exacerbated by structured products like PRDC notes and legacy hedging positions like non-resettable cross currency basis. In a stylized the manner, the duration of PRDC notes increases as yen strengthens against commodity currencies like AUD, which could trigger large receiving of 30y JPY swaps due to hedging needs. Conversely, when yen weakens precipitously, as in the past month, the hedging flows could push up super-long end swaps and drive 30y swap spreads less negative. On the other hand, for banks with foreign funding participating in the Japanese market, even single-currency swaps would be exposed to cross-currency basis risks. As many dealers were said to be holding flattening positions that were effectively short gamma, the sharp depreciation of yen in recent weeks add to the underperformance of long-end swaps. We think this trend could continue into fiscal year end with favorable seasonality (Figure 47) where banks buy the super-long bonds on asset swap terms for the carry advantage and unwind the trades once the new fiscal year starts in April and risk appetite recovers.

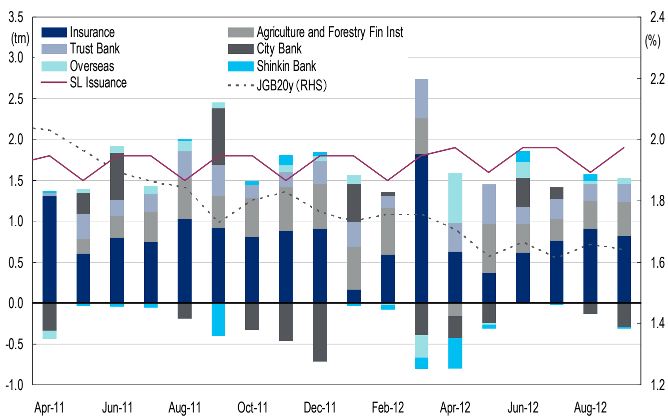
Figure 47. Seasonality of 30y Swap Spread (3-year History)



Source: Citi Research

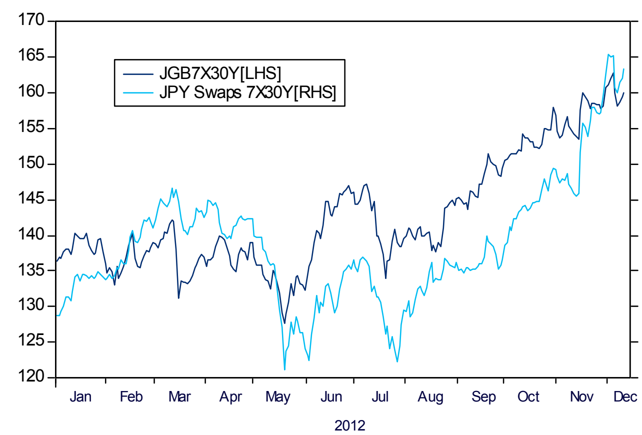
We believe change in the JGB yield curve is likely to center on the zone with 7–10 years to maturity, as was the case this year. This sector tends to underperform when rates are declining and outperform when rates are rising. The medium-term sector is supported by the BoJ's duration commitment, so yields change little when interest rates are rising, but we see little room for rates to decline given the 0.1% interest rates on excess reserves. For banks, whose liabilities are of 1–4 years' maturity, the medium-term sector is a core portfolio that is used to fill the gap between deposits and lending, so they tend to buy irrespective of the market outlook. Life insurers, who place most emphasis on the absolute level of yields, are the main buyers in the super-long zone (Figure 48), and tend to buy more as JGB yields rise. However, their buying needs tend to diminish when interest rates fall below budgeted levels. A contrarian investment strategy by regional financial institutions such as regional banks and shinkin banks, under which they have bought the super-long sector since last spring, is another factor constraining yield fluctuations in the sector. There is strong demand in the 7yr–10yr zone, not only from investors targeting carry and roll-down but also for dealing positions. The 7yr sector is subject to futures arbitrage, a common activity among foreign investors. Banks and the like often trade short term in the 9yr–10yr zone, targeting capital gains.

Figure 48. Super-Long JGB Purchase By Investor Type



Source: Bloomberg, Citi Research

Figure 49. JGB vs Swaps of 7-30yr Spread [bp]

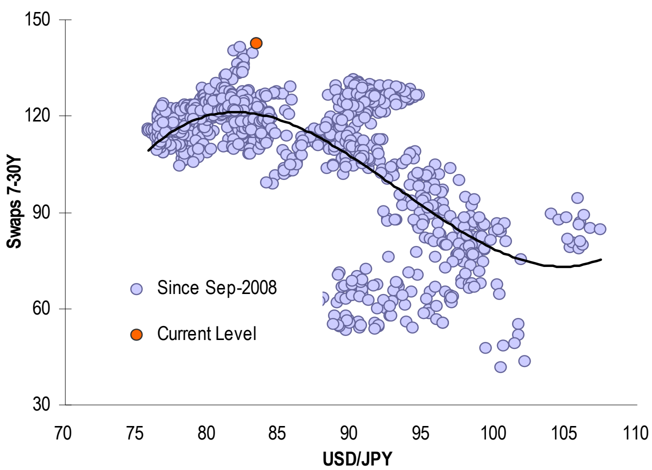


Source: Bloomberg, Citi Research

The spread between JGBs and swaps normally moves so that swaps become cheaper when rates rise and more expensive when they fall. Banks' investment behavior is one reason for this. If investors' become wary that JGBs are over-valued (i.e., the view spreads that there is little downside for rates), then they will likely reduce purchases of physical bonds and adjust interest rate risk with swaps. There is a risk of large capital losses on the sale of cash bonds bought at high prices. The book value of investors' portfolios is rising, as they repeatedly reshuffled them to realize profits in a narrow range market. So many bonds are likely to be subject to unrealized losses even if rates rise only slightly. This would increase the risk of a JGB price decline, but if investors need to reduce interest rate risk volume they are in some cases using swap payments rather than selling physical bonds and realizing losses. There are frequent cases in which the shape of the yield curve varies between swaps and JGBs. Foreign investors' share of trading in swaps is larger, so the swap curve is more closely correlated with overseas markets. Supply-demand in the JGB market differs by sector, with banks dominating the medium-term sector and life insurers the super-long sector. An increase in the "Abe trade" since mid-November, for example, has caused the JGB yield curve to steepen less than the swap yield curve, and as a result the super-long sector looks cheap for

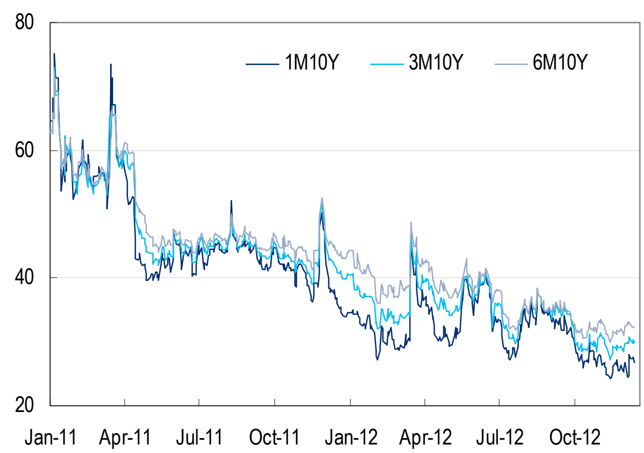
swaps (Figure 49). Buying of asset swaps (combination of JGB purchase and swap payment) in the super-long zone by regional financial institutions might have had a significant effect. We think the 7–30yr swap spread has widened too far. In the past, this spread has tended to flatten as the exchange rate has approached USD/JPY90 (Figure 50). This is probably because demand from life insurers and the like was realized after long interest rates had risen to some extent, causing the curve to flatten. After steepening bias peaks in Spring, we see a yen interest rate swap 7yr–30yr flattener as an attractive strategy throughout the year.

Figure 50. JPY Swaps 7-30yr[bp] vs USD/JPY



Source: Bloomberg, Citi Research

Figure 51. 10yr Implied Volatility [bp]



Source: Bloomberg, Citi Research

If, as we expect, there is a switch to more reflationary fiscal and monetary policy and markets move to risk on causing JGB yields to rise, then volatility would probably also increase. In deciding on a swaption maturity investors need to get a handle on fiscal and monetary policy and major political events. In chronological order, the main upcoming events are the drafting of the FY2012 supplementary budget and the FY2013 budget in January 2013, the appointment of a new governor and deputy governors to the BoJ in March or April 2013, and the Upper House election around July 2013. The option maturity can be selected from among one-, three- or six-month options, depending upon relative premiums at the time. Based on the size of interest rate movements and the extent of liquidity, we would consider mainly the 7yr–10yr maturity when buying payers' (Figure 51). We think there will be situations in which a long gamma and Vega strategy could work well as we approach next spring.

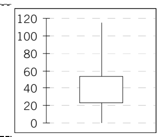
Tradesheet

New Trades: Buy QTC 22 vs NSWTC 22. Entry +31bps. Target +11bps. Stop +41bps.

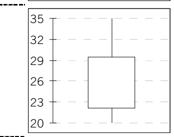
Closed Trades: Pay AUD 3m1yr versus 3y1y. Closed on stop (loss of 6bp)

Figure 52. Record of Open Trades

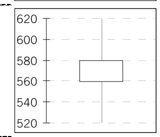
Country	Trade	Levels		Publication Date
AUD	**Buy AUD 1y2y 75bp wide 1/2/1 receiver fly**	Open	22c	
		Current	53.18c	
Volatility	Buy 1 x AUD 1y2y ATM receiver (4.21% strike)	**P&L**	**31.18c**	
	Sell 2 x AUD 1y2y 75bp OTM receiver (3.46% strike)	Target	115c	
	Buy 1 x AUD 1y2y 150bp OTM receiver (2.71% strike)	Stop	0c	*APAC DMRS 29 March 2012*



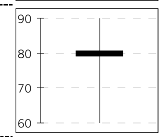
AUD	**Buy ACGB 5.5% April 2023. Sell ACGB 4.5% April 2020**	Open	29.5bp	
		Current	22bp	
Cash Curve	Buy ACGB 5.5% April 2023	**P&L**	**7.5bp**	
	Sell ACGB 4.5% April 2020	Target	20bp	
		Stop	35bp	*APAC DMRS 8 May 2012*



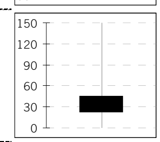
AUD	**Sell AUD 5y5y ATM Straddle**	Open	580c	
		Current	558.33c	
Volatility	Sell AUD 5y5y ATM Straddle	**P&L**	**21.67c**	
		Target	520c	
		Stop	620c	*APAC DMRS 21 June 2012*



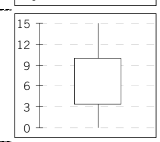
AUD	**Buy ACGB 4.75% April 2027, Sell ACGB 4.25% July 2017**	Open	79bp	
		Current	80.75bp	
Cash Curve	Buy ACGB 4.75% April 2027	**P&L**	**-1.75bp**	
	Sell ACGB 4.25% July 2017	Target	60bp	
		Stop	90bp	*APAC DMRS 19 July 2012*



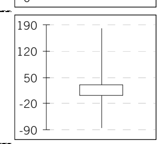
JPY	**JPY 6m fwd 5y/10y ATM conditional steepener via payers**	Open	46c	
		Current	21c	
Volatility	Sell 2 x JPY 6m5y ATM payer (0.41% strike)	**P&L**	**-25c**	
	Buy 1 x JPY 6m10y ATM payer (0.895% strike)	Target	150c	
		Stop	0c	*APAC DMRS 13 September 2012*



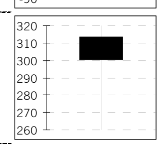
AUD	**Buy QTC 15, Sell SAFA 15**	Open	10bp	
		Current	3.25bp	
Cash Curve	Buy QTC 15	**P&L**	**6.75bp**	
	Sell SAFA 15	Target	0bp	
		Stop	15bp	*APAC DMRS 13 September 2012*



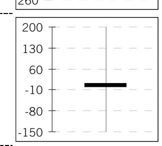
AUD	**Sell AUD 3m3y 50bp wide strangle and buy 1y3y 50bp OTM receiver**	Open	0bp	
		Current	30.24c	
Volatility	Sell AUD 3m3y 50bp wide strangle (2.75% and 3.25% strike)	**P&L**	**30.24c**	
	Buy AUD 1y3y 50bp OTM receiver (2.64% strike)	Target	180c	
		Stop	-85c	*APAC DMRS 27 September 2012*



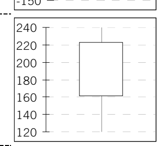
NZD	**Receive NZD 2y1y**	Open	300bp	
		Current	313.52bp	
Swap Curve	Receive NZD 2y1y	**P&L**	**-13.52bp**	
		Target	2.60%	
		Stop	3.20%	*APAC DMRS 4 October 2012*



AUD	**Sell AUD 3m10y 75bp OTM payer and buy 55bp OTM receiver**	Open	12c	
		Current	-1.64c	
Volatility	Sell AUD 3m10y 75bp OTM payer (4.3% strike)	**P&L**	**-13.64c**	
	Buy AUD 3m10y 55bp OTM receiver (3% strike)	Target	200c	
		Stop	-150c	*APAC DMRS 4 October 2012*

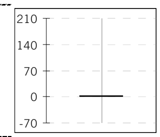
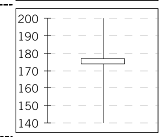
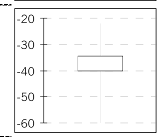
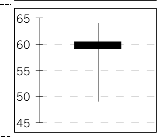


AUD	**Sell AUD 2m10y ATM straddles vs 6m10y**	Open	160c	
		Current	222.71c	
Volatility	Sell AUD 2m10y ATM straddles	**P&L**	**62.71c**	
	Buy AUD 6m10y ATM straddles	Target	240c	
		Stop	120c	*APAC DMRS 1 November 2012*



Source: Citi Research

Figure 53. Record of Open Trades

AUD/USD	**Sell 1.11 x AUD 6m10y 4% payer and buy 1 x USD 6m10y ATM payer**	Open	0c		
		Current	#VALUE!		
Cross-market	Sell 1.11 x AUD 6m10y 4% payer	**P&L**	**#VALUE!**		
	Buy 1 x USD 6m10y ATM payer	Target	210c		
		Stop	-70c	*APAC DMRS 22 November 2012*	
AUD/USD	**Receive AUD 5y5y versus USD 5y5y**	Open	177bp		
		Current	173.29bp		
Cross-market	Receive AUD5y5y	**P&L**	**3.71bp**		
	Pay USD 5y5y	Target	140bp		
		Stop	200bp	*APAC DMRS 28 November 2012*	
AUD	**AUD Dec12 / Jun13 OIS Flattener**	Open	-34.5bp		
		Current	-40.7bp		
Swap Curve	Pay AUD Dec12 OIS	**P&L**	**6.2bp**		
	Receive AUD Jun13 OIS	Target	-60bp		
		Stop	-22bp	*APAC DMRS 30 November 2012*	
NZD	**Receive bellly of NZD 3m fwd 1y-7y-10y butterfly**	Open	59bp		
		Current	60.49bp		
Swap Curve	Receive 2 x NZD 3m7y	**P&L**	**-1.49bp**		
	Pay NZD 3m1y and 3m10y	Target	49bp		
		Stop	64bp	*APAC DMRS 7 December 2012*	

Source: Citi Research

Appendix A-1

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