

## European Rates Strategy

### Bund: Decoupling?

- The market is still heavily relying on the concept of rates convergence between the US and the Eurozone, even though most recent price action and correlation compound with a diverging macro and policy trade to increase the probability of a decoupling scenario.
- Trade recommendations:
  - Lighten up on USD/EUR 5y5y wideners
  - Bunds to stay close to 1.5% for the next 12 months

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## Bund: Decoupling?

The market is still heavily relying on the concept of rates convergence between the US and the Eurozone, even though most recent price action and correlation compound with a diverging macro and policy trade to increase the probability of a decoupling scenario.

## Market Information and Expectations

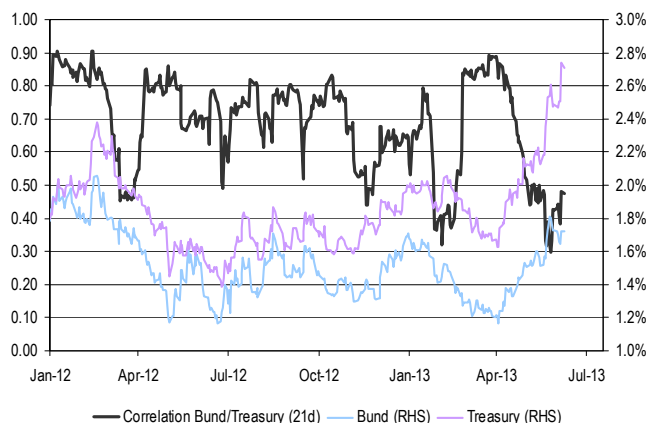
### Declining correlation...

We should get used to periods like the past two months, when the correlation between German and US 10y yields dropped from 0.8/0.9 to 0.4/0.5 (Figure 1), while the Treasury/Bund spread widened by 55bp. We should also get used to days like last Friday, when US Treasury yields jumped 14bp, while Bund yields increased by 'only' 7bp.

### ...adds to diverging fundamentals

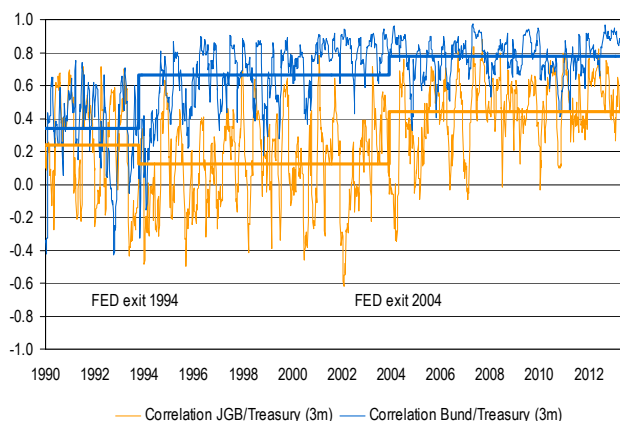
Correlation and spread action are the two main market variables to check when analyzing the probability of a de-coupling between the US and the Euro fixed income markets. We have already dealt with the striking fundamental differences between the Eurozone and the US and the striking fundamental similarities between the Euro rates market and the JGB market of the 'lost decade'<sup>1</sup>.

Figure 1. Correlation drops in the Treasury sell-off



Source: Citi Research

Figure 2. Regimes in long-term correlations



Source: Citi Research

### Decoupling already happened in the past

Looking at long-term patterns (Figure 2), we note how the JGB market was relatively unaffected by yield movements in the US in the second half of the 90s. In fact, the average correlation between JGBs and Treasuries declines from already very low levels after the FED's 1994 exit (300bp of tightening in just 15 months), with frequent periods of negative yield correlation! Under a set of specific macroeconomic and policy conditions, there can be protracted periods of de-coupling between G10 rates. We think the probability of such a de-coupling taking place between Bunds and Treasuries is now higher than in the past.

### Price action: Wider spreads

Markets – being almost efficient almost 100% of the time – have already taken notice of the underlying fundamental and policy differences between the US and the Eurozone: 10y Treasury/Bund spreads are about 60bp wider compared with early January levels and now diverge significantly from fair value models based on

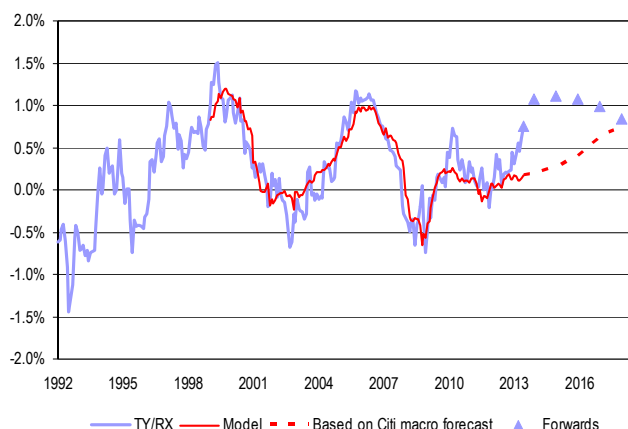
<sup>1</sup> "ECB: The Future of Monetary Policy Strategy" (8 May 2013, <https://ir.citi.com/Y0CMmAcB74iAwJMcyEvHSqhWeaby1rZQnLp0610%2BaGNPchw7gPPmDQ%3D%3D>) and "The Implications of Negative Deposit Rates" (14 December 2012, <https://ir.citi.com/JRMKZLAYj6YXZIPLo%2BNus4WZ1vtLmTwcl3AJrkYBu0n%2BYSNtHisYYA%3D%3D>)

fundamentals (Figure 3), perhaps an indication of the extent of liquidity distortions induced by overly expansionary monetary policy.

#### Probability of decoupling has increased

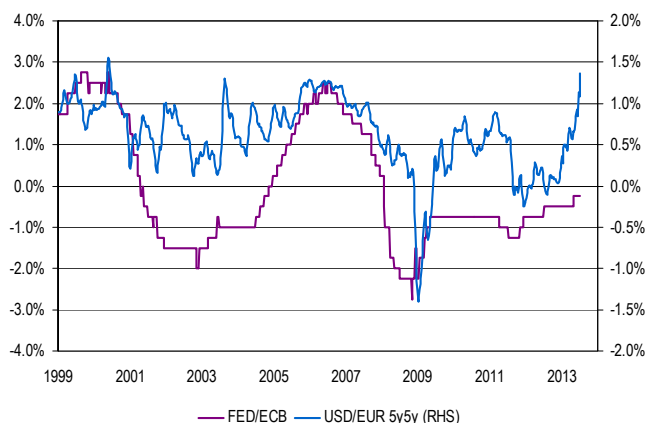
An interesting point is the shape of 10y-forward spreads: Again, looking at Figure 3, we note how the market is implicitly pricing in a modest convergence of Treasury and Bund yields, after a two-year period of further mild widening. The concept of yield convergence is very difficult to undermine, having been the workhorse of cohorts of fixed income analysts in the past. We're not saying it is the wrong assumption, but merely that the probability of de-coupling keeps rising. In any case, the current level of Treasury/Bund spreads is roughly in line with our model-based expectation five years forward from now...so far as to markets' dexterity in elaborating and pricing in expectations.

Figure 3. Modeling the Treasury/Bund spread



Source: Citi Research

Figure 4. Policy differentials and yield curves



Source: Citi Research

#### Differential policy leads to differential yield curve shapes

Another spread that provides an informative metric of market expectations about the yield curve – and hence of de-coupling probability – is the USD/EUR 5y5y differential: This spread has widened by approximately 90bp since start of the year (currently around 135bp, Figure 4), reflecting not only the evolving probability of 'tapering' in the US versus 'low-for-longer' in the Eurozone, but also the steepening of the USD 5/10s curve (+25bp) relative to the EUR curve (unchanged). This second-order effect results from the ECB still being in a rate cutting cycle, while the FED is being perceived – rightly or wrongly – to be also closer to an exit in the more standard sense.

#### Trade Recommendations

##### Lighten up on USD/EUR 5y5y widenings

We have recommended paying the USD/EUR 5y5y spread @12bp in our [Outlook for 2013](#) (6 December 2012). While the trade may still make sense from a fundamental point of view, we need to consider the risk/reward, which is less of a convincing argument at these levels. We now recommend investors to lighten up on this position and wait for a retracement to the 115bp area before re-considering this strategy.

##### Decomposing Bund yields

With regards to the absolute level of Bund yields, we remain of the idea expressed in the [European Rates Weekly](#) published at the end of June: "Current Bund yields (1.70-1.75%) look 30/35bp too high compared to our model values". The main argument behind our analysis is based on a simple decomposition of Bund yields into their building blocks, i.e. the natural rate (proxied by a Taylor rule), term- and liquidity premium as well as an EMU spread between Germany and other AAAs.

Figure 5. Bunds: Fair value modeling

Scenario 1 - The Upper Bound for Yields							
Eurozone	2013	2014	2015	2016	2017	2018	2019-2022
GDP (ECB + Consensus)	-0.6	1.1	1.5	1.6	1.5	1.5	1.4
Potential growth (EC)	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Output gap	-1.1	0.6	1.0	1.1	1.0	1.0	0.9
HICP (ECB + Consensus)	1.4	1.3	1.8	1.9	1.9	2.0	2.0
ECB target	2.0	2.0	2.0	2.0	2.0	2.0	2.0
ECB refi (Taylor rule)	1.2	2.0	2.4	2.5	2.5	2.5	2.5
ECB refi / Bund spread	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Excess liquidity premium	-0.4	-0.2	-0.1	0.0	0.0	0.0	0.0
Bund spread vs EMU	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
<b>Bund 10y (implied)</b>	<b>1.4</b>	<b>2.4</b>	<b>3.0</b>	<b>3.2</b>	<b>3.1</b>	<b>3.2</b>	<b>3.1</b>

Scenario 2 - Using Citi's Forecasts							
Eurozone	2013	2014	2015	2016	2017	2018	2019-2022
GDP (Citi)	-0.8	0.0	0.7	1.1	1.4		
Potential growth (EC)	0.5	0.5	0.5	0.5	0.5		
Output gap	-1.3	-0.5	0.2	0.6	0.9		
HICP (Citi)	1.4	1.2	1.2	1.3	1.3		
ECB target	2.0	2.0	2.0	2.0	2.0		
ECB refi (Taylor rule)	1.1	1.4	1.7	2.0	2.1		
ECB refi / Bund spread	1.2	1.2	1.2	1.2	1.2		
Excess liquidity premium	-0.4	-0.2	-0.1	0.0	0.0		
Bund spread vs EMU	-0.6	-0.6	-0.6	-0.6	-0.6		
<b>Bund 10y (implied)</b>	<b>1.3</b>	<b>1.8</b>	<b>2.3</b>	<b>2.6</b>	<b>2.8</b>		

Source: EC, ECB, Consensus, Citi Research

Decoupling = Bunds @1.5%

The analysis is based on two sources of inputs: ECB/Consensus and Citi Economics (Figure 5): In both cases, the fair value yield level for Bunds in 2013 is around 1.3/1.4%. The results diverge significantly during the period 2014/107 where the average Bund yield under the ECB/Consensus scenario is 2.6% (with a peak at 3.2%), while it is only 2.2% under Citi's scenario. Bottom line: We project Bund yields to average 1.5% over the coming 12 months.

## Appendix A-1

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