11th June 2013

CGMS <GO>

Global Macro Strategy and Asset Allocation

EMU Deflation Risk: EUR Asset Market Impact

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EMU Deflation Risk: EUR Asset Market Impact – Summary

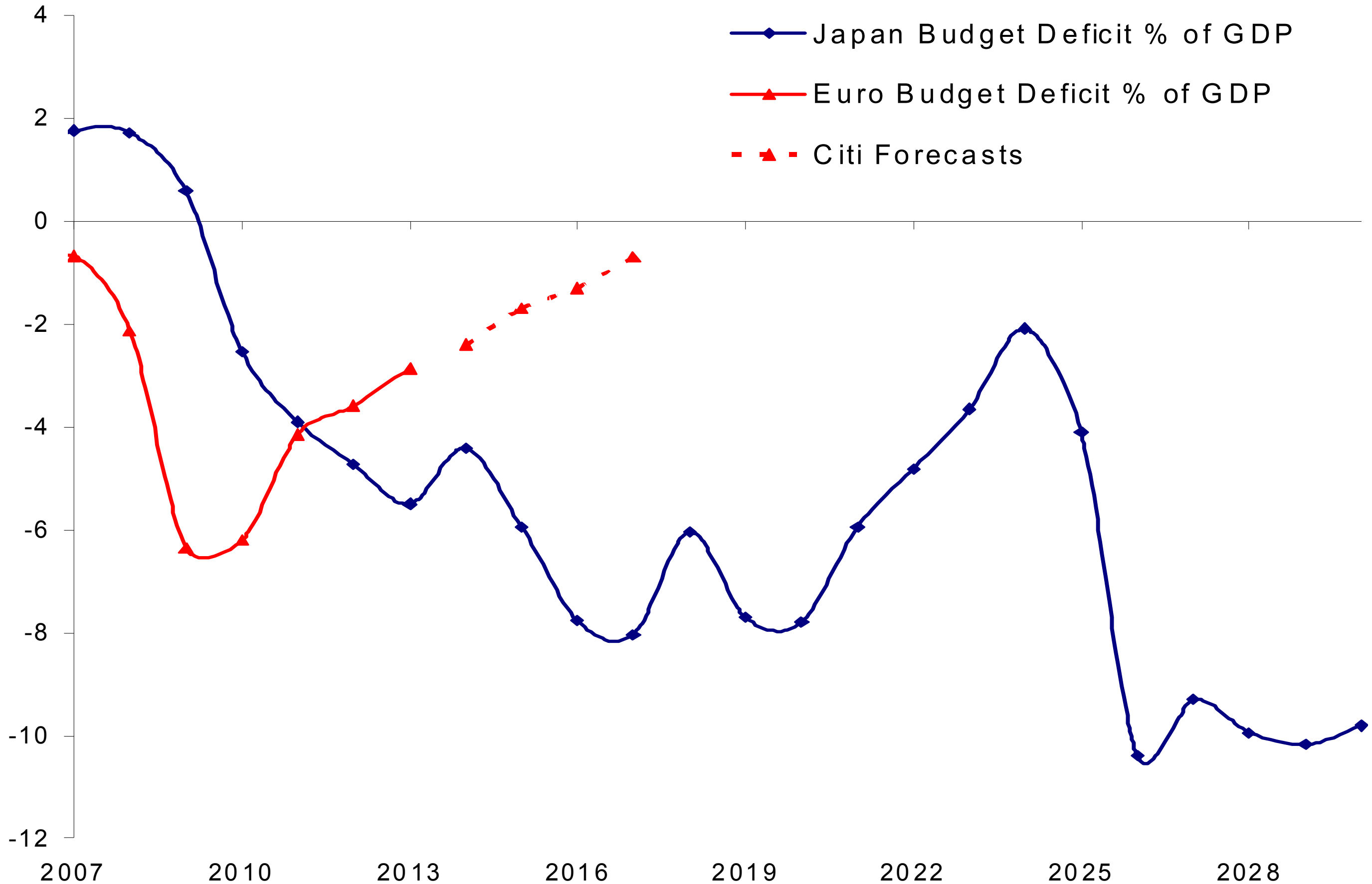
- With European fiscal policy materially more contractionary than was Japan's post 1990, and monetary policy arguably similar, the risks of a Japanese style lost decade of low real growth and very low inflation/deflation are high.
- European current account surpluses are rising which, together with portfolio and direct investment inflows, ensures a high and rising "broad" balance of payments surplus. In Japan, current account surpluses were of similar magnitude but portfolio and direct investment flows were negative. So Europe's balance of payments could be even more supportive of EUR than was Japan's of JPY. Weak growth is driving the current account? Yes and it did in Japan too.
- Meanwhile, core CPI inflation in the Euro Area is annualising at less than 0.5% over the past three months and is approaching the low end of the range since the ECB assumed monetary control.
- So what does this all mean for EUR asset markets?
- **FX**
  - Deflation in Japan was very positive for the nominal exchange rate. To maintain a broadly stable real exchange rate, PPP needs a higher nominal currency value. Could this now happen to the EUR too?
  - A broad balance of payments surplus could also be EUR positive medium term, especially if short term outflows subside (mainly repo and FX hedges we think).
- **Fixed Income**
  - Curve flattening is priced but via bear flattening/ higher 2y yields in the forwards. We think a bull flattening is more likely. This is probably best expressed by receiving likes of 5y5y EUR either outright or with pay USD or JPY as a hedge.
  - Elsewhere, EUR Inflation products seemingly price in too much inflation.
- **Equities**
  - A strict overlay to Japanese stocks in the 90s looks ugly for European stocks from here.
  - But the NKY was very highly rated (rich, high P/E) when the Japanese crash started in 1990 and Japanese corporates diluted their shares throughout the 90s. This is not the case in Europe currently.

Sources: Citi Research

Policy Impact

European Fiscal Policy Much Tighter than Japan's Was

Overlay of Japan on Europe With 1990 Japan and 2007 Europe Lined Up



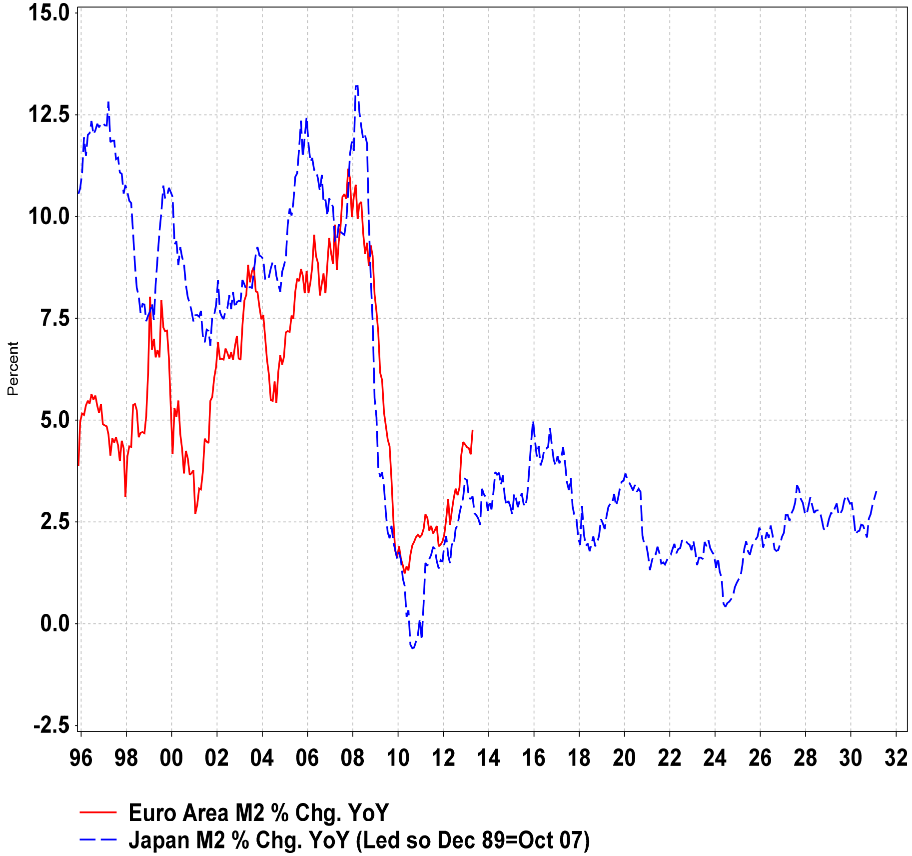
Japan allowed fiscal policy to support growth as asset prices fell. The budget surplus of 1989/90 turned to a deficit of around 8% of GDP ten years later.

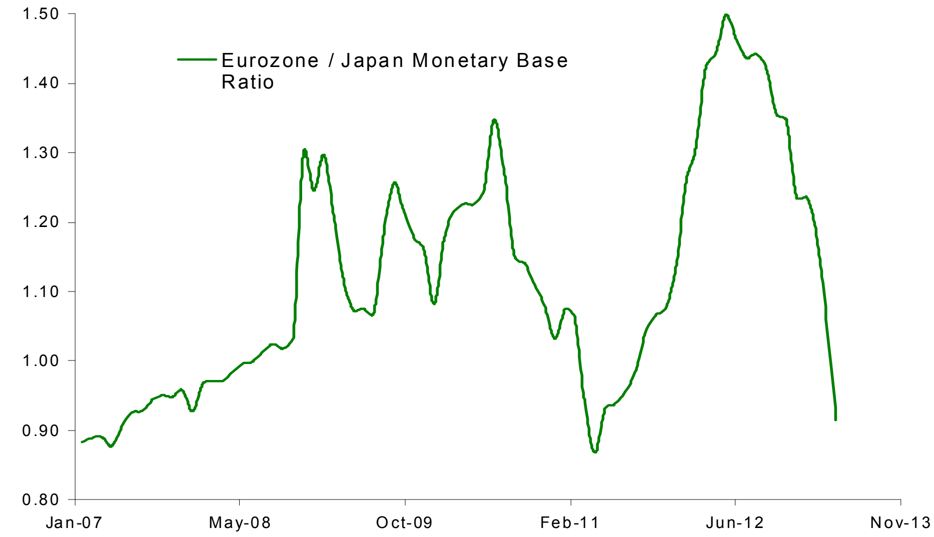
European policy (since 09) has been sharply counter-cyclical. In the absence of offsetting growth stimuli elsewhere (monetary policy or world activity), this is arguably even more deflationary than in Japan.

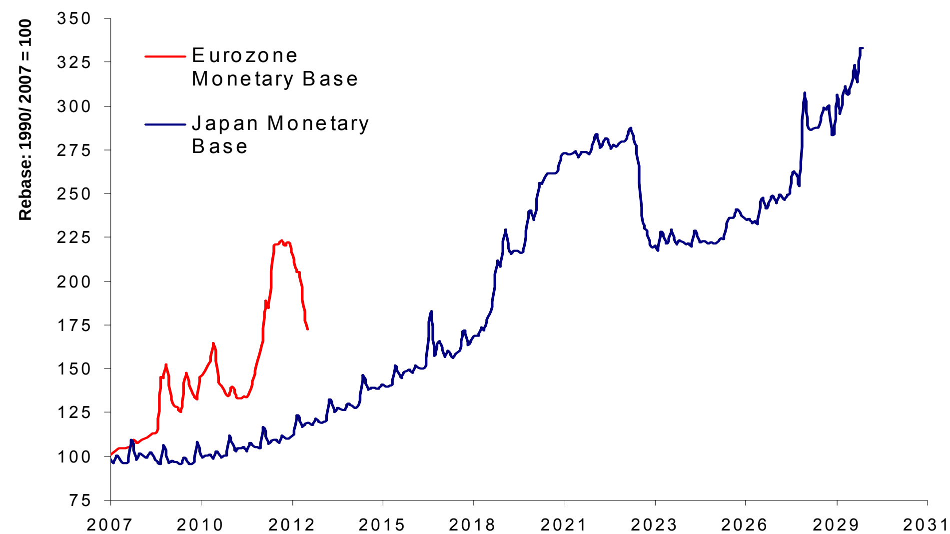
Sources: IMF and Citi Research

Same Monetary Story in Japan and Europe?

Chart on Left and Bottom Right Show Overlay of Japan on Europe With 1990 Japan and 2007 Europe Lined Up





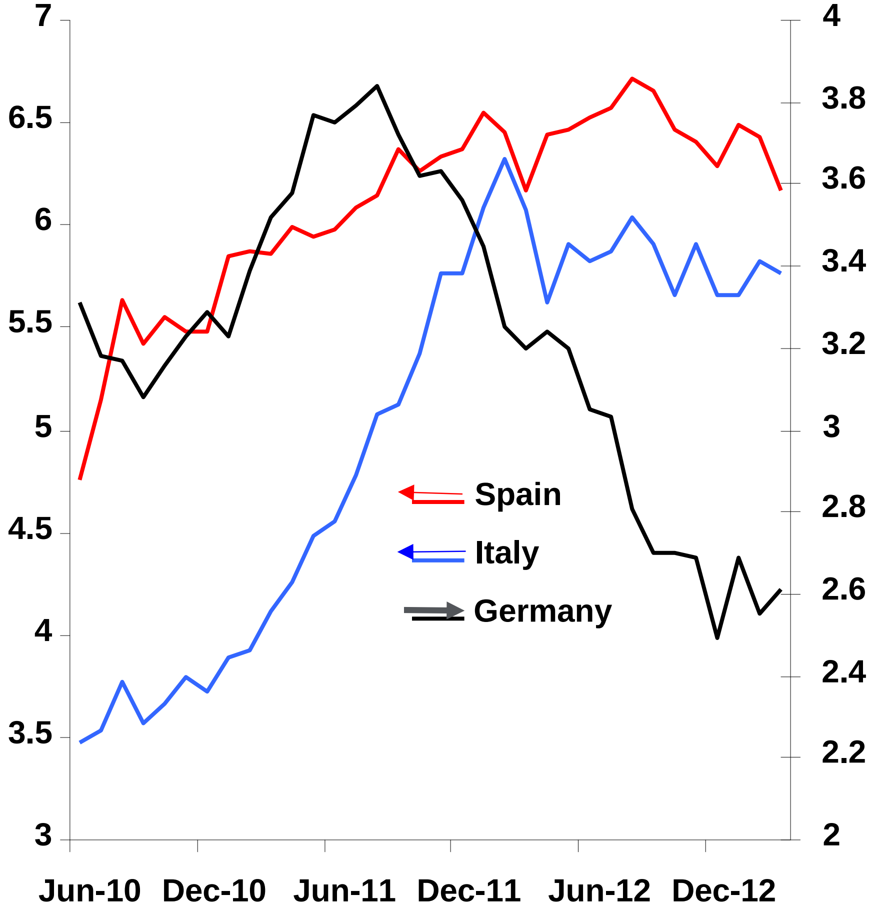


The ECB expanded the money base for a while but is now allowing contraction. Broad money trends very similar… why bet against deflation in Europe?

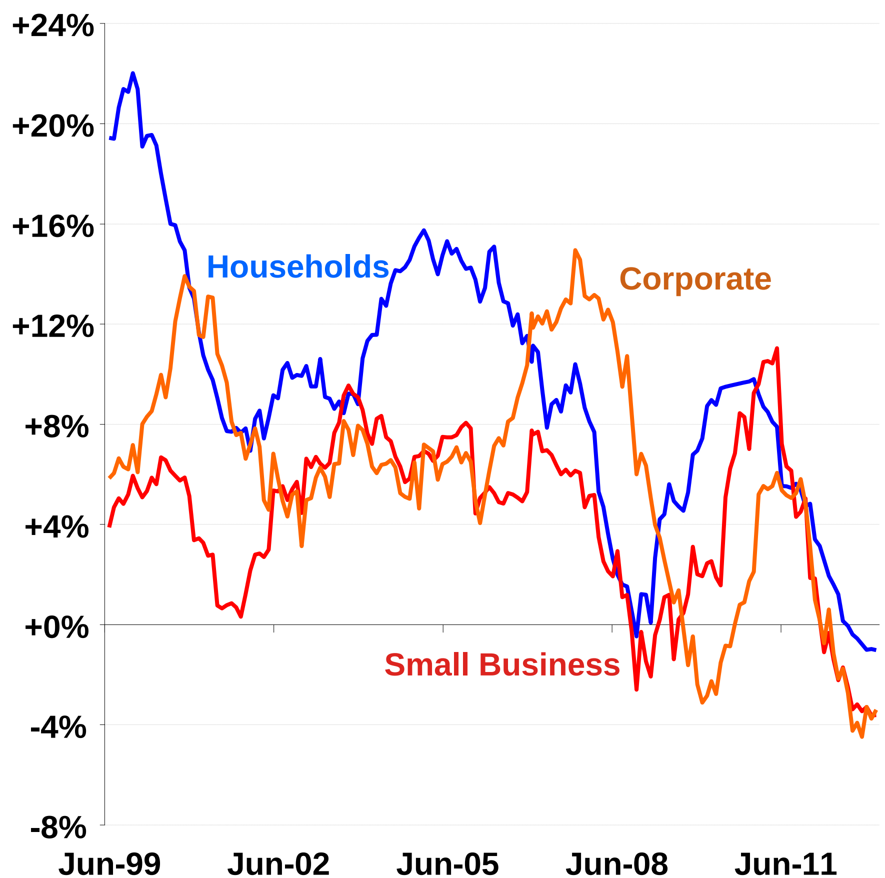
Sources: Reuters EcoWin, Bloomberg and Citi Research

ECB Easy Money is Not Trickling Down

Banks Aren't Passing on Savings to SMEs
Average Loans Rates to Sole Proprietors and Unincorporated Partnerships, *%*



Loan Growth in Italy at an Historic Negative
Bank of Italy Aggregate Loan Growth by Type, %

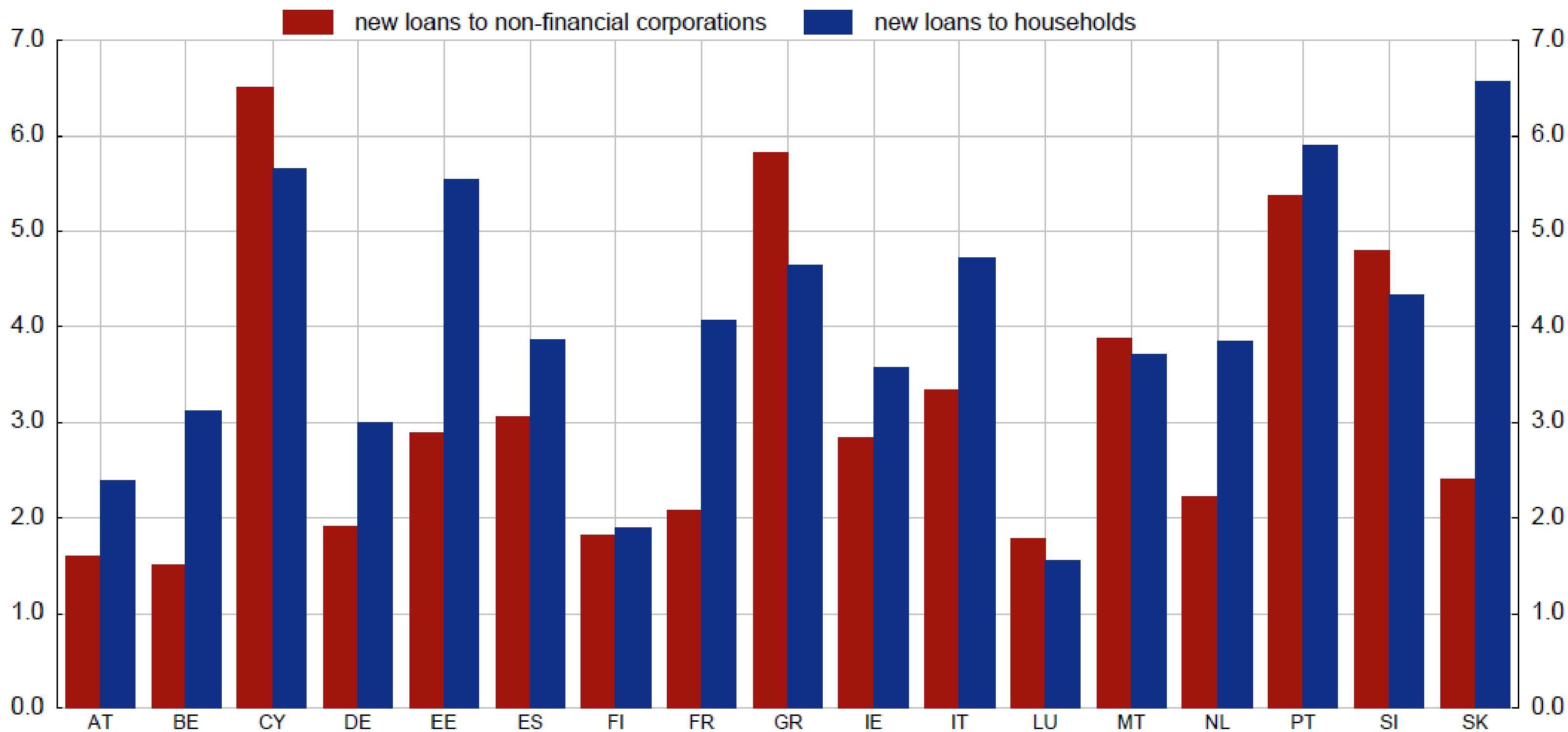


The ECB OMT threat reduced sovereign spreads…but not rates for many corporates who drive economic growth…not surprisingly, loan growth is negative in certain periphery economies

Sources: Citi Research, ECB and Bank of Italy

Single Market? Loan Spreads Higher in Peripheries and…

Very Uneven Distribution of Lending Spreads to SMEs in the Eurozone,
LIBOR Lending Spreads to Non-Financial Corporations and Households Dec 2012, %



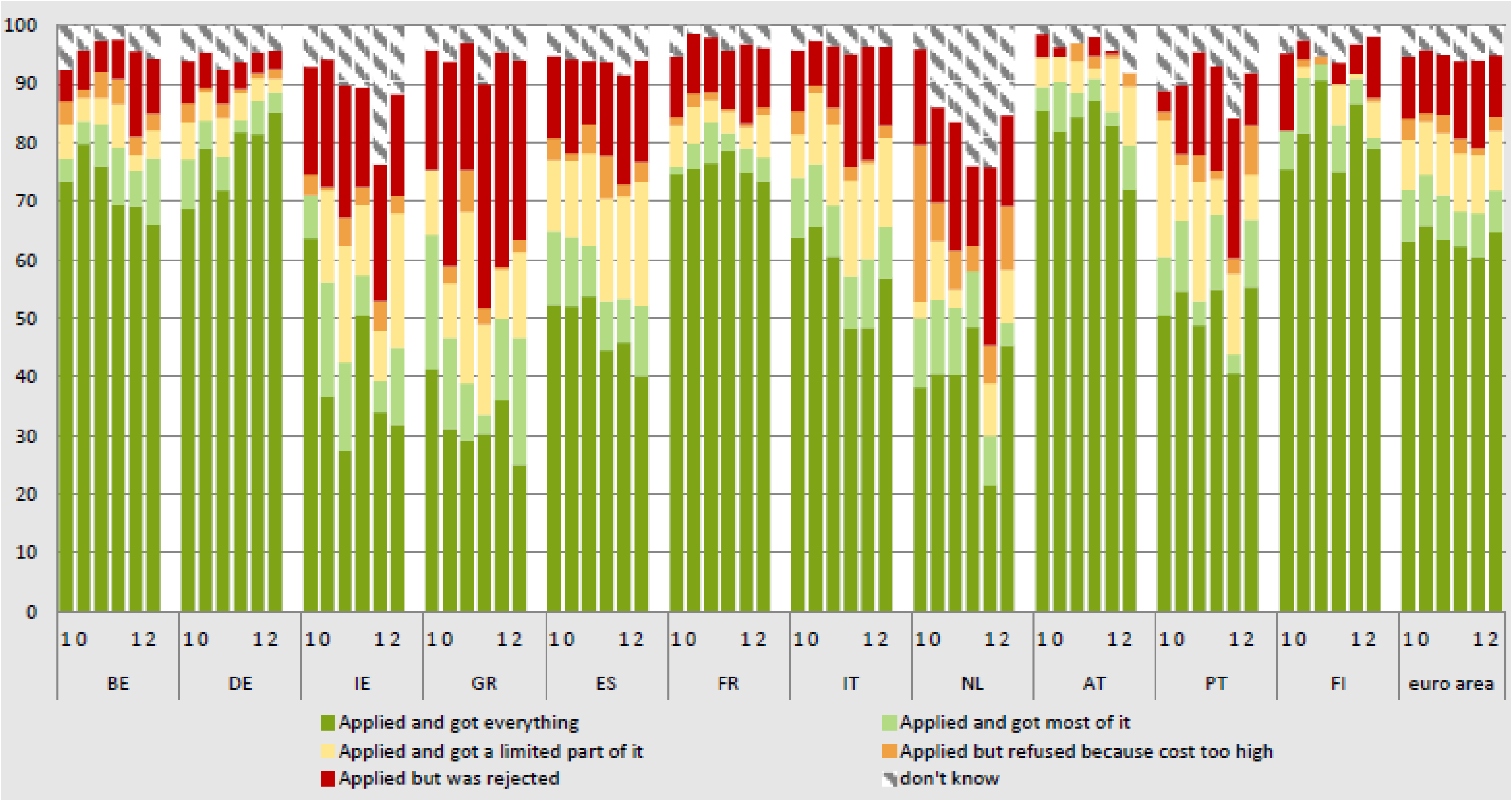
Sources: ECB, Thomson Reuters and ECB calculations.
Notes: Lending spreads are calculated as the weighted average of the spreads for the relevant breakdowns of new business loans using the volumes as weights. The spreads are measured as the difference between monetary financial institutions' interest rates for new business loans and the swap rate with a maturity corresponding to the loan category's initial period of rate fixation.

Spreads generally penalise the periphery…

Sources: ECB

…There Are Far Fewer Successful Loan Applications Too

Outcome of the Application for Bank Loans By SMEs Across Euro Area Countries
Over the Preceding Six Months; Percentage of SME that Applied for Bank Loans %

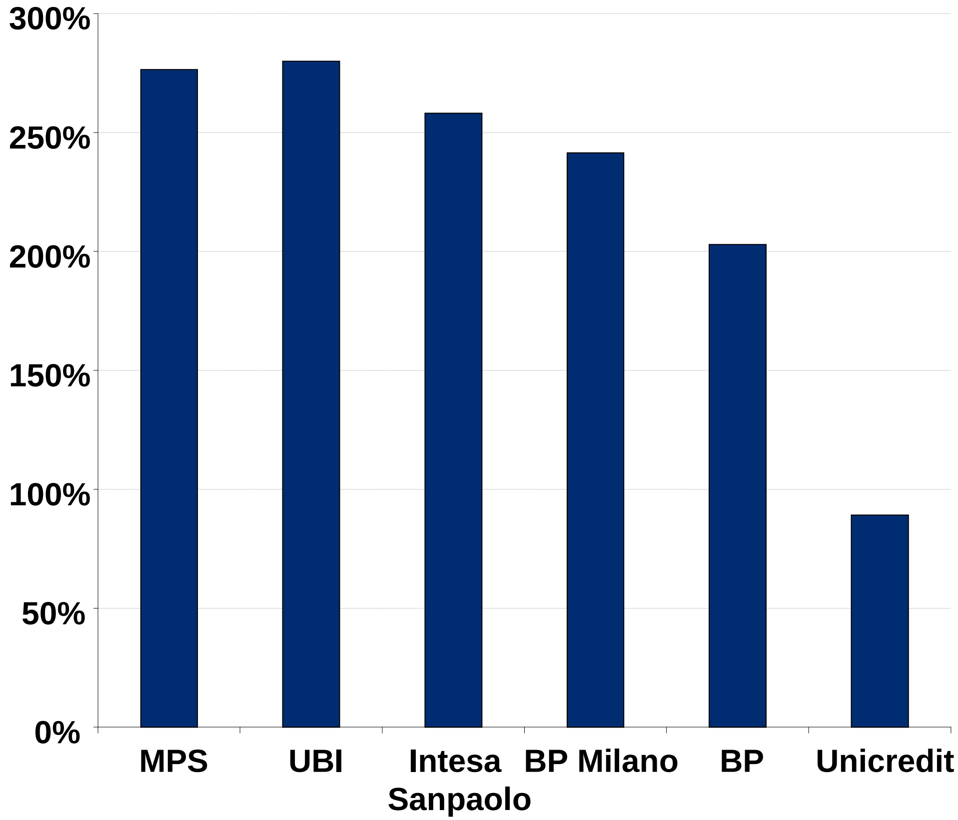


…credit demands rejected more in the periphery.

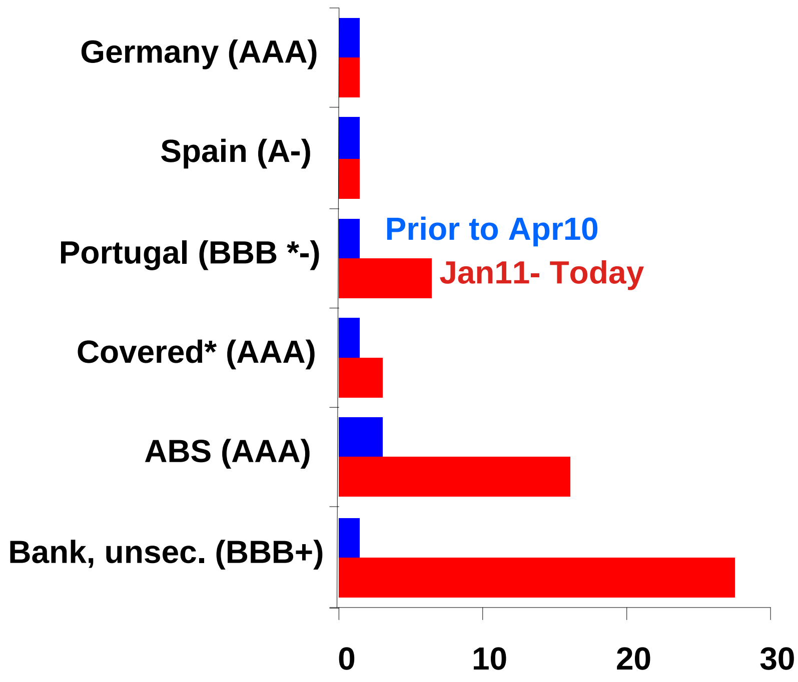
Sources: ECB Oct-March 2013 SME Survey

Financial Repression Crowding Out SME Lending

With BTPs Offering Over 4%, Why Try Harder?
Ratio of Government Bonds to Tangible Equity, %



ECB Has Steered Banks *Away* From ABS and HY
ECB valuation haircuts on selected bonds, 2y, %



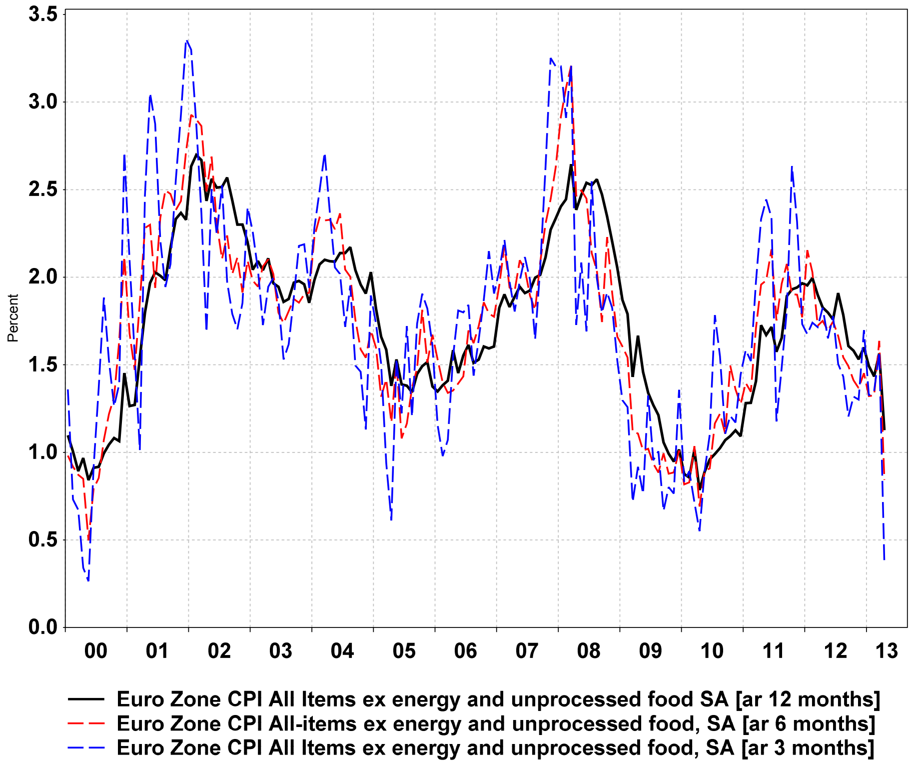
*downgraded

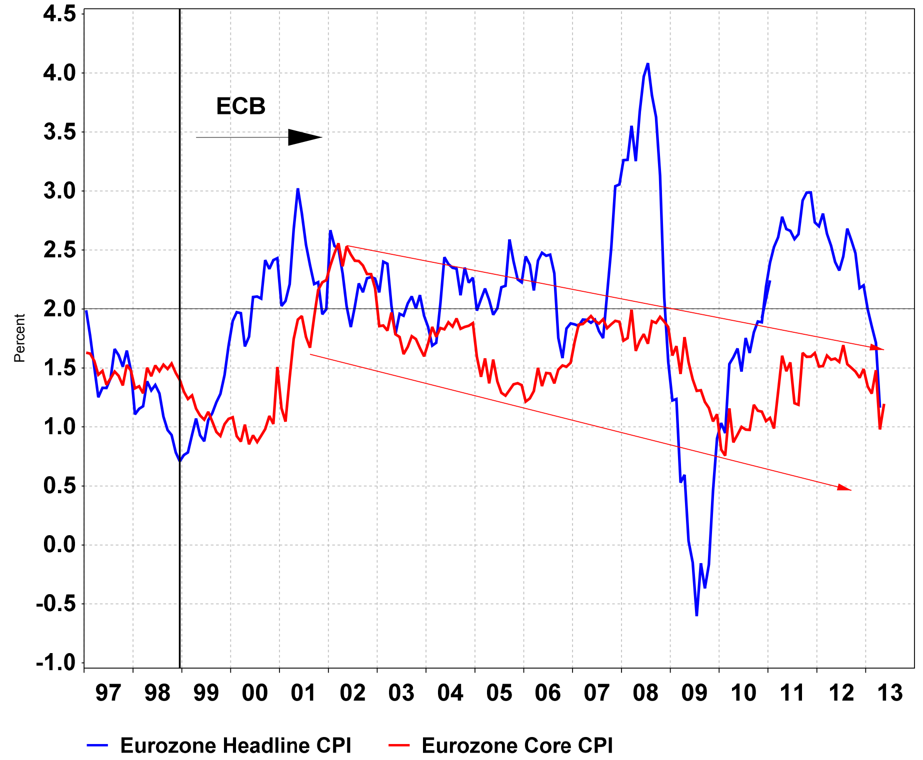
…as banks "encouraged" to own sovereign bonds, not to lend to risky corporates.

Sources: Citi Research, ECB, Company Reports, Haver and Bloomberg

Euro Area Disinflation – 1

Disinflationary Pressures Building?





Core CPI inflation in the Euro Area is annualising at less than 0.5% over the past three months.

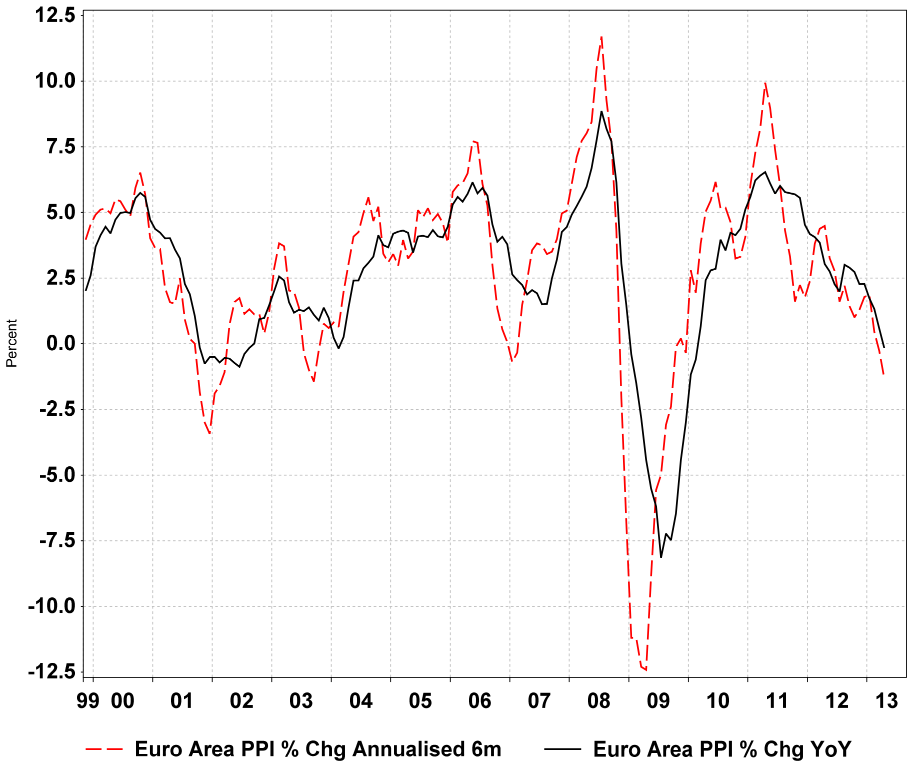
There is a clear downtrend evident through the past two cycles.

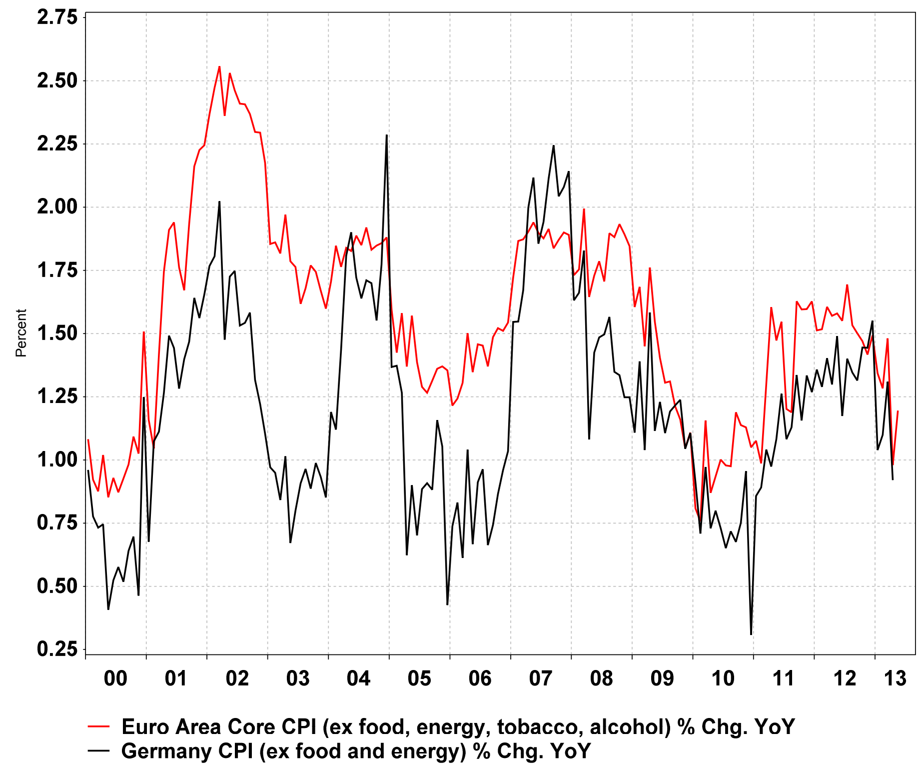
Core inflation is approaching the low end of the range since the ECB assumed monetary control.

Sources: Citi Research and Reuters EcoWin

Euro Area Disinflation – 2

Disinflationary Pressures Building?





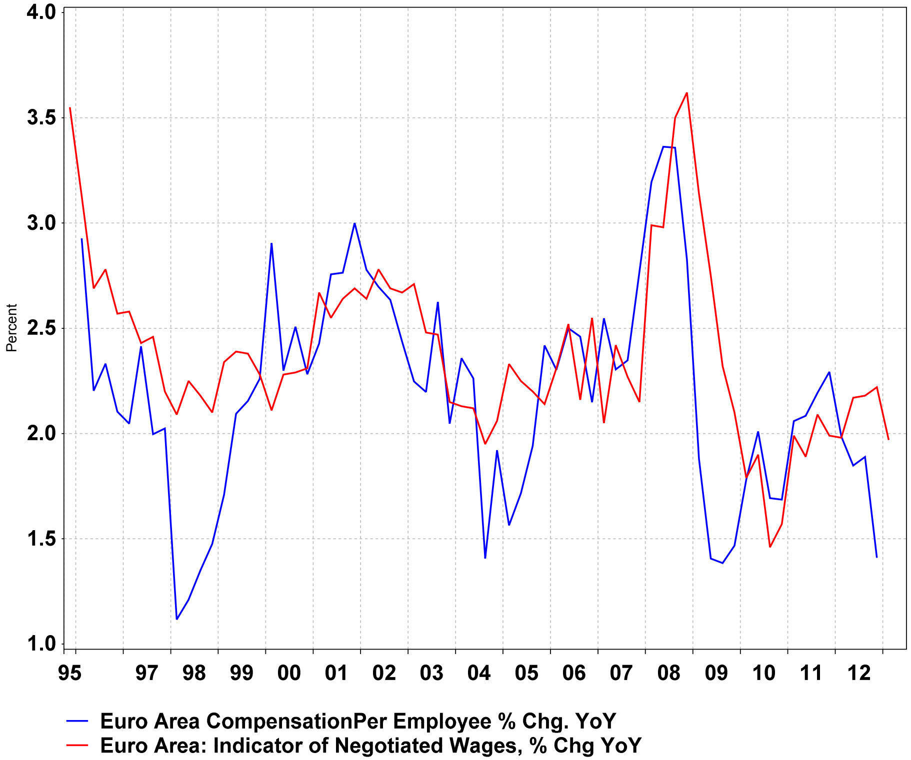
PPI inflation also close to zero…

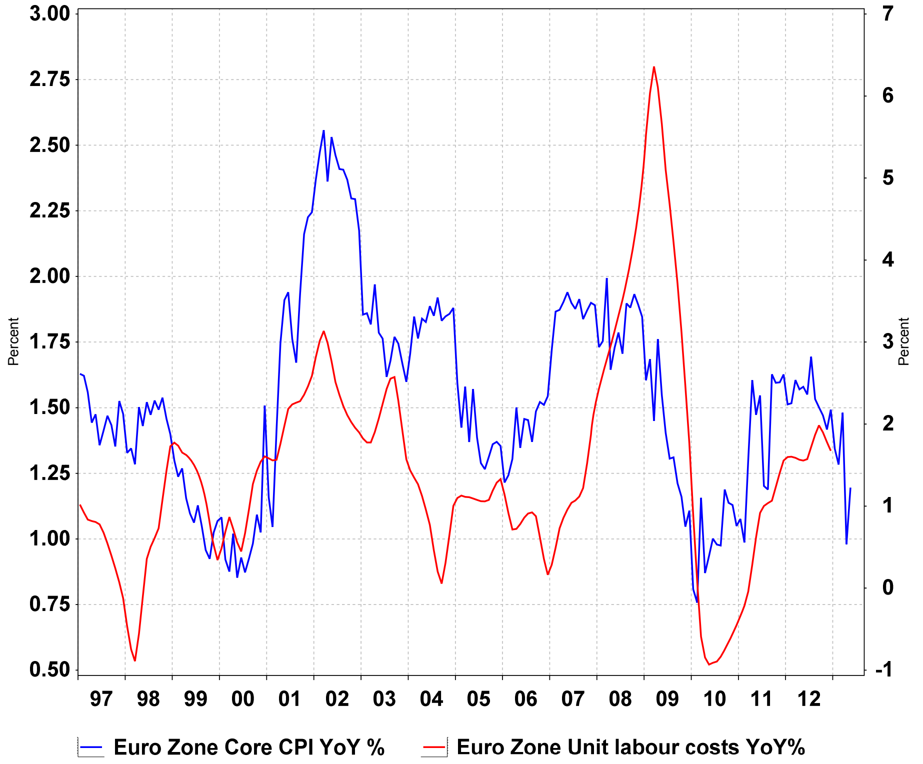
…And core CPI falling in core & periphery

Sources: Citi Research and Reuters EcoWin

Euro Area Disinflation – 3

Disinflationary Pressures Building?





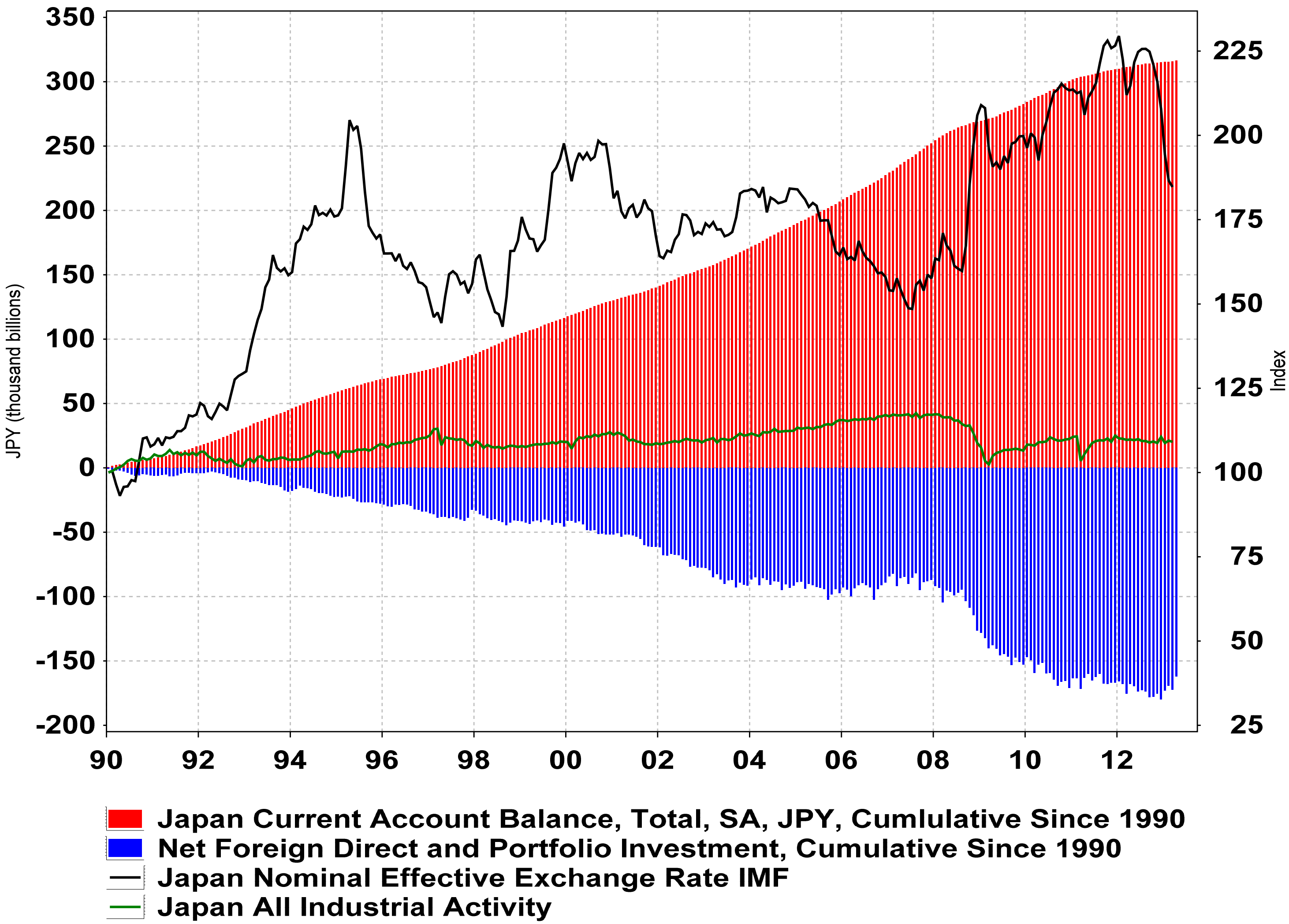
Wage growth also dropping sharply…

…Although Unit Labour Costs seem to follow, not lead, inflation

Sources: Citi Research and Reuters EcoWin

FX Impact

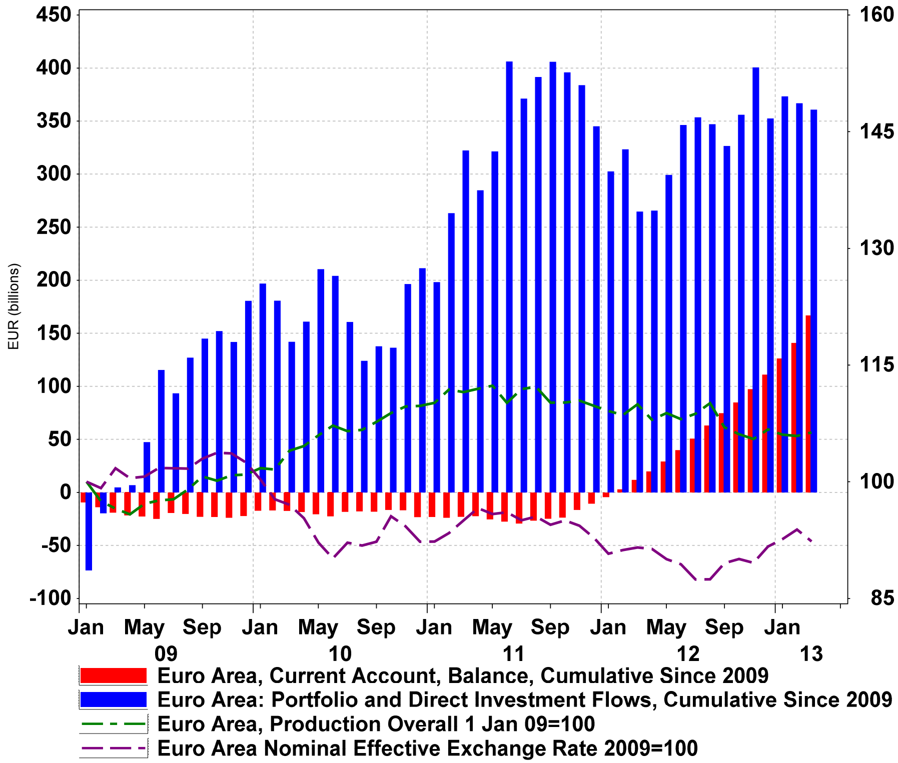
JPY: Strong Balance of Payments Trumped Weak Growth

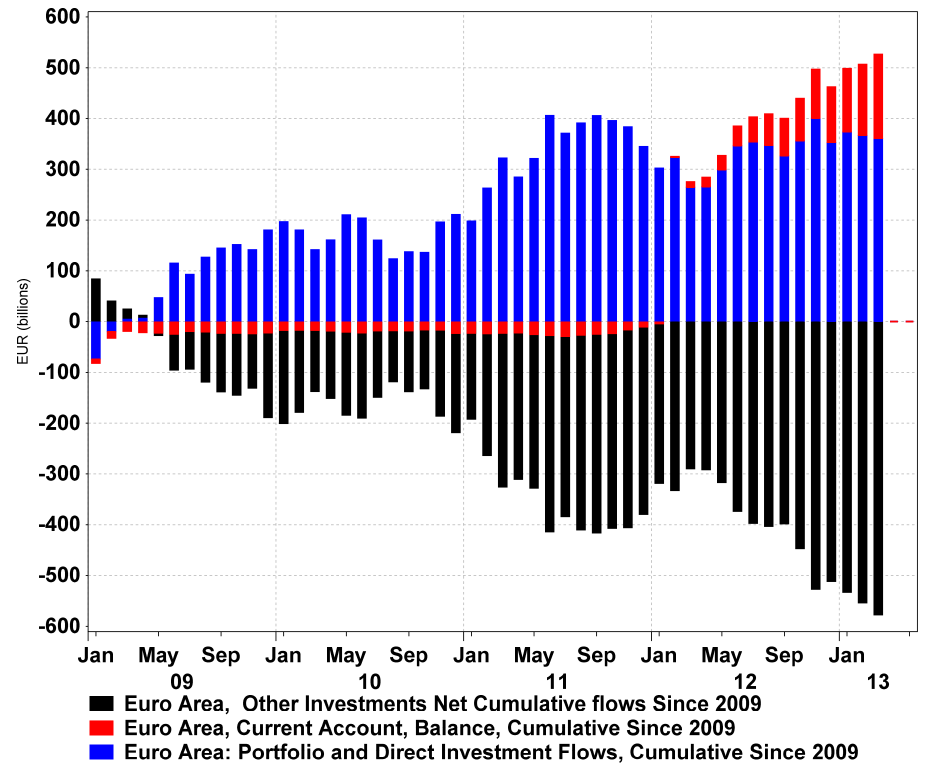


Japan has run huge cumulative current accounts which have swamped medium term capital outflows such as portfolio flows and direct investment. This has boosted JPY until recently, despite very weak growth over the whole period.

Sources: Citi Research and Reuters EcoWin

EUR: Broad Balance of Payments Very Positive. But…





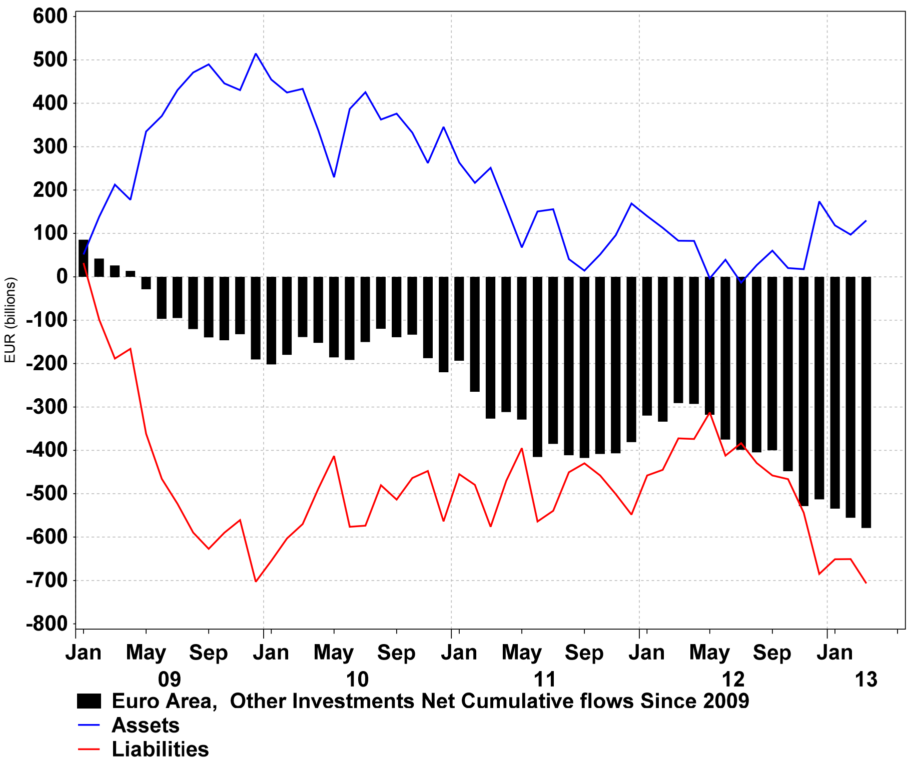
Euro Area cumulative current account surpluses now adding to a large surplus on combined portfolio and direct investment flows…

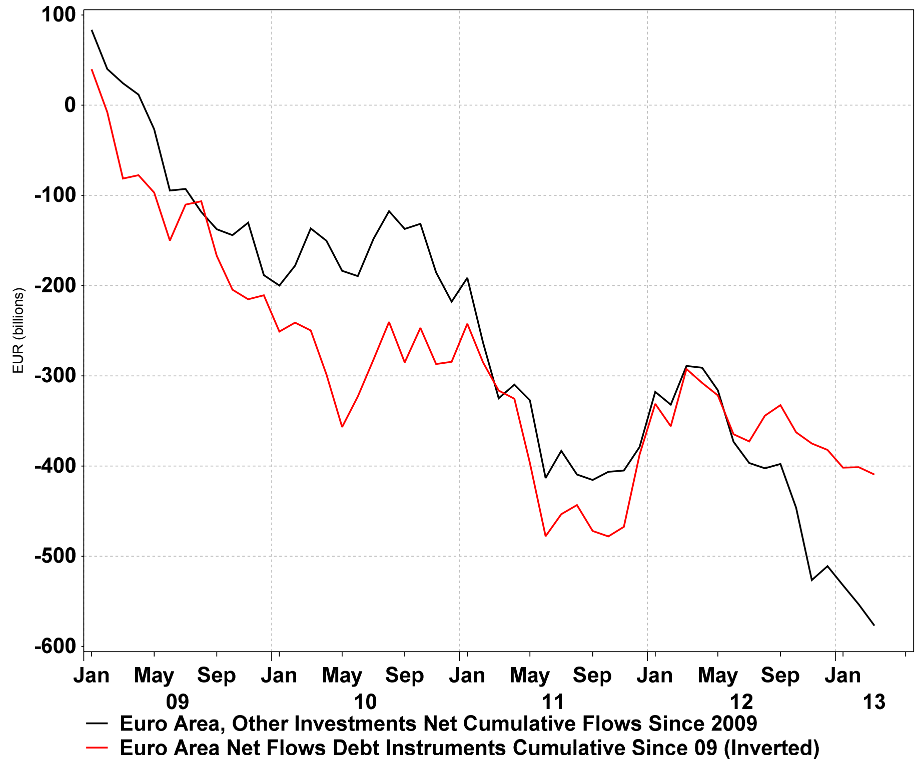
…Because of an even larger net outflow of funds from "other" investments

So why is the EUR not stronger…?

Sources: Citi Research and Reuters EcoWin

"Other" Investment Outflows…Could They Slow?





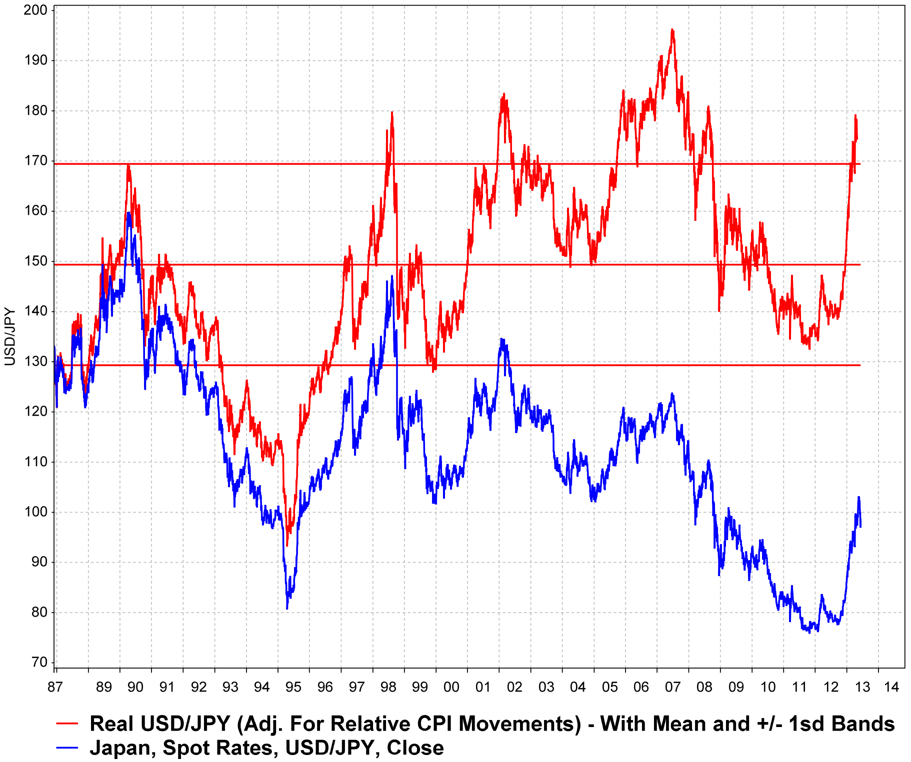
Euro Area residents' flows are relatively small in this asset class. Instead, it is foreigners "selling" that is driving the outflow…these are predominantly FX hedges and repo transactions…if these dry up, or stabilise even, EUR could rise strongly

These hedges/ repo are the counterpart to FI inflows to Bunds and periphery sovereigns depending on the part of the EMU risk cycle we have been in… it's a circular argument, but if these investors no longer believe EUR depreciation is a risk, and stop hedging, EUR could be materially stronger

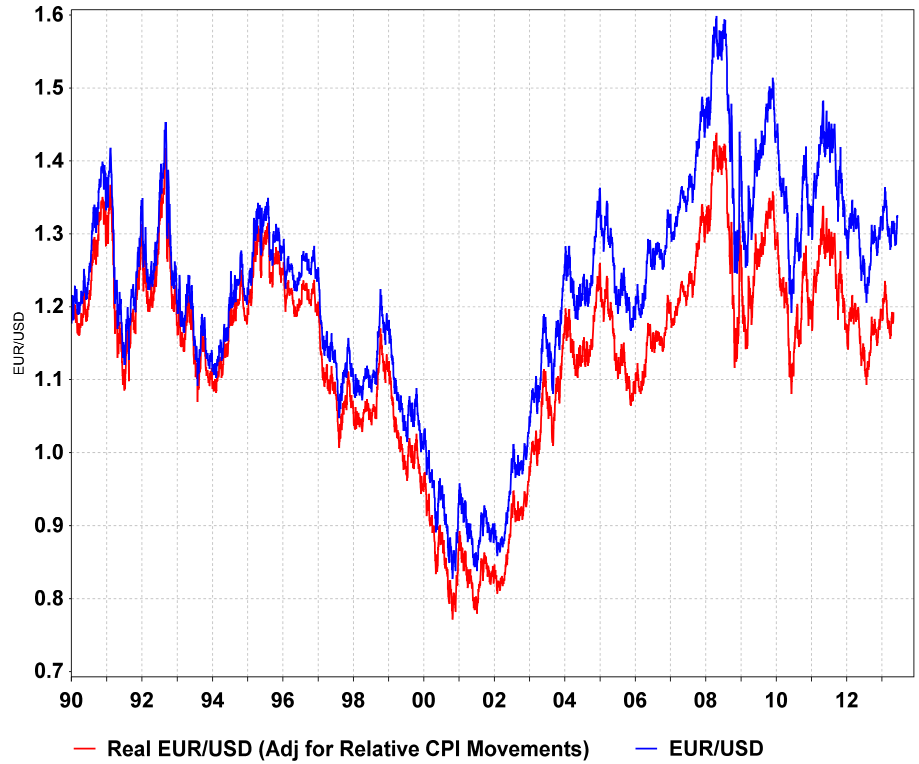
Sources: Citi Research and Reuters EcoWin

FX: The Power of Deflation to Cause Appreciation: EUR Next?

USD/JPY: Nominal and Real



EUR/USD: Nominal and Real



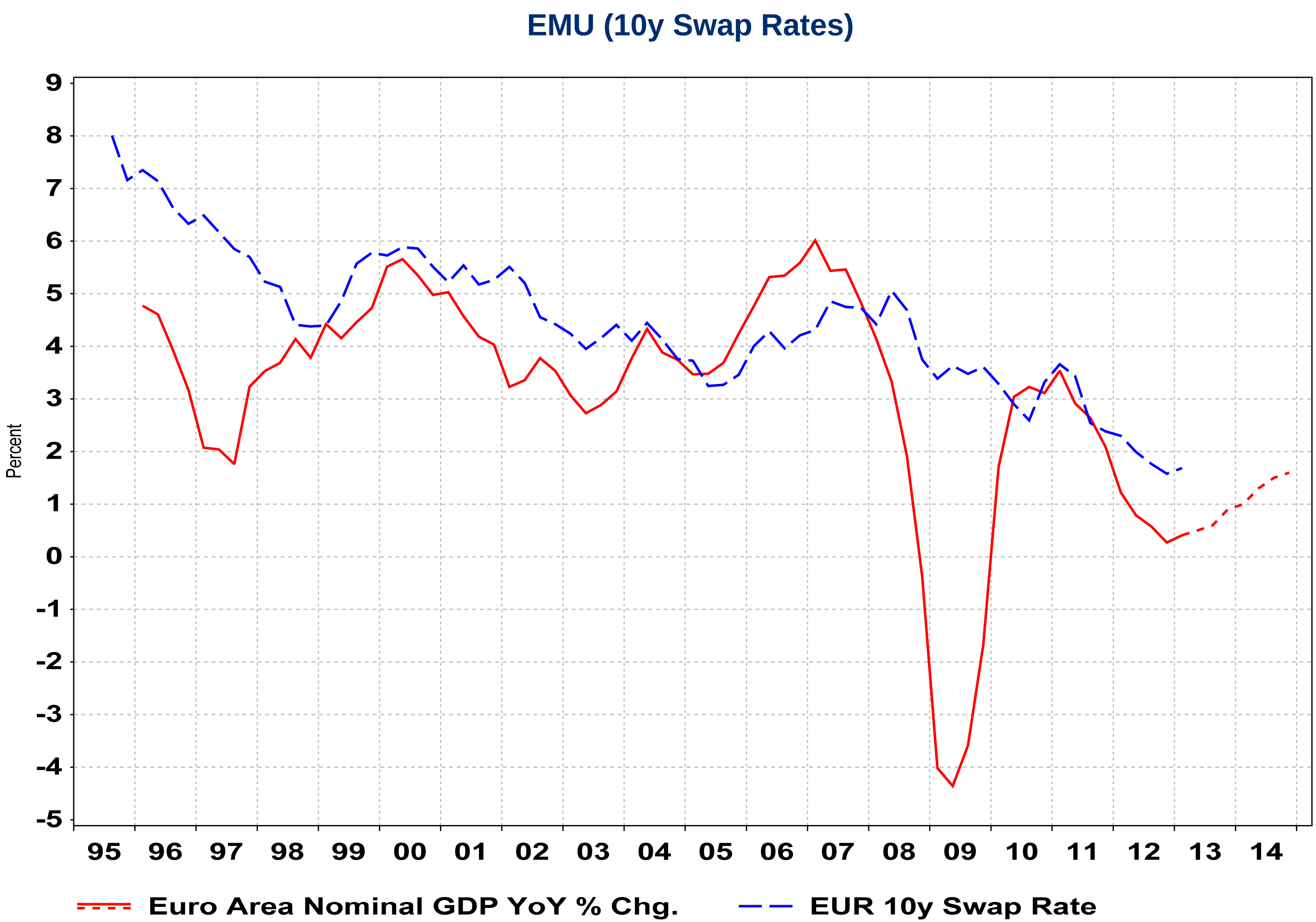
Relatively tight ECB monetary policy and very tight fiscal policy could result in sustained low inflation or even deflation. Deflation in Japan was very positive for the nominal exchange rate. To maintain a broadly stable real exchange rate, PPP needs a higher nominal currency value.

Could this now happen to the EUR too? Suppose US CPI inflates 2.5% pa for 10 years and EMU CPI by 0.5%. EUR might rise to nearly 1.60 to keep the real exchange rate stable.

Sources: Reuters EcoWin and Citi Research

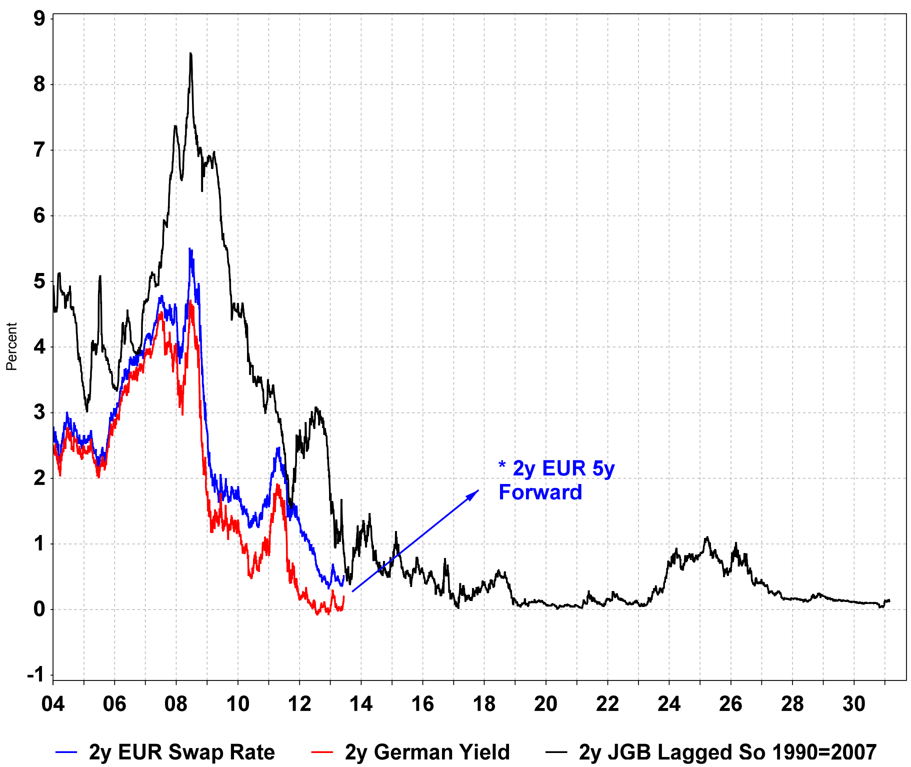
Rates Market Impact

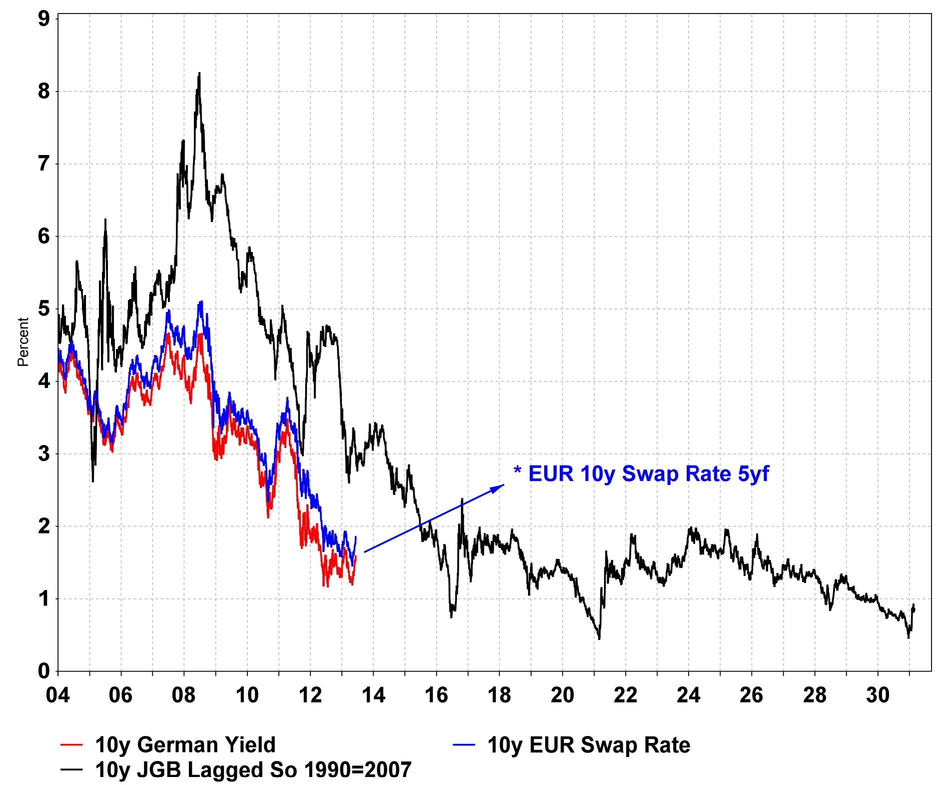
Sustained Low Nominal Growth Suggests Low Yields to Persist



Sources: Citi Research and Reuters EcoWin

EUR Rate Forwards Could Be Too High





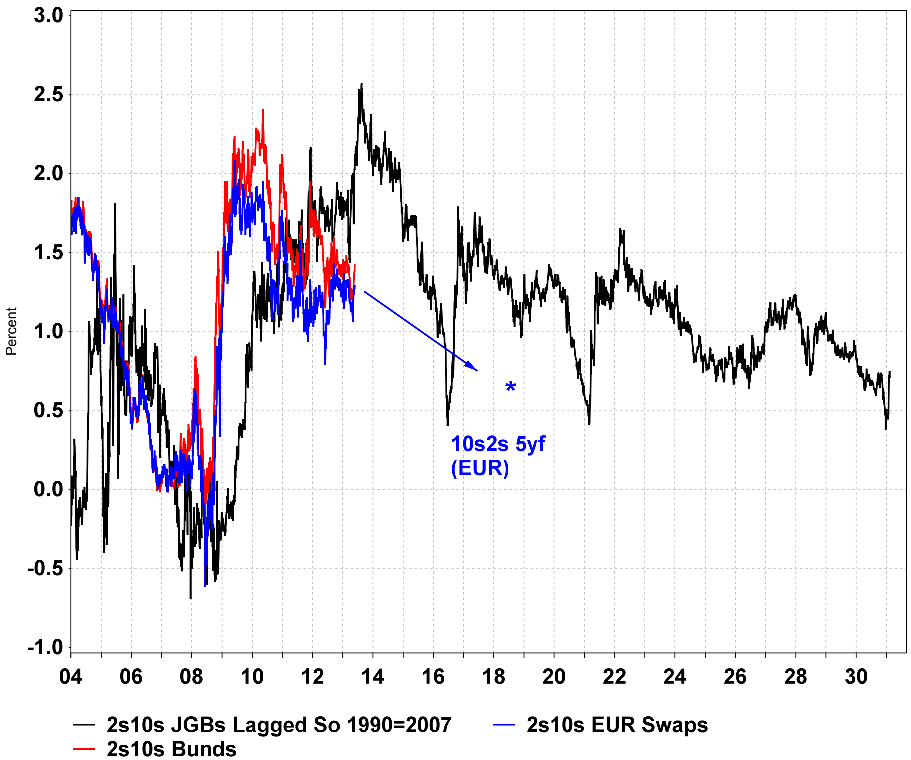
If the ECB persists with a relatively tight monetary policy, the EUR is a strong currency and low inflation/ deflation persists, EUR rates may de-couple from any rise in the US/ RoW.

Forwards may therefore be too high and carry and roll type trades likely to remain attractive.

Forwards in the front end rise more and may be most likely to be undershot.

Sources: Citi Research and Reuters EcoWin

Flattening Priced in Curve About Right?



Priced Curve flattening may already be excessive… But a bear flattening is priced… Bull Flattening more likely?

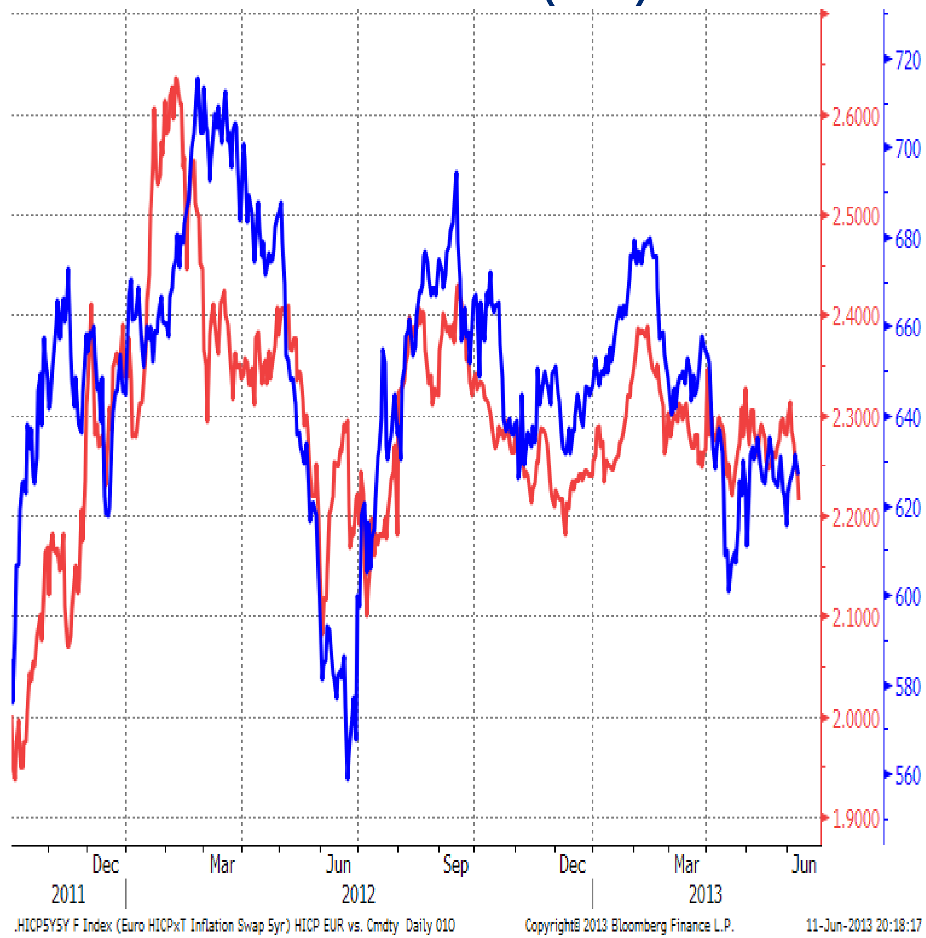
…Curve flattening with lower yields probably best expressed by receiving likes of 5y5y EUR either outright or with a pay USD or JPY hedge

Sources: Citi Research and Reuters EcoWin

EUR Inflation Rates Products Price In Too Much Inflation?

HICPxT 5y (Black) vs. 10y (Red) EUR Inflation Swaps and Spread (Green)

HICPxT 5y5y EUR Inflation Swap (Red) vs. S&P GSCI Index (Blue)



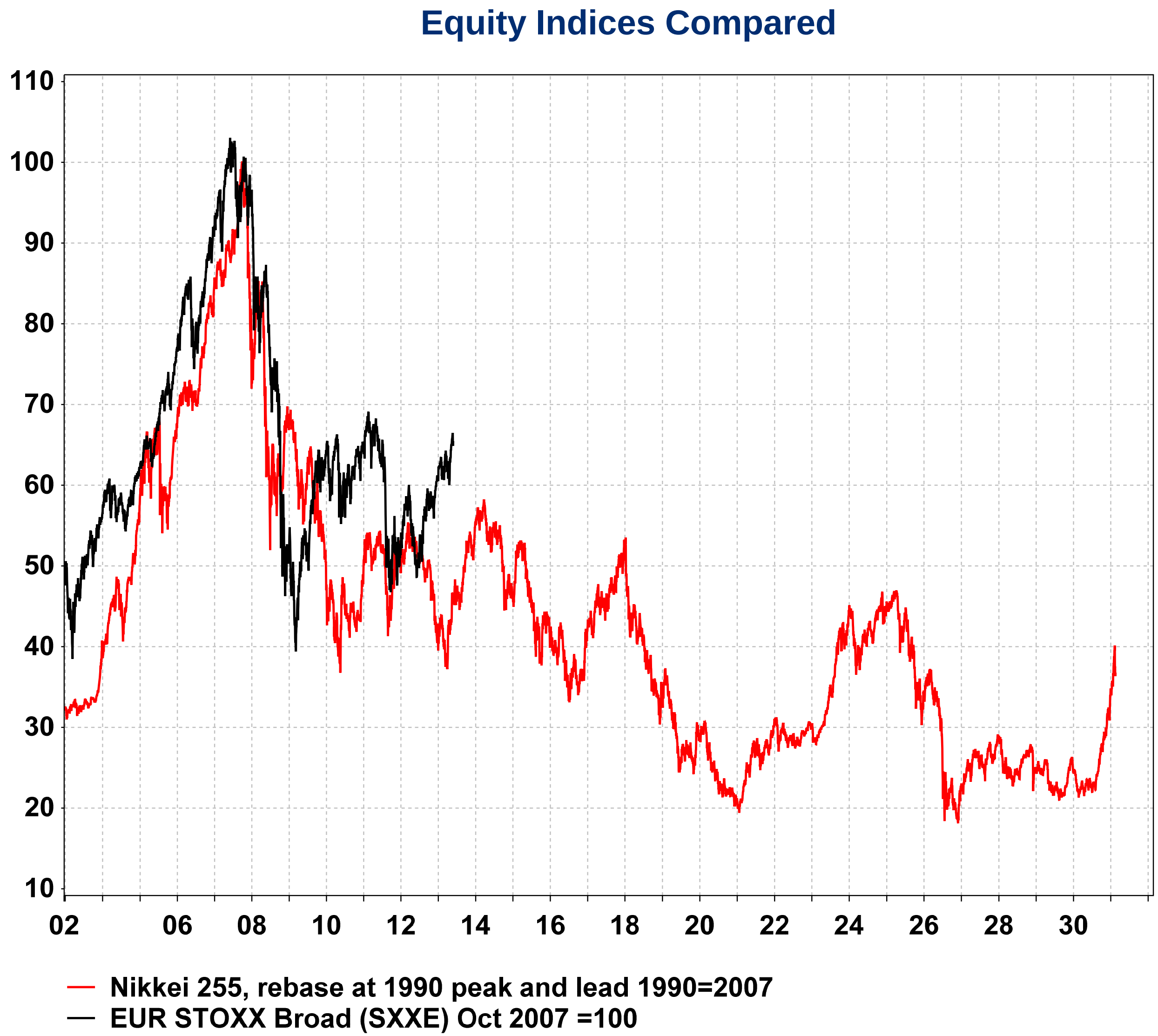
HICP Inflation Curve very steep…making forward points like 5y5y rich?

Lower commodity prices also point this way

Sources: Bloomberg and Citi Research

Equity Impact

Japan vs. European Equities…Overlay Points to Downside…

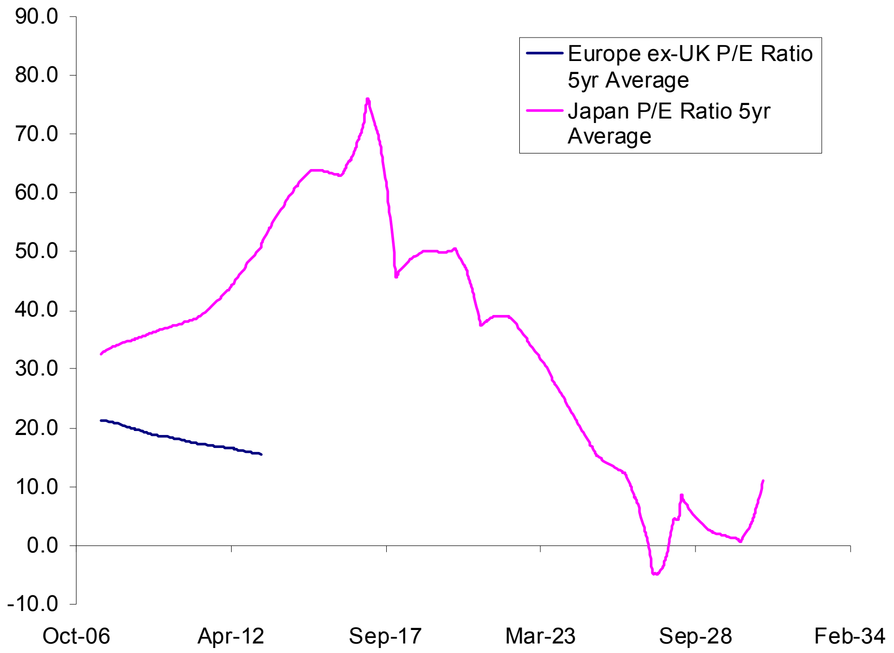


A strict overlay looks ugly for European stocks from here…

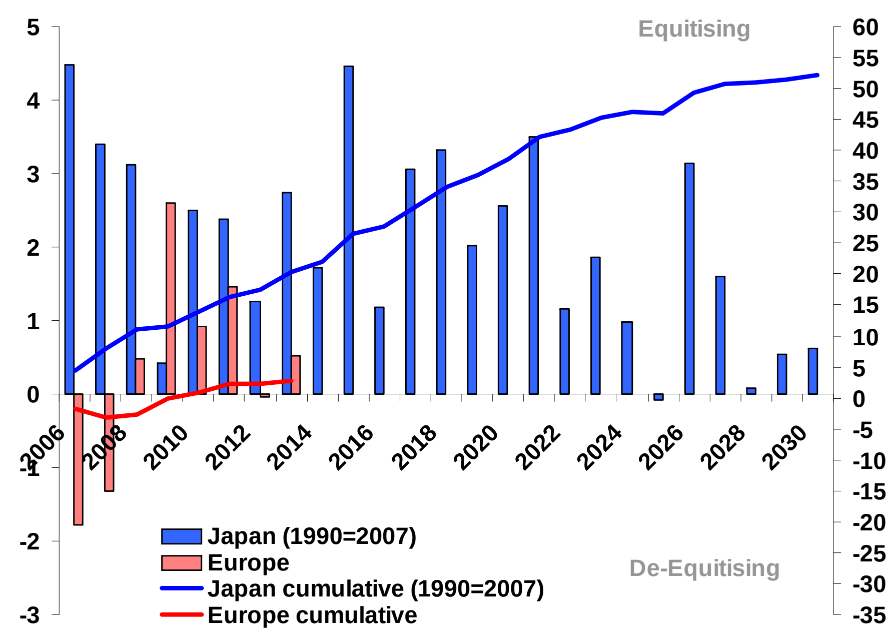
Sources: Citi Research and Reuters EcoWin

…But Don't Forget Valuations and Dilution Effect

Valuations Compared



Equitisation* Compared



* Equitisation calculated as change in market cap not explained by price performance

NKY was very highly rated when the Japanese crash started in 1990. This is not the case in Europe currently.

In the 1990s, Japanese corporates diluted their shares. To date, this is much less the case in Europe. Actually, we have seen occasional de-equitisation in Europe post GFC.

Sources: Citi Research and Reuters EcoWin

Appendix A-1

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