

Developed Market Rates

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Euro Rates Strategy

EMU Curve Trades & the LTRO

- The outcome of the second 3yr LTRO is likely to dictate near-term price action for EMU spreads and curves.
- In broad terms, we do not expect the second 3yr LTRO to have as large a market impact as the first.
- The risk-reward of maintaining 2s10s steepeners has deteriorated, in our view. We prefer flatteners here.
- For those looking to express flatteners, or fade the richness of the 5yr sector, we prefer the less volatile higher-rated markets (AA and above) to the periphery.
- **Trades:** Selling 2s5s10s flies in Finland, France and Belgium all look appealing. For flatteners, the 5s10s Belgium curve looks like a good candidate to us.

Jamie Searle

+44-20-7986-9493

jamie.searle@citi.com

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EMU Curve Trades & the LTRO

The 3yr LTRO has impacted all markets, not just the periphery

The impact of the 3yr LTRO has been felt across all markets, not just the periphery. Indeed, the 3yr LTRO and associated carry trades are one explanation for the decoupling of 2s5s and 5s10s curves in markets rated AA and above (see page 3). As such, the outcome of this week's second 3yr LTRO could be pivotal for the near-term performance of 2s5s10s flies and 5s10s curves (all eyes will then be on the Greek PSI).

The second 3yr LTRO is likely to have less impact than the first

In broad terms, we do not expect that the second 3yr LTRO will have as large a market impact as the first. There will still be plenty of liquidity to put to work, but the market has probably already priced in much of the impact (unlike the first 3yr LTRO when it took time for the market to understand how bullish it was for EMU spreads). The latest Reuters consensus is for a take-up of €492bn.

Possible market reactions

- **A large downside surprise, in the region of €300bn and below:** This is likely to prompt bear flattening in 2s10s, given how much is priced in.
- **A large upside surprise, somewhere above €650bn:** We expect this to initially trigger bull steepening, but this could quickly turn into bull flattening as the extra confidence prompts carry trades to be extended further along the curve.
- **An outcome close to consensus (€450-500bn):** On paper, this will still be very supportive for EMU spreads and carry trades as liquidity is put to work. However, a lot of the good news has probably been priced-in and, given how steep 5s10s curve already are (and how rich 2s5s10s flies are), further steepening is likely to be relatively limited.

We prefer the risk-reward of flatteners to steepeners here

The recent richening of 2s5s10s flies and steepening of 5s10s curves (see page 3) is testament to the supportive backdrop for EMU spreads and the impact of the 3yr LTROs. The liquidity provided by the second 3yr LTRO should continue to support carry trades. That said, a lot is already priced-in and the risk-reward of maintaining steepeners has deteriorated considerably. We prefer flattening risk here.

We suggest taking profits on existing periphery steepening exposure. For those looking to express flatteners or fade the richness of the 5yr sector, we prefer the relatively less volatile AA or above markets to the periphery.

Trades

Selling 2s5s10s flies in Finland, France and Belgium all looking appealing ways to fade the richness of 5s (see page 2).

For flatteners, the 5s10s Belgium curve looks like the best candidate, especially now that this week's supply is out of the way (see [Belgium Auction Preview](#) of 24 February 2012).

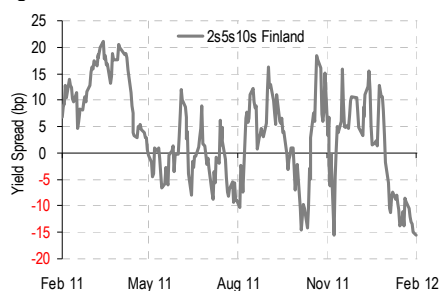
We also still like 5s10s flatteners in France outright or boxed against Bunds.

2s5s10s EMU flies look rich (especially Finland, France and Belgium)

(1) Fading the richness of 5s

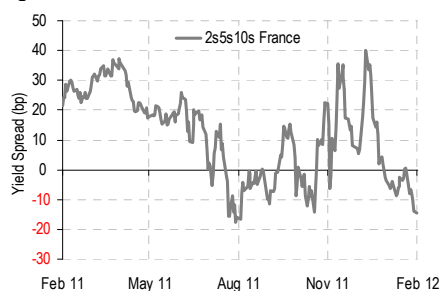
Many 2s5s10s flies core and near-core markets have richened back towards historic lows. The charts below show 2s5s10s for Finland, France and Belgium (using rates derived from the Citi relative value curves). Among EMU curves, these flies stand out as rich relative to their one-year history and are all close to levels which have previously marked a turning point.

Figure 1. 2s5s10s Finland



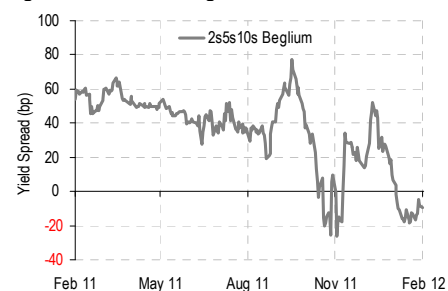
Source: Citi Investment Research and Analysis

Figure 2. 2s5s10s France



Source: Citi Investment Research and Analysis

Figure 3. 2s5s10s Belgium

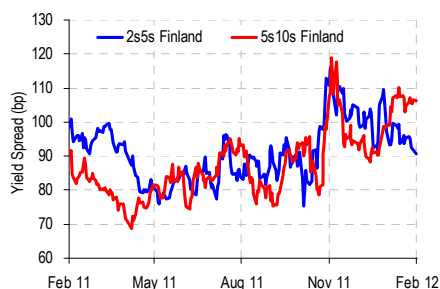


Source: Citi Investment Research and Analysis

2s5s flattening vs 5s10s steepening

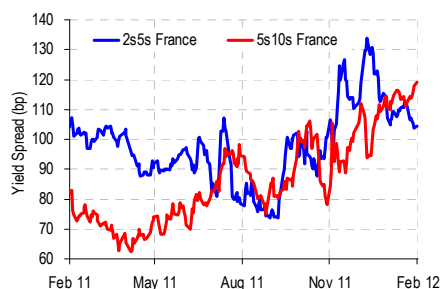
The recent sharp richening of the 2s5s10s flies shown above has been driven by a de-coupling of 2s5s and 5s10s. In the last few weeks, 2s5s curves have generally flattened while 5s10s have steepened.

Figure 4. 2s5s vs 5s10s Finland



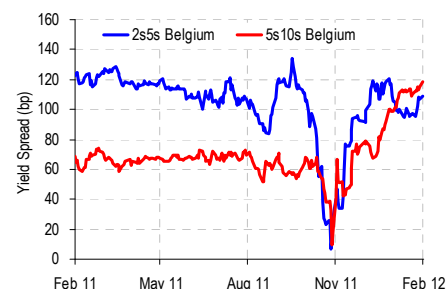
Source: Citi Investment Research and Analysis

Figure 5. 2s5s vs 5s10s France



Source: Citi Investment Research and Analysis

Figure 6. 2s5s vs 5s10s Belgium



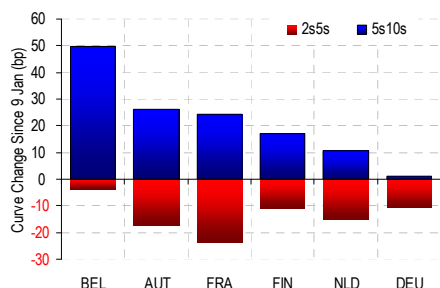
Source: Citi Investment Research and Analysis

Belgium has led the steepening of 5s10s

(2) 5s10s Flatteners

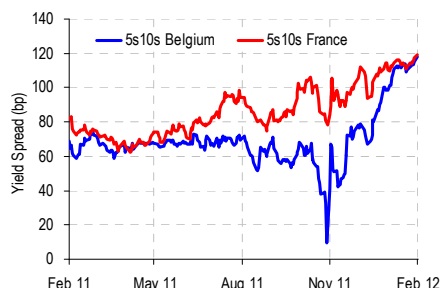
The recent steepening of 5s10s has been most pronounced in Belgium (+50bp in the last six weeks alone, Figure 7). France and now Belgium have the steepest 5s10s curves among euro sovereign issuers rated AA and above (Figure 8).

Figure 7. Change in 2s5s and 5s10s



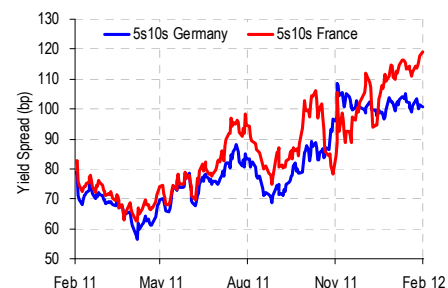
Source: Citi Investment Research and Analysis

Figure 8. 5s10s Belgium vs France



Source: Citi Investment Research and Analysis

Figure 9. 5s10s Germany vs France



Source: Citi Investment Research and Analysis

Appendix A-1

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