

Euro SSA and Covered Bonds Monthly

2014 Outlook – Navigating a Low Spread Environment

- **Tectonic plates:** Although the market for bank bonds has been shrinking over recent years, public sector debt volumes continue to increase. The greatest moves regarding these tectonic plates have probably passed, but the general trend of elevated SSA supply versus net negative issuance in covered bonds is likely to continue in 2014.
- **Where to go?** From a macro perspective, the net shrinkage of the covered bond market compared with the SSA sector is generally seen as a positive for the former in terms of relative performance. However, this masks differentiation both across and within the different markets. We detail the relative value across SSAs, covered bonds, government bonds and senior unsecured corporate debt.
- **2014 regulatory topics:** Investors in SSA debt and covered bonds face an evolving regulatory environment, and one in which the importance to keep abreast of new terminology and definitions is paramount. We detail the key regulatory topics we think will be high on the agenda in 2014, including the LCR, AQR and CRR.
- **SSA supply likely to remain elevated:** One clear characteristic of the SSA market remains its resilience amid an environment of elevated supply. This dynamic should not be underestimated and underlines a strong technical backdrop which we think will also be prominent in 2014. We expect similar levels of euro SSA supply as seen this year. Combined with firm demand, we generally expect a low and range-bound spread environment, maintaining a clear preference for relative value strategies.
- **New entrants in the agency market:** We anticipate certain new entrants in the UK, French and Dutch agency sectors later in 2014. Trends in 2013 also point to the possibility of further green bond issuance next year.
- **Covered bond supply:** Net negative issuance will mostly affect the most traditional covered bond segments. The Spanish market will stand out against other segments. The new markets will not offset this shrinkage, which is why we expect the benchmark covered bond market to shrink by more than €40bn in 2014.
- **Trading patterns:** We expect spread compression to continue in the covered bond market over the medium term. Some events – not least central bank policy – are likely to impact the market in 2014. Hence, the longer the spread compression theme lasts, the more it makes sense to hunt for value and not for yield.
- **Supply outlook:** In terms of euro-denominated SSA supply, we expect €95.5bn in 2014 from supras and over €80bn from the key agencies – similar to 2013. In covered bonds, YTD issuance stands at €95bn and in 2014 we expect €113bn.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Euro SSAs and Covered Bonds in 2014

We expect demand – not least that driven by regulation – for spread products to remain firm in 2014. Together with further easing by the ECB, we generally expect spreads to remain relatively low next year for both SSAs and covered bonds. We unearth trends both within each asset class but also between them. For one, the contrasting development of market sizes (SSA generally rising, covered bonds generally shrinking) is likely to hold market implications. In addition, we delve into the RV within each sector where we continue to see various opportunities to enhance returns in what will otherwise be a generally low yield environment.

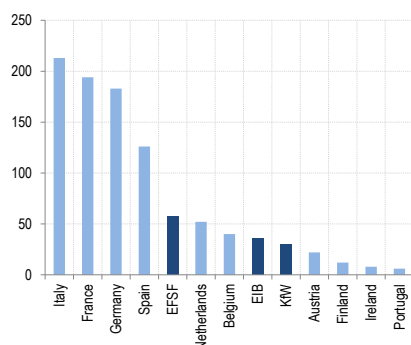
1) Shifting tectonic plates – covereds to outperform SSAs?

Covereds to outperform SSAs: We believe 2014 will be another year of good SSA and covered bond performance, driven in part by the growing strength of regulatory demand (more on page 7) and changing supply dynamics. In terms of relative performance, we take a macro view of the RV between covereds, SSAs, corporate debt and government bonds. In general, we continue to see scope for covereds to trade near or even through sovereign curves and thus outperform agency debt in a few sectors, whose 'natural boundary' remains the sovereign guaranteeing it.

The tectonic plates are shifting....

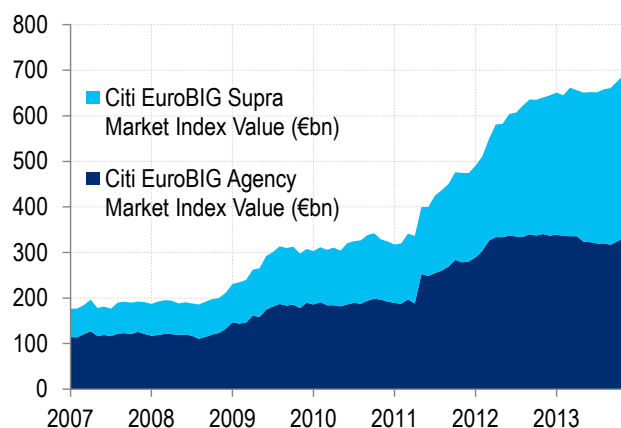
Changes in a market's size can take time, especially to isolate specific trends. However, there is enough evidence now to compare the well established pattern of a growing SSA market – especially in terms of supra supply (page 13) – with a shrinking covered bond market in some specific countries. The development of those two markets is characteristic of a general trend seen in global debt markets. Some supranational institutions (especially bailout facilities) have become more important in EMU political decision-making, but also the reliance on them as a supportive tool has increased as well. Many SSAs now issue more in the euro fixed income markets than some EMU sovereigns (Figure 1). Another characteristic of the debt market evolution is, of course, the increase in non-private sector debt – be it SSA or direct government debt. Both markets have grown markedly during the years of the financial crisis (Figure 2, Figure 3).

Figure 1. 2013 EUR issuance by EMU sovereigns and select European SSAs (€bn)



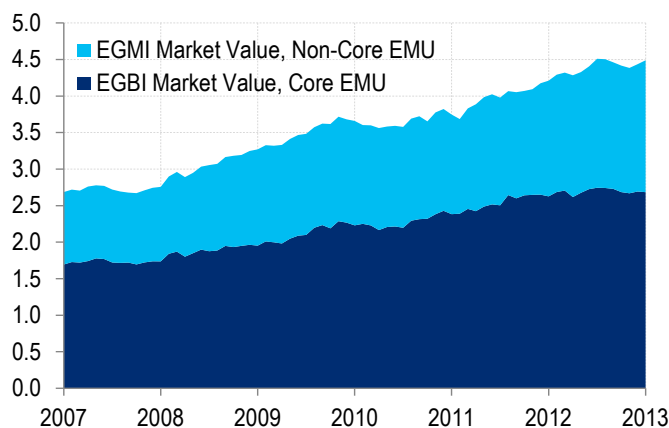
Source: Citi Research, DMOs, SSAs

Figure 2. Euro SSA market outstanding has surged....(€bn)



Source: Dealogic, Citi Research

Figure 3. ...while the government market has risen more steadily (€tn)



Source: Dealogic, Citi Research

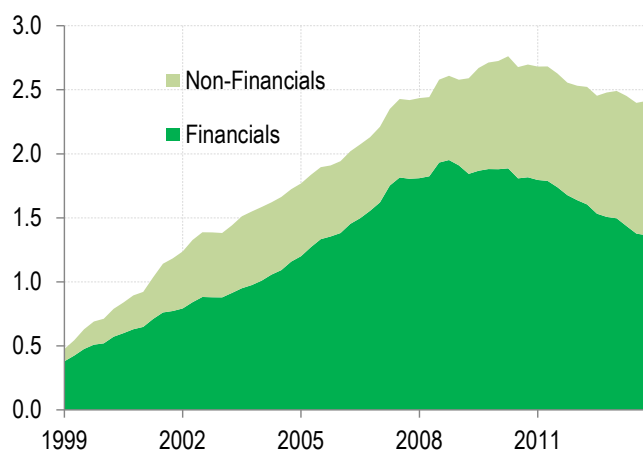
The benchmark covered bond market is shrinking

Meanwhile, the growth of corporate and financial debt markets has lost momentum or already started shrinking. This can be found in the unsecured financial and non-financial market (Figure 4). Similarly, certain covered bond markets have been shrinking for a while or have just been starting to lose volume (Figure 5). The failure of issuance – especially in the traditional European covered bond markets – to offset redemptions is only partly compensated by an increasing share of covered bonds from non-European segments.

Same symptoms, different reasons

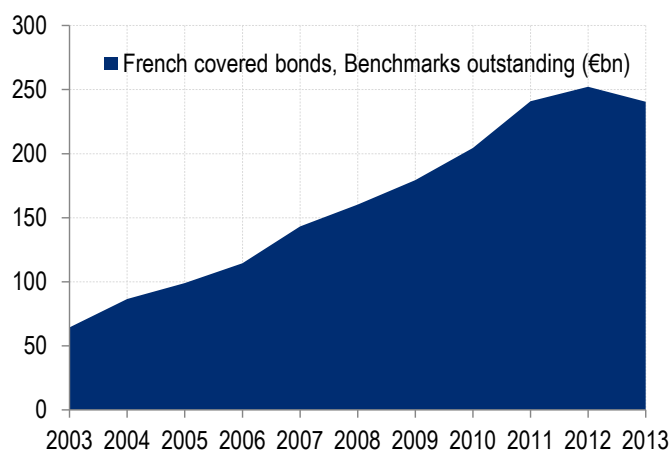
Two examples of shrinking markets within the covered bond space are the German pfandbrief and French covered bonds. The former has been shrinking for more than ten years. This is due mainly to idiosyncratic factors, i.e. the substantial decrease in public sector funding and the changes of the eligibility criteria at the beginning of this century. Hence, recent developments are not the main reasons for a shrinking segment, which are instead structural in nature. This doesn't hold for the French covered bond market, which will see its first net negative supply in 2013, and we expect this to be repeated in 2014. The main drivers are deleveraging banks in general, a decrease in gross residential mortgage lending and public sector lending but also extraordinary measures by central banks.

Figure 4. Unsecured corporate market is shrinking...(€tn)



Source: Citi Research

Figure 5. ...as is the covered bond universe in specific countries



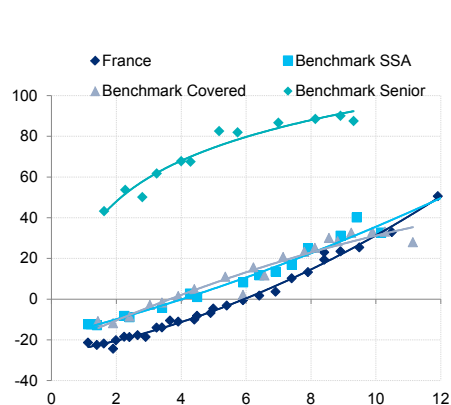
Source: Citi Research; Bloomberg, French EUR benchmark covered bonds, €bn

Market implications – net negative issuance of covered bonds

Net shrinkage is just one spread driver

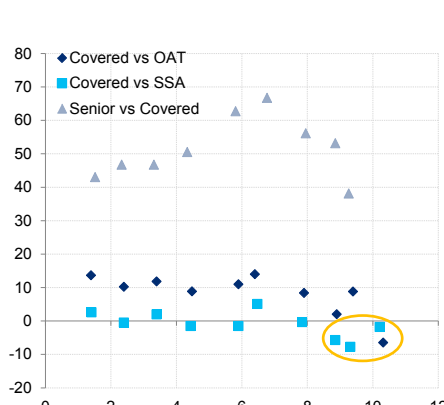
SSA debt performance is generally linked to the standing (and perception of) the guarantor(s). As SSAs tend to be government guaranteed, it would be unusual for SSA bonds trade inside the guaranteeing sovereign's curve. We do not expect this to happen. Even explicitly guaranteed paper should trade with a spread to governments (even if this is in the single digits), given liquidity premiums inter alia. We labour this point, of course, because this is not the case for covered bonds. Various markets have now proven that under specific circumstances secured paper can trade richer than sovereign debt and hence SSA debt. So far, however, this pattern has been most pronounced in the periphery (Figure 6, Figure 7, Figure 8)

Figure 6. ASW curves, France, bp



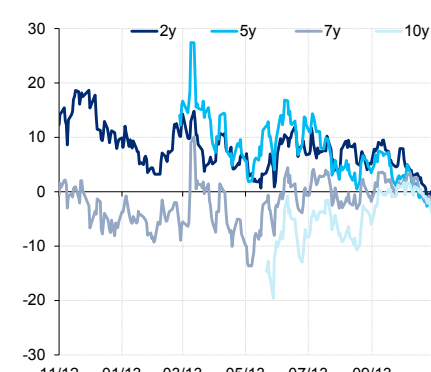
Source: Citi Research

Figure 7. Yield spread, France, bp



Source: Citi Research

Figure 8. Yield spread Covered vs SSA, France, bp

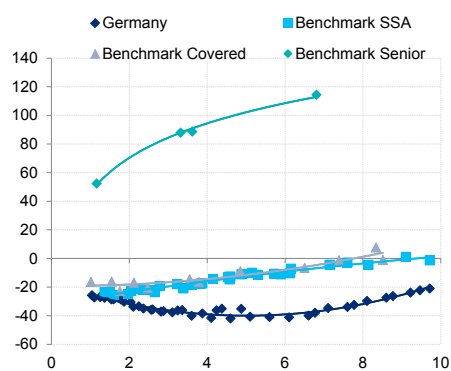


Source: Citi Research; benchmark issuers used

But credit quality and the 'collateralized hedge' are further reasons

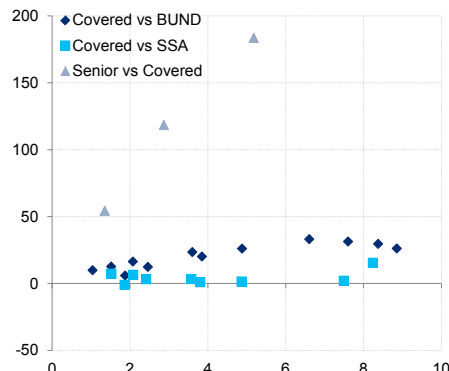
In our opinion, this pattern will continue during 2014. However, we do not think that the market will move back to all-time lows in covered vs govie spreads as recorded in 2013 in the peripheral countries. The main reason for this is the slow but existing recovery of the sovereign debt markets in these countries which might also be accompanied by positive rating developments (which is already happening, page 19). A different path might be found in France where the covered bond market is not only expected to shrink but also where we see rating pressure clearly remaining (S&P downgraded France to AA+ in November and Moody's maintains a negative outlook). However, we think the market reaction to most EMU downgrades should be generally limited. Therefore, we think that French covered bonds will grind even tighter vs sovereign and SSA debt.

Figure 9. ASW curves, Germany, bp



Source: Citi Research

Figure 10. Yield spread, Germany, bp



Source: Citi Research

Figure 11. German Covered vs Bunds (bp)



Source: Citi Research; benchmark issuers used

This is why we believe that pfandbriefe tend not to price richer than Bunds

The German market impressively illustrates that covered bonds do not always trade richer than government debt due simply to negative supply dynamics. Although pfandbriefe currently trade at very rich levels vs agency debt and sovereign debt, we do not expect German covered bonds to trade richer than the underlying sovereign paper. Hence, spreads between both asset classes are much more a function of credit quality, rating differentials and demand dynamics.

The biggest tectonic shift has already happened but will likely continue

Conclusion: tectonic shifts have already occurred but can continue

SSA markets have seen elevated levels of supply recently, especially in supras. For next year, we expect supply be similar to that of 2013 (page 13). The covered bond market has seen a decline in benchmark issuance from the highest levels in 2011. Next year we expect supply to stabilise at slightly higher levels than in 2013. Hence, the tectonic shift from higher leverage of the public sector and a shrinking market of financial debt might have already started to take place over the last two years – with growing SSA and government debt markets vs declines in some private sector debt markets such as covered bonds.

We think that this dynamic can probably continue for now. With respect to relative value between the asset classes, changing supply dynamics point to continued good performance of some covereds relative to some SSAs. However, we also note regulatory demand for both assets classes is also a general spread positive and this is where our attention now turns.

2) Regulatory themes in 2014

2014 will be another year of important regulatory decisions

2013 has been an interesting year in terms of regulatory decisions. Amongst other things, developments include:

- the proposal of a European-wide single resolution regime
- refinements to the introduction of Solvency II
- further developments on a more specific definition of the LCR
- changes to the repo operational framework of the ECB

2014 will be a year of further decision making and investors have to incorporate a library of acronyms and regulatory terminology increasingly to navigate the investment landscape. In the following, we summarize which topics are likely to re-surface in 2014. More information on regulatory themes can be found in our last two SSA and covered bond monthly publications ([Euro SSA and Covered Bond Monthly - EBA & HQLA](#), [ECB & AQR: Acronyms to look out for in 2014](#)).

Liquidity Coverage Ratio

Final definition on LCR

In October this year, the EBA published preliminary results regarding the liquidity of different asset classes. The results showed that covered bonds would effectively be as liquid as government bonds. Hence an equal treatment could have been the conclusion. However, the EBA recommended the European Commission treat covered bonds as Level 2A assets as proposed under Basel III, according to the Danish government. Some questions clearly remain regarding precisely where covered bonds will finally end up. For one, will there be an exclusion of covered bonds rated worse than AA-? Will there be a harmonized treatment of covered bonds or should differentiation with respect to market volume, disclosure or geography be implemented? A legal implementation should be expected until June 2014. We think that there is still a good chance that European politics do not follow EBA recommendations and define covered bonds as Level 1 assets.

Risk weights and the Capital Requirement Regulation

Checking the risk weights

As of January 2014, risk weights for covered bonds will be directly derived from the security's rating. Before, weights were linked to the rating of the sovereign or the issuing bank. Again, risk weights differ as a function of external credit assessments. As this may have unintended repercussions, it is once more in the hands of the EBA to examine if changes might have to be made to decrease potential distortions to financial markets. This will likely be a crucial topic during 2014. With this comes the additional investigation as to whether transparency requirements set within CRR are enough and which specific effects they may have on the market. Moreover, one topic will be whether aircraft loans should be treated equally to other eligible loans for covered bonds within CRR. As transparency requirements have to be fulfilled as of January 2014, the ECBC label initiative changed its requirements for banks to receive a label and amend transparency needs to CRR premises.

Asset encumbrance

Further developments with respect to asset encumbrance

As if this wasn't enough, the EBA will also monitor the developments with respect to asset encumbrance in 2014. Asset encumbrance is not a direct issue for covered bondholders per se. However, the structural subordination of other creditors might lead to consequences for asset encumbering securities like covered bonds. We do not expect issuance limits for covered bonds. However, we might see amendments to covered bond laws which grant covered bondholders a substantial claim on the

bank's assets. This is especially the case under the Spanish covered bond law. Hence, we would not be surprised to see changes to the covered bond framework or a preference for an already existing covered bond law by issuers which would decrease the structural subordination of "un-covered" creditors (we think about the use of bonos de hipotecarias). This might eventually lead to a complete overhaul of covered bond laws and a start of further harmonization.

ECB monetary policy

Might there be changes to ECB's collateral framework?

We expect there will be additional unconventional monetary measures in 2014 (*Global Economic Outlook and Strategy - Prospects for Economies and Financial Markets in 2014 and Beyond*). This might include negative deposit rates as well as a further LTRO. In another scenario, we do not preclude changes in the central bank's collateral framework. This might imply changes to haircuts on covered bonds.

ECB's Asset Quality Review

AQR will be a topic that permanently escorts market participants in 2014

The first details on the Asset Quality Review carried out by ECB will probably be published until the end of the first quarter 2014 (*Euro Rates Strategy - ECB's Comprehensive Assessment & EMU fixed income markets*). The AQR should be completed until the end of October 2014. We think that this measure will have the potential to affect markets during 2014. It has to be seen how various banks can generate more capital regarding the AQR. It remains to be seen how national actions like the treatment of DTA in Spain or the revaluation of Bank of Italy's shares held by domestic banks are interpreted by market participants (also see *Spanish Banks - DTA Forbearance Officially Passed – SAB, CABK Benefit Most on Our Estimates*).

Conclusion – regulatory terminology on the increase

Investors in SSA debt and covered bonds face an evolving regulatory environment, and one in which the importance of keeping abreast of new terminology and definitions is paramount. We have outlined the broad approaches of CRD IV and Solvency and how agency, supranational and covered bonds are treated. This largely depends on the nature of the guarantee (in the case of SSAs) and intrinsic asset and legal characteristics (in the case of covered bonds).

In general, the regulatory treatment is supportive for investors focused on high-quality assets. Relative to other credit markets such as corporate bonds, senior unsecured debt and securitizations, we believe there are supportive regulatory characteristics for covered bonds and SSAs. However, the final treatment of such assets is still evolving – especially for covered bonds.

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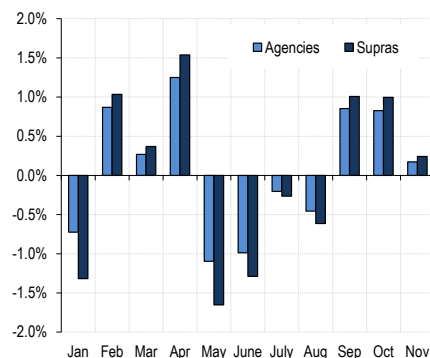
Euro SSA Strategy

(1) 2014 Market Outlook and Trades Ideas

The outlook in brief: Both agency and supranational bonds have yielded positive returns so far in 2013 (1.94% and 0.54%, respectively, based on € iBoxx total return indices, YTD Figure 12). One clear characteristic of the market remains its resilience amid an environment of elevated supply. This dynamic should not be underestimated and underlines a strong technical backdrop which we think will also be prominent in 2014. We expect a similar (and historically) elevated level of supply next year: for example euro supra supply was around €103bn in 2013 and we expect €95bn in 2014 from the main issuers (page 13). We also expect new entrants in 2014, this time from the agency sector rather than the supra sector (page 18). In terms of performance spreads have generally tightened vs swaps (year-to-date performance is shown in Figure 13). In short, we expect a range-bound spread market in 2014 highlighting the importance of relative value considerations and the strong (regulatory) demand for high-quality assets. Our core trading strategies would be to add on weakness and to move up in quality when yields compress.

New entrants: Another prominent theme of the SSA market is the continued evolution of new entrants. 2013 saw the emergence of Deutschland bonds, euro green bonds and the ESM. In 2014, we expect further development of such markets as well as new issuance from the French and UK agency market (municipal finance) and from the Dutch agency sector (in the housing market; more details on page 18).

Figure 12. Monthly Total Returns of € iBoxx Agency and Supra indices (%)



Source: Citi Research

The downgrades of France and the Netherlands by S&P mean there is now a rating differential between some EMU sovereigns and some core SSAs

Figure 13. SSA yield and ASW changes year-to-date

Issuer	SSA bond	Maturity	Level (%)	Change (bp) since 02 Jan 13	Level (bp)	Change (bp) since 02 Jan 13
				Yield		Spreads to Swaps
EIB	EIB 4.125 Apr 24s	15-Apr-24	2.24	14	19	-11
EFSF	EFSF 2.25 Sep 22s	05-Sep-22	1.98	8	16	-13
EU	EU 2.75 Apr 22s	04-Apr-22	1.79	14	4	-6
KFW	KFW 4.625 Jan 23s	04-Jan-23	1.81	14	-7	-8
RENTEN	RENTEN 2.875 Aug 21s	30-Aug-21	1.55	10	-9	-8
CADES	CADES 4.125 Apr 23s	25-Apr-23	2.20	-1	28	-24
BNG	BNG 3.875 May 23s	26-May-23	2.14	10	20	-13
iBoxx Index	€ iBoxx Agencies		1.54	2	36	-21
iBoxx Index	€ iBoxx Supranationals		1.90	19	23	-8

Source: Citi Research *10yr sector or near enough to ensure bonds with a complete history since January 2013.

Two themes for next year – what to do

Move up in quality: If there are two overriding strategic themes we see for 2014, one is the idea of 'moving up in quality'. This has become all the more apparent given the recent downgrades of various sovereigns such as France and the Netherlands. Liquidity, supply and broader technicals will continue to play their part in driving spreads and must be respected in terms of the ability to execute trades when moving out of EMU sovereigns and into SSAs. However, we would prioritise the monitoring and analysis of such yield differentials when there are positive spread pick-ups out of lower-rated sovereigns into higher-rated SSAs throughout 2014.

Buy on weakness: Given our base case for a largely range-bound spread market, with supply influencing many market moves and relative performance among issuers, another core strategy we recommend is to buy on weakness. We see little reason for a fundamental re-pricing of core SSAs and, should spreads widen on supply or further sovereign downgrades, then this is likely to represent a buying opportunity in related SSAs, in our view.

Credit markets will be focused on Fed tapering; SSA spreads will likely be a passenger within the prevailing market trend

Monetary policy to support spread products

Credit markets in general have become susceptible to the withdrawal – or more accurately, the *expectation* of withdrawal – of central bank liquidity. Citi's base case is for tapering to be announced in March and for the Fed's balance sheet to peak next September (*Global Economic Outlook and Strategy - Prospects for Economies and Financial Markets in 2014 and Beyond*).

In Europe, the ECB will probably loosen further

While the tapering event is likely to put upward pressure on credit spreads in general (both in the US and Europe), note that in Europe, we expect further loosening of monetary policy. This should generally spur European fixed income outperformance, including the SSA sector. To be clear, Citi economists expect the ECB to cut its key interest rates in H1-2014 and introduce additional non-standard measures, as detailed in the latest *Global Economic Outlook and Strategy*.

Furthermore, various indicators are pointing to historically low levels of systemic risk. This can be seen from Citi's GRAMI index (Figure 14). This is important because it was precisely such elevated levels of systemic risk back in 2011 (and consequent rise in risk of sovereign downgrades) that precipitated significant spread widening in some SSAs. Our key message is that, although bouts of event risk may widen spreads, we do not expect a structural re-pricing or significant fundamentally inspired SSA spread widening. This is largely based on the following three drivers:

- Accommodative central bank policy in Europe
- Relatively low levels of systemic risk
- Growing (regulatory) demand to hold high-quality assets

Note also, that more and more EMU sovereigns are being put back on stable outlook by the rating agencies (such as Spain by S&P on Friday 29th November). In turn, this should deliver stability in agency and supra ratings (see page 19).

The relative value to watch out for

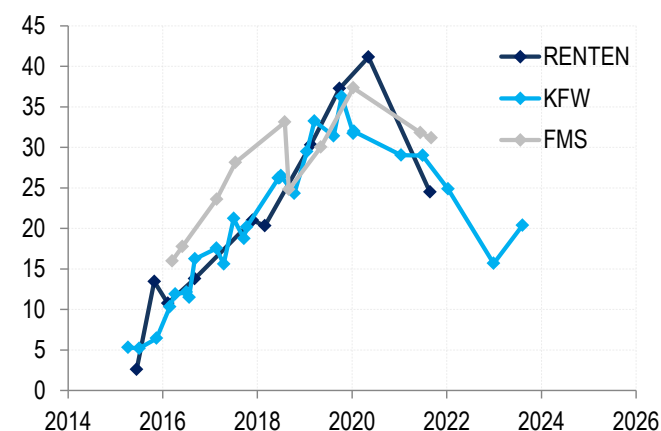
Range-bound spreads: Our base case therefore is for spreads to be relatively low and range-bound in 2014, indicating the importance of relative value analysis as a means to enhance returns in an otherwise low-yield environment.

Figure 14. Citi's Global Risk Aversion Index



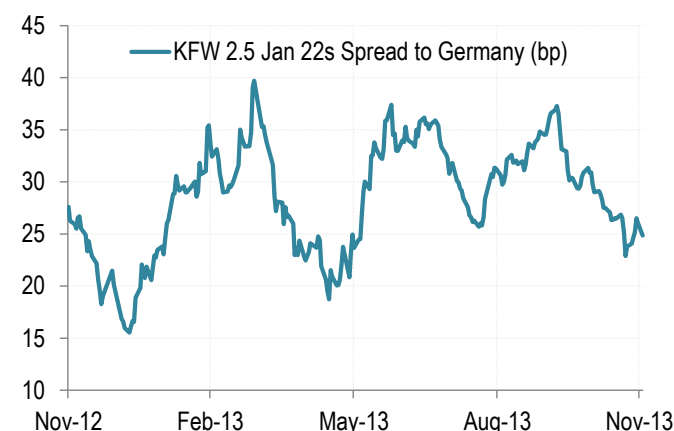
Source: Citi Research, Bloomberg

Figure 15. German agency spreads to Germany (bp)



Source: Citi Research

Figure 16. 8yr KfW spreads to Germany - a classic SSA range (bp)



Source: Citi Research

Watch spreads between agencies and their respective sovereigns

KfW vs Germany: Clear evidence of the range-trading theme can be seen in the classic spread between German agencies and Bunds. Core agencies include KfW and RENTEN which both benefit from an explicit German government guarantee (as of Jan 2014 when the RENTEN guarantee becomes effective). They also benefit from the German Anstaltslast provision. FMS will also be explicitly guaranteed by SoFFin next year too. As such, we expect little differential in secondary market spreads among such issuers. German agencies currently offer around 30bp-35bp in spread pick-up to the sovereign curve in the 8yr sector (depending on the sector and agency, Figure 15). Given any weakening in the strong connection to the German state next year is very unlikely, we do not expect any fundamentally inspired spread widening. We would continue to see supply and flight-to-quality induced rallies in Bunds as key drivers of these spreads – which should attract buying interest should levels of around 40bp-45bp to Bunds materialise (depending on the sector, Figure 16). Given current pricing, we would wait for better entry levels for this RV consideration.

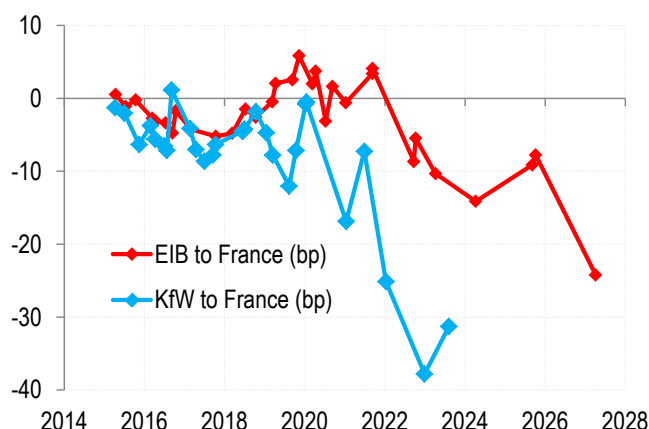
A step-up-in-quality idea.... SSAs vs EMU

KfW and EIB vs France: France was downgraded for a second time by S&P in November 2013 to AA (the first downgrade was in January 2012). EIB, on the other hand, maintains its AAA rating and has recently had its outlook revised by S&P to stable following a €10bn capital increase. As such, the rating differential between SSAs such as KfW and EIB versus France is now two notches (S&P ratings). We therefore believe monitoring the relative value between such entities will continue to be a popular trading strategy in 2014. The spread curves to France for KfW and France are shown in Figure 17. Recent history provides evidence that spreads are seldom positive for very long (ie the ability to move out of France and into KfW at a spread pickup, Figure 18). Isolating relative value considerations on the curve, we would note that such trades have typically been achievable in the following:

■ **3yr-5yr KfW-France sector**

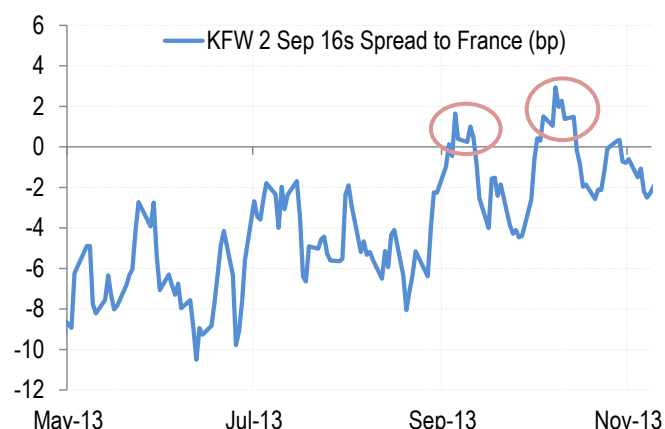
■ **7yr-9yr EIB-France sector**

Figure 17. EIB and KfW to maturity matched OAT bonds (bp)



Source: Citi Research

Figure 18. KfW 16s to France (spread, bp)



Source: Citi Research

Dutch and French agencies: A similar theme is possible for Dutch agencies and trading BNG and NEDWBK vs OAT is also likely to remain popular (*Euro SSA and Covered Bond Monthly*, p11). In general, we see the Dutch and French agencies as key providers of liquidity and additional spread to German and Austrian agencies, noting of course their rating differentials (Dutch agency ratings now normalised to the Netherlands by S&P). We tend to favour Dutch agencies in the belly of the curve vs OATs – again, expecting spreads to be largely range-bound in 2014.

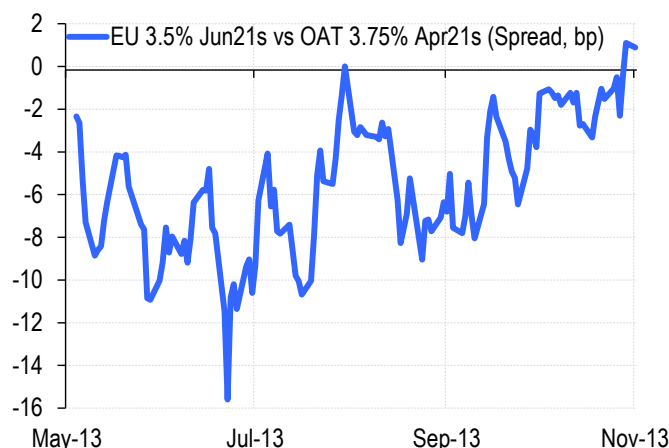
The return of the EU – buy in primary

The EU returns in 2014

Primary market: After a drought of supply in 2013, the EU is scheduled to return to the market next year. It has indicated a preliminary issuance calendar of €2.6bn in Q1 2014 and €2.1bn in Q2 2014. Although the EU will be an issuer for many years (given the need to refi existing debt issued to assist EU sovereigns, see page 14), the relative scarcity of its bonds means that opportunities are perhaps best sought in the primary market. For those interested in secondary market value however, we would point out the following:

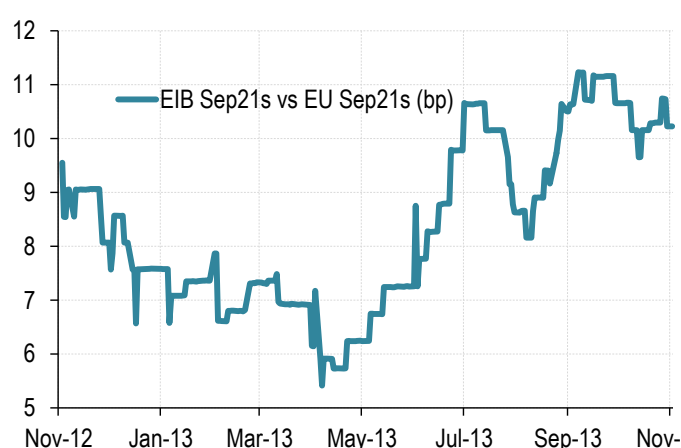
RV vs France: The 'supra vs France theme' also holds true for EU, albeit bond liquidity in EU debt is probably a factor in secondary market dynamics. At present, it is currently possible to switch at a flat spread out of France (AA, Aa1) into EU (AAA/Aaa) in the 7yr sector (Figure 19).

Figure 19. EU vs France (Spread, bp)



Source: Citi Research

Figure 20. EIB vs EU (Spread, bp)....we wouldn't fade the move

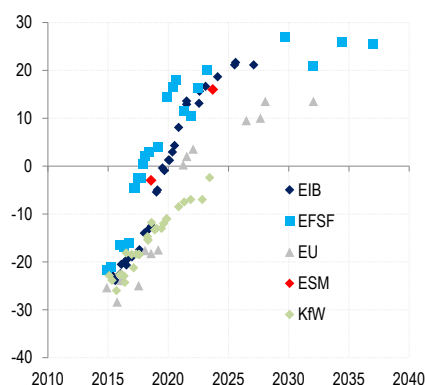


Source: Citi Research

We continue to expect EU bonds to trade tight to EIB's curve

RV vs EIB: One theme that has worked quite well in 2013, and one that we recommended last year, was to be long EU relative to EIB, primarily on the differing supply profile. One example is in the belly of the curve, where spreads have doubled from the tightness seen in April 2013 (Figure 20). Given various fundamental (EU has much less debt) and technical factors (EIB's higher supply profile) we would not fade this move. In 2014, we would continue to look for opportunities to be long EU vs EIB as and when spreads (and liquidity) permit.

Figure 21. Core SSA ASW Curves (bp)



Source: Citi Research

The establishment of the ESM

The ESM will further establish itself in 2014 with a provisional issuance target of €17bn. The paid-in capital – €80bn following delivery of the final tranche in April 2014 – enables the ESM to trade near to EIB's curve. In some ways, there are arguments to suggest the ESM is more akin to EIB given its capital structure (*The EFSF and ESM in 2013*). Note that EIB has a longer and more established presence and asset quality that reflects EU project finance rather than assistance to distressed sovereigns. Although ESM bonds have traded slightly inside EIB bonds in some cases, such factors may limit the extent to which this can persist in 2014.

Conclusion – range-bound spreads, hunt for RV

In brief, we expect core SSA spreads to be largely range-bound in 2014, with macro factors, such as central bank policy, and supply (see overleaf) governing trends. This places renewed importance on relative value considerations and primary market opportunities, in our view.

(2) 2014 Supply Outlook – similar to 2013?

Issuance likely to be of similar levels seen in 2013

It's been another year in which the SSA market has grown – both in terms of gross supply, but also in the proliferation of issuers (2013 entrants include Deutschland bonds and the ESM). As ever, SSA supply forecasting depends greatly on universe definitions and whether all issuance is included – benchmark and non-benchmark. Overall, we expect euro-denominated supply in 2014 of €95.5bn by the main supras which is similar to the €103bn issued this year. Euro agency supply was over €80bn in 2013 and we expect a similar amount of gross issuance in 2014. SSA redemptions remain generally high next year too.

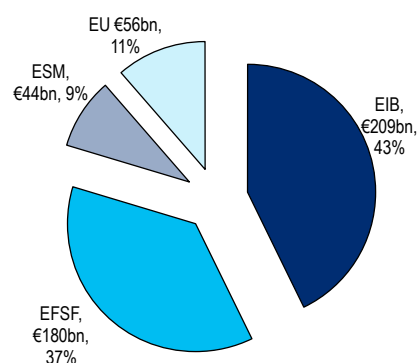
Supras – supply to remain at elevated levels in 2014

Gross supra issuance across all currencies is around €160bn in 2013; the euro portion of this – around €103bn – has grown significantly over recent years. The main driver behind the surge in supply has been the growth in bailout facilities in Europe. It is a fact that when detailing the euro-denominated market structure, the EFSF is now nearly as large (in terms of euro debt outstanding) as EIB – and the EFSF was the largest euro supra issuer this year (Figure 22).

We expect a similar volume of euro issuance in 2014 (Figure 23). The EFSF and ESM have already factually detailed a preliminary funding programme of €34bn and €14bn for next year to fund their various assistance programmes. The EU has indicated €4.7bn next year and has €3bn of redemptions. We assume a similar level of euro supply from the EIB as in 2013. This would entail total euro supranational supply by these issuers of around €95.5bn. In terms of redemptions next year, euro-denominated debt maturing by these supras totals €56.5bn (Figure 24).

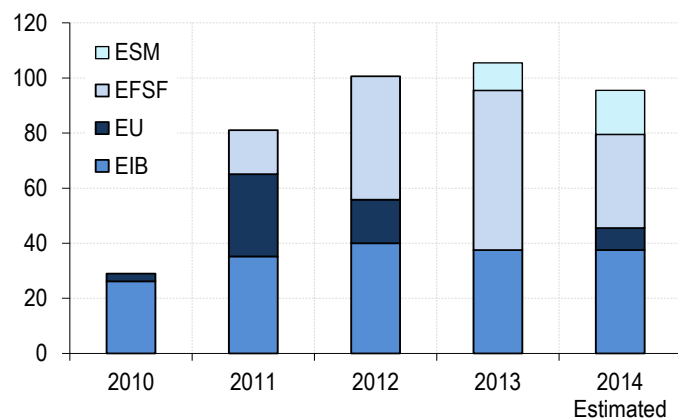
Another reason why EIB's issuance levels may remain at recent levels relates to its €10bn increase in paid-in capital (the key reason why S&P revised its outlook on EIB from “negative” to “stable”). This provides EIB with the opportunity to further its support to EU project finance, which in turn, may keep bond issuance at similar levels seen in recent years.

Figure 22. EUR Supra debt outstanding (€bn)



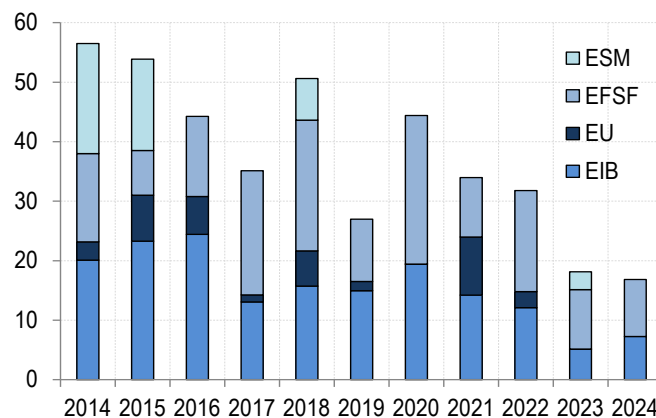
Source: Citi Research, Bloomberg

Figure 23. EUR supranational bond supply (€bn)



Source: EFSF, ESM, EIB, EU, Citi Research estimates

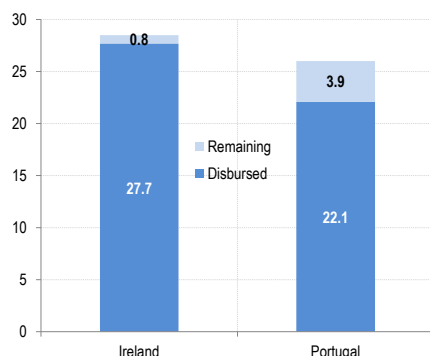
Figure 24. EUR supranational bond redemption profile (€bn)



Source: Citi Research, Bloomberg

In terms of the EU, the EFSM facility has disbursed €27.1bn to Ireland and €22.1bn to Portugal. It therefore has €4.7bn remaining to distribute (Figure 25). There are no new commitments foreseen for the remaining unused resources from the €60bn allowable maximum of the EFSM. However, of interest to note, loans made under the Troika programmes to Ireland and Portugal have had their maturities extended from around 12.5yrs to 19.5yrs. The bond market effect of this is essentially to keep

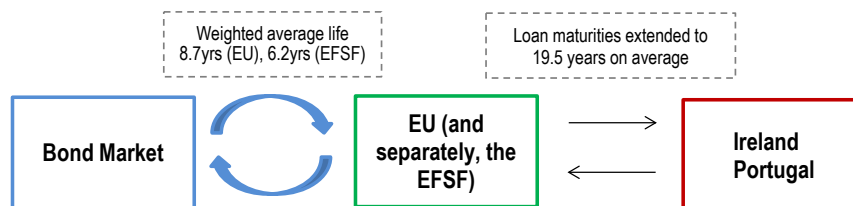
Figure 25. EFSM loan disbursements



Source: Citi Research, EU

the EU as an active issuer given the need to roll this debt until all loans are repaid (Figure 26). This dynamic has relevance for the EFSF, which will also remain an active issuer in the bond market until all its assistance funds are repaid by the sovereign borrowers. Given its debt outstanding and weighted average life, we look for around €30bn of issuance per year for the foreseeable future.

Figure 26. EU (and EFSF) bonds will continue to be rolled in the bond market until all assistance loans have been repaid by the sovereign borrowers.



Source: Citi Research

Agencies – need to support EMU recovery to remain firm

The euro agency sector is generally fragmented and diversified. Gross issuance projections therefore depend very much on universe definition. We tend to focus on the core EMU agencies that are large issuers within the euro market.

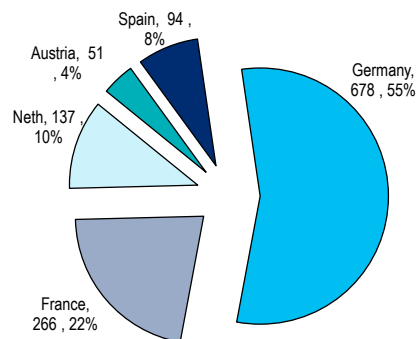
Unlike supranational issuance, euro supply by agencies is stabilising (see main article, p4). That said, issuance levels remain at historically elevated levels given the important contribution development banks can make in supporting the euro area recovery. At present, most agencies have not indicated their 2014 supply programmes (which typically get announced later in December and January).

FMSWER has the largest amount of absolute EUR redemptions in 2014

And the agency with the largest amount of EUR redemptions is...

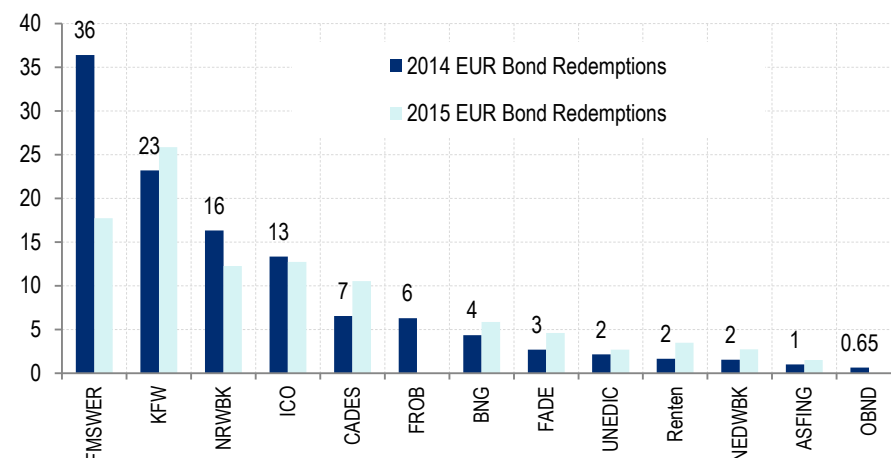
2014 redemptions: Total redemptions for key agencies remain relatively high in 2014, with FMSWER having the highest amount of maturing debt next year (Figure 28). Aggregating across such agencies, total euro denominated supply in 2013 was around €81bn. We expect a similar level in 2014, although it is more likely that issuance will be slightly higher than in 2013 rather than lower.

Figure 27. Key European Agencies, Debt Outstanding (all currencies, in €bn)



Source: Citi Research, Bloomberg

Figure 28. EUR bond redemptions (€bn)



Source: Citi Research, Bloomberg DDIS

German agencies

Overview: The German agency remains the largest agency market in Europe, with around €680bn in bond debt outstanding across all currencies. In general, there are three broad strands to the German agency market: German development banks, agencies associated with a particular Land and agencies established to wind down particular asset portfolios. As of January 2014, RENTEN will operate under an explicit guarantee from the German Republic and FMSWER will operate under a guarantee from Soffin. Further details on the German agency market can be found in our primer: [Overview and opportunities: German agency and covered bonds](#).

2014 KfW expected supply €65n-€70bn of which €30bn-€35bn likely in euros

2014 EUR redemptions €23bn

KfW: Kreditanstalt fuer Wiederaufbau is Germany's leading development bank founded in 1948. It is owned 80% by the Federal Republic and 20% by the Federal States and ever since 1998, it has benefited from an unconditional and explicit guarantee. KfW lowered its funding requirement from €70bn-€75bn to €65bn-€70bn due to high off-schedule loans back in July 2013. Total issuance this year amounts to €62.3bn (roughly half of which came in euros), with the 3yr USD supply in late October concluding the 2013 programme. KfW has indicated (15th August press release) that it is witnessing increased demand for its financing facilities (such as from SMEs and municipality infrastructure). *Ceteris paribus*, we expect a similar level of €65bn-€70bn from KfW next year, with euro supply around €30bn-€35bn.

2014 RENTEN expected supply €9bn-€10bn of which €3bn is expected in euros

2014 EUR redemptions €1.7bn

RENTEN: RENTEN is German's development bank for the agricultural sector found in 1949. An explicit guarantee from the Federal Republic of Germany comes into effect on 1st January 2014 for RENTEN bonds. As of 19th November, RENTEN indicated it had issued €9.7bn across all currencies (35% of which came in euros, down from 47% in 2012). Although our base case is for gross issuance to remain around €10bn next year, note that redemptions are €1.66bn in 2014. In addition, as S&P recently noted (29th November), RENTEN's balance sheet, at €81.6bn, is 11% smaller than in 2012 which also points to the likelihood that supply may be slightly lower in 2014 than in 2013.

2014 NRWKB expected supply €10bn-€11bn of which €5bn expected in euros

2014 EUR redemptions €16.3bn

NRWBK: NRW.Bank is the development bank of the State of North Rhine-Westphalia (explicitly guaranteed), supervised by Bundesbank and BaFin. Its private sector businesses focus on housing, developments & protection policies within the environment and education and SME promotion. It also operates within the public sector and cooperates with KfW and EIB. It is one of the largest development banks in Europe by total assets. Its funding programme for 2013 is €10bn-€11bn, of which €8.9bn has been issued. We expect a similar amount next year, of which €5bn can be expected in euros. NRWKB also recently issued its first "green bond" (€0.25bn in NRWKB 0.75% Nov17s) and has said further issuance can be expected going forward (see page 18).

2014 FMSWER expected supply €10bn-€15bn of which €5-€8bn expected in euros

2014 EUR redemptions €36bn

FMSWER: FMSWER is the public law vehicle originally established in July 2010 with the specific purpose of winding down the assets of Hypo Real Estate. In October 2010, €175.7bn of assets were transferred to FMS. It will operate under an explicit guarantee of SoFFin from 1st January 2014. We expect a funding programme akin to 2013. Total redemptions, although high compared with 2015, are €48bn (all currencies) which is similar to 2012 (€49.4bn).

French agencies

Overview: The French agency market is the second-largest agency market in Europe (after Germany). Like many SSA markets, the French agency sector is heterogeneous with issuance and debt stocks spread among many issuers varying in structure. Very broadly speaking, French agencies fulfil a public policy role or a role that is connected with the economic activity of France. Many operate within an

2014 CADES expected supply €20bn-€30bn of which €10-€15bn expected in euros

2014 EUR redemptions €6.5bn

established legal framework (*Etablissement Public*) which is a legal framework granting an explicit status within the French sovereign. Further details on the French agency sector can be found in our primer [Euro SSA and Covered Bond Monthly - French agencies and covered bonds in focus](#).

CADES: The key French agency is CADES which constitutes roughly half of all French agency debt outstanding and around 8% of all public French debt. The agency benefits from EPIC status and is responsible for amortising French social security debt. We expect funding to be around €20bn-€30bn in 2014 in line with previous trends. Its 2012 long-term funding programme was €20bn, at the lower end of recent gross issuance ranges: in 2012 medium term funding was €30.2bn and in 2011, it stood at €31.4bn. Total euro redemptions in 2014 are €6.5bn

Dutch agencies

Overview: Unlike the German and French agency markets, where there are many issuers operating under a variety of structures and mandates, the Dutch agency market is smaller and less diverse. There are two main issuers, BNG and NEDWBK, although the smaller NEDFIN has also been present in capital markets. We also think a new agency (NHI) may emerge in 2014 (see page 18). The Dutch agency market represents around €140bn in bond debt outstanding, 65% of which is BNG and 34% of which is NEDWBK. Total issuance has been around €30bn across the two issuers in recent years. Further details on the Dutch agency sector can be found in our primer [The Dutch and Austrian markets in focus](#).

2014 BNG and NEDWBK supply expected to be around €15bn and €10bn for each across all currencies

2014 EUR BNG and NEDWBK redemptions are €4.4bn and €1.56bn respectively

BNG and NEDWBK: BNG has issued around €15bn in recent years (€14.9bn in 2012 and its 2013 funding programme is €15bn). We expect a similar amount in 2014. NEDWBK is smaller both in terms of total assets and gross supply. For context, in 2012, NEDWBK raised €12bn in long-term funding across all currencies and €7.7bn in 2011. A base case issuance expectation for 2014 NEDWBK supply based on recent patterns and the small redemption (€1.56bn in 2014) is around €10bn. For both agencies, 40%-50% of total issuance is in euros (in 2012, note NEDWBK proportion of euro long-term funding was actually 60%).

Austrian agencies

Overview: The Austrian agency market includes OBND (€19.7bn in assets) and ASFING (€14.4bn in assets), both of which have explicit guarantees from the Republic of Austria. Total debt outstanding is around €51bn, making it smaller than the Dutch agency market. Issuance is much smaller by both agencies, typically around €1bn-€2bn a year. Further details on the Austrian agency sector can be found in our primer [Euro SSA and Covered Bond Monthly - The Dutch and Austrian markets in focus](#).

2014 BNG and NEDWBK supply expected to be €1bn-€2bn each (all currencies)

2014 EUR OBND and ASFING redemptions are €0.65bn and €1bn respectively

OBND and ASFING: OBND is the entity in charge of Austria's railway infrastructure and owned of virtually the entire Austrian railway network. In terms of funding, OBND issued €1.1bn in 2012 and has an annual refinancing plan of around €2bn across all instruments. It tends to issue one euro benchmark a year. ASFING is the state-owned company in charge of Austria's primary road network. Activities include managing tolls, as well as building and maintaining roads. ASFING issued €1bn in 2012 and had a funding need of €2bn in 2013. We expect a similar range in 2014. ASFING euro redemptions next year are €1bn.

Spanish agencies

Overview: The Spanish agency market represents around €94bn in bond debt outstanding. Although there are four agencies that have issued bonds over recent years, the market is dominated by the leading development agency, ICO (around two-thirds of all Spanish agency debt outstandings). The other agencies are FADE, FROB and CORES. Total bond supply across the Spanish agency market last year was €23bn: €17.4bn of which (75%) was issued by ICO. Further details on the Spanish agency sector can be found in our primer [Euro SSA and Covered Bond Monthly - The Iberian markets and the spread outlook](#).

2014 ICO supply expected to be around €10bn-€15bn, over half of which like to come in euros.

2014 euro ICO redemptions are €13bn

ICO: ICO was founded in 1971 as the entity to co-ordinate and control state-owned banks. Since the 1991 state banking reforms, ICO took on its current role as the state-owned bank providing loans (both directly to companies and second-floor facilities whereby funds are 'on-leant' to banks and saving banks) and the role of state finance agency. It is supervised as a credit institution by the Central Bank of Spain and has an explicit guarantee from Spain. A large part of ICO's economic activities is promoting SME finance which we expect to remain central in its lending functions. Total assets as of September 2013 were €102.6bn, down from €115.2bn in 2012. Issuance in 2013 is targeted at €11bn by ICO (reduced mid-year from an initial ICO estimate of €14bn). Based on recent trends and a euro redemption profile of €13bn, a base estimate for gross supply next year is in the order of €10bn-€15bn, over half of which is likely to come in euros.

Upcoming cash flows in Q1 2014

Redemptions in Q1 2014 from core SSAs in the euro market

We detail upcoming key euro fixed rate bond redemptions for Q1 2014 (Figure 29). All things being equal, large redemptions should be tactically supportive for the market. On the supra side, there are no euro fixed redemptions from the EU or ESM in Q1 2014. For agencies, there are no euro fixed redemptions from FMSWER, CADES, NEDWBK or OBND.

Figure 29. Key euro bond redemptions in Q1 2014 (€bn)

Redemptions = €47bn											
Redemptions	EIB 5	EFSF 15	KFW 5	RENTEN 2	NRWBK 4	UNEDIC 2	BNG 2	ASFING 1	ICO 6	FADE 3	FROB 3
(Fri) 10-Jan-14			0.1								
(Wed) 15-Jan-14	5.0				0.5						
(Mon) 20-Jan-14					0.5				2.7		
(Tue) 28-Jan-14			0.1								
(Fri) 31-Jan-14									0.5		
(Mon) 03-Feb-14					0.0				0.0		3.0
(Fri) 14-Feb-14							0.1				
(Tue) 25-Feb-14			5.0								
(Wed) 05-Mar-14							0.1				
(Mon) 10-Mar-14							0.5				
(Wed) 12-Mar-14		14.8		1.5							
(Fri) 14-Mar-14							1.3	1.0			
(Mon) 17-Mar-14										2.5	
(Tue) 18-Mar-14					2.0						
(Wed) 19-Mar-14					0.5						
(Thu) 20-Mar-14					0.1						
(Mon) 31-Mar-14						2.2			2.9		

Source: Citi Research, Bloomberg, Issuer information

(3) SSA market developments

The euro and sterling agency market continues to evolve

New entrants in the UK, Dutch and French agency sectors

We anticipate certain new entrants in the agency sector later in 2014, further diversifying the market especially in the area of municipal finance.

Agence France Locale

France – municipal finance: The establishment in October 2013 of 'Agence France Locale' with the aim of supporting local government finance in France may bring issuance later next year. The new agency is owned by the local authorities themselves. Its long-term ambition is to ultimately raise 25% of the annual flow of the local sector (around €4bn). This provides a new stream of funding for French local authorities and deepens this sector within the SSA market. We await further details regarding its funding plans and capital structure. We view this as another positive development within the French agency sector, deepening liquidity and broadening investment opportunities.

UK municipal bond agency

UK – municipal finance: The UK Local Government Association has provided a case to revive deepen local council access to capital markets via a bond agency, backed by the UK government and hence effectively lowering borrowing costs. This would be akin to frameworks established in the Scandi and Dutch sectors. On the 26th November, the LGA announced that preliminary plans were voted through following 18 councils' formal expression of interest in the notion of a new UK agency (the main one at present being UKRAIL). As Moody's comments (2nd December), local authorities in England and Wales would usually borrow £5bn for infrastructure projects in a typical year. We believe the expansion of financing options for local government and the delivery of further opportunities for investors is a market positive for the sterling SSA sector and for UK infrastructure projects more broadly.

New Dutch agency focused on the housing market

The Netherlands – housing market: The Dutch Ministry of Finance plans to introduce a new Dutch Agency (NHI, the Nederlandse Hypotheek Instelling) whose main responsibility will be the refinancing of specific loans that have been originated by Dutch banks and pension funds and transferred to the agency. There is no plan that the NHI acts as originator of loans itself. The entity will solely act as issuer of government guaranteed bonds. We understand that issuance should be expected rather for late 2014 allowing for further diversification amid the Dutch agency sector. Further details can be found in our note *"a new entity in the Dutch market"* 31st Oct.

Green shoots in euro green bonds

Healthy development of euro green bonds in 2013...

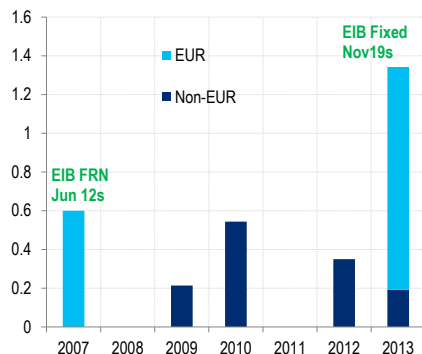
The SSA market also saw several green shoots in the euro green bond market in 2013 with issuance from EIB and NRKBK (Figure 30) and we think recent trends point to further issuance in 2014. Put simply, green bonds are bonds whose proceeds are channeled into an environmental cause typically associated with climate change projects, renewable energy and sustainability.

Growing number of euro issuers may continue to deepen the market next year

The euro market is still relatively small. EIB is the leading issuer under its Climate Awareness programme and serves as a sector proxy. In July 2013, EIB issued €0.65bn in a fixed rate Climate Awareness Bond (EIB 1.375% Nov19s) and it has since increased the amount outstanding to €1.15bn (Figure 31). Such issuance enables investors to contribute to projects associated with climate change whilst benefitting from the high credit quality and expertise of EIB. Specifically for EIB:

- Eligible projects include renewable energy (such as wind and solar power) and energy efficiency (such as building insulation)
- Use of proceeds are reported in financial statements

Figure 30. EIB CAB* Issuance (€bn)



Source: Citi Research, EIB, *Climate Awareness Bond

- Bonds are pari passu with other EIB bonds; investors in such green bonds aren't exposed to the specific project risk.

Figure 31. EUR Benchmark Green Bond Issuance this year

Date	Auction	Issuer	Coupon	Maturity	Amount	Outstanding	Bond info
11-Jul-13	new issue	EIB	1.375%	15-Nov-19	0.65	0.65	Climate Awareness Bond
03-Sep-13	tap	EIB	1.375%	15-Nov-19	0.25	0.9	Climate Awareness Bond
24-Oct-13	tap	EIB	1.375%	15-Nov-19	0.25	1.15	Climate Awareness Bond
21-Nov-13	new issue	NRWBK	0.75%	28-Nov-17	0.25	0.25	Sustainability Bond

Source: Citi Research, Bloomberg, EIB, NRWKB

However, more and more issuers have signaled interest. Note that Rentenbank issued a small €50mn placement (1.455% Aug20s) in August 2013 as a “renewable energy bond” and in November, NRW Bank (the state-owned German development bank) has issued €250mn in a sustainability bond (NRWBK 0.75% Nov17s). Total euro benchmark issuance is therefore around €1.4bn YTD for 2013. Furthermore, there is also nascent interest in green bond issuance from the wider corporate sector (so far, mostly in USD). Further details can be found in our piece [European Rates Weekly – Green shoots in € green bonds](#).

Fundamental outlook – rating stability

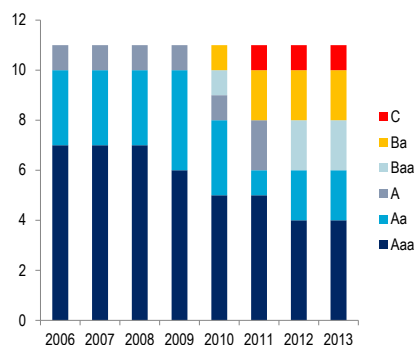
EMU ratings to be more stable – literally: As Moody's explicitly stated in its recent 2014 Outlook (25 November), “After several tumultuous years, global sovereign credit worthiness is likely to be comparatively stable in 2014”¹. In 2014, we expect the pace of rating changes to slow. There is already evidence of this from 2013 and note that more sovereigns have been placed back onto “stable” outlook by various rating agencies ([European Rates Weekly](#)). Most notably, Spain was recently returned to BBB- stable by S&P. As more and more sovereigns have a stable rating outlook, so too should the SSAs on which guarantees depend.

The rating distribution by Moody's of EMU-11 countries is the same in 2013 as it was in 2012 — following several downgrades in 2010-2012 (Figure 32). In fact, this year so far only saw 3 downgrades, all by S&P (Italy from BBB+ to BBB, France from AA+ to AA, and the Netherlands from AAA to AA+).

For the SSA universe, recent developments include:

- **S&P downgrade of France to AA:** France was downgraded by S&P from AA to AA+ stable on 8th November 2013. French agencies rated by S&P were subsequently normalized to AA Stable as was the EFSF ([Euro Rates Strategy](#)).
- **S&P downgrades the Netherlands to AA+ Stable:** The Netherlands was downgraded by S&P to AA+ Stable on 29th November. BNG and NEDWBK had their ratings revised by S&P on 3rd December. The market impact was muted.
- **S&P revises Spain's outlook to Stable:** S&P moved its BBB- rating of Spain to Stable on 29th November. Spanish agencies share the same S&P outlook as a result.

Figure 32. EMU-11* Rating Transitions (Count of sovereigns as rated by Moody's at the end of each year)



Sources: Citi Research, Moody's, Bloomberg
*Germany, France, Italy, Spain, Netherlands, Belgium, Austria, Finland, Ireland, Portugal, Greece

¹ Moody's Investor Service “2014 Outlook – Global Sovereigns” 25 November 2013.

Covered Bond Strategy

(1) Strategy views

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The information provided below should be seen as a weighting recommendation of covered bond segments in order to outperform the iBoxx covered bond index in the medium term. Moreover, we added country-specific recommendations.

Figure 33. Recommendation sheet

Covered Bond Segment	Portfolio recommendation	Changes	Environment	Country-specific recommendation
Australia	Neutral	⇒	Non-Euro diversification, strong banking system	Australian covered bonds performed well and look rich again
Austria	Overweight	⇒	Solid fiscal and economic situation, potential risks of AQR	Prefer covered bonds to RAGB and SSA; Prefer BACA to ERSTBK
Belgium	Neutral	⇒	Diversification, but rich versus other covered bond segments	Prefer covered bonds at the short-end and sovereign bonds at the longer end
Canada	Neutral	⇒	Highly rated, healthy sovereign, expensive at current stage	Inaugural issuances should be more attractive than current outstanding bonds
Denmark	Neutral	⇒	Weak property sector, strong sovereign	Prefer covered bonds to senior secured bonds
Finland	Overweight	⇒	Strong sovereign, high quality cover pools, latest cheapening vs peers	Prefer highest yielding name AKTIA
France	Neutral	⇒	Attractive demand-supply pattern, relatively high secondary market liquidity	Prefer CIFEUR over other issuers
Germany	Underweight	⇒	Safe haven bid, very attractive demand-supply pattern, trading very expensive	Prefer PBBGR and DEXGRP to most expensive names
Ireland	Overweight	⇒	Easing situation on property market and the economy, backdrops to be expected, potential risks of AQR	Prefer MACS vs PSACS; Outperformance potential vs sovereign limited
Italy	Overweight	⇒	Generally weak capitalised banks (potential risks of AQR), political support (CdP)	OBG look expensive to BTP at current stages
Netherlands	Neutral	⇒	Housing market about to stabilize, deteriorating macro outlook, attractive demand-supply pattern	Prefer SNS to other Dutch covered bond issuers
New Zealand	Neutral	⇒	Non-Euro diversification, elevated house prices	Covered bonds of NZL affiliates caught up and look expensive against Australian covered bonds
Norway	Neutral	⇒	Strong sovereign, decreasing new issuance pressure, political uncertainty	Prefer highest yielding name EIKBOL
Portugal	Overweight	⇒	Headline risk, contagion risk, relatively high quality cover pools	Prefer covered bonds being upgraded lately
Spain	Overweight	⇒	Weak housing market, very attractive demand-supply pattern	Prefer selected CEDGBP vs POPSM; Prefer covered bonds to senior bonds
Sweden	Neutral	⇒	Trading rich to historical levels, favourable demand-supply pattern	Prefer highest yielding name LANSBK
Switzerland	Underweight	⇒	Overheating property market, strong sovereign, very expensive	--
UK	Neutral	⇒	Non-Euro diversification, supportive demand-supply pattern, politically induced risks to the mortgage market	Prefer covered bonds to senior bonds

Source: Citi Research

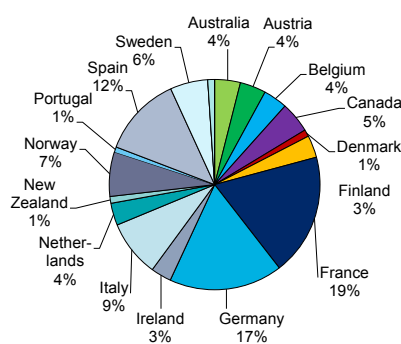
(2) 2014 Primary market outlook

€113bn of new issuance expected

View upfront: We expect EUR benchmark covered bond issuance in 2014 of around €113bn. Main factors will be the recovery of the European economy and the development of mortgage lending activity. Moreover, the senior market can continue to provide an attractive funding channel. Repayments under the established long-term refinancing operations and the option of another LTRO will be additional supply drivers. For the USD covered bond market, we expect more issuance than in 2013 given the finalized implementation of the Canadian covered bond law. For the GBP covered bond market we expect willingness to issue will remain limited given the extraordinary measures of BoE.

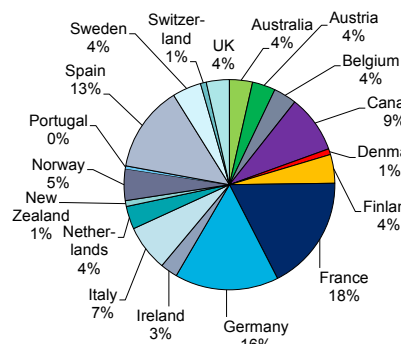
Supply and Redemption Analysis 2013 and 2014

Figure 34. EUR benchmark supply 2013, %



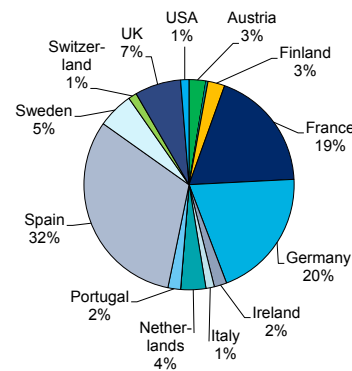
Source: Citi Research, as of 30/11/2013

Figure 35. EUR benchmark supply 2014E, %



Source: Citi Research

Figure 36. EUR benchmark redemptions 2014, %

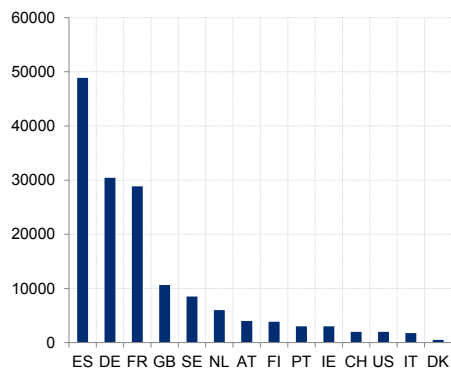


Source: Citi Research

Peripheral and Canadian issuers surprised positively in 2013 and will do so in 2014, we think

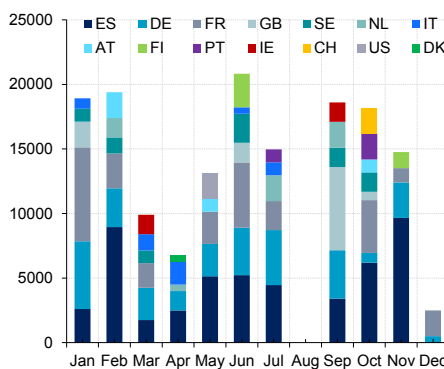
After more than €170bn of EUR Benchmark supply in 2010 and 2011, issuance dropped significantly in the following years, with €106bn in 2012 and ytd issuance of €95bn. French and German banks have been most active in the primary market this year. However, volumes have been rather small. A positive surprise is the comeback of peripheral covered bond issuers. Its relative share recovered substantially in 2013, at 25% after a decline from 24% to 14% between 2010 and 2012. Moreover, the comeback of Canada has had a positive impact on overall supply this year. Activity by UK banks has again been disappointing given the extraordinary measures (especially Funding for Lending Scheme) put in place by BoE.

Figure 37. EUR benchmark redemptions in 2014 by country, EURmn



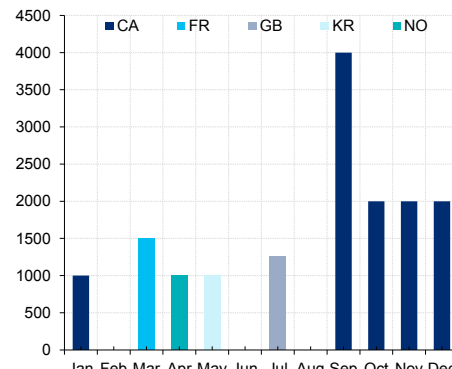
Source: Citi Research

Figure 38. EUR benchmark redemptions in 2014 by month, EURmn



Source: Citi Research

Figure 39. USD benchmark redemptions in 2014 by month, EURmn



Source: Citi Research

Redemptions of €155bn expected...

The covered bond market will again be characterized by record-high redemptions after more than €155bn in 2013. In 2014, the total amount of maturing EUR benchmark covered bonds will be €155bn. In USD, benchmark redemptions will total €16bn while no redemptions can be recorded for the GBP market. As has been the case in 2013 already, the biggest markets are those with the highest redemptions. In general, maturities are not heavily skewed to the first two months of the year but are more evenly distributed with peaks in January, February, June and September. In August, there are no redemptions at all. In the USD market, the overall amount is much smaller and skewed to the later months of the year.

...with a big share of it coming from Spain

As has already been the case in 2013, the German and the Spanish markets record the highest amounts of redemptions. However, in 2014, cédula redemptions will total €49bn, that is nearly one third of the whole covered bond market. This is followed by Germany where redemptions total €31bn and France with €29bn. In the UK, which hasn't seen any new issuance since February 2011, redemptions will total €11bn. There are some segments that will not record any redemptions of benchmark covered bonds in the coming year, among others Norway and the 'younger' segments Australia, Belgium, Canada and New Zealand. In the USD market, most redemptions will be recorded in Canada. The seasonal pattern of redemptions is very similar in the biggest EUR benchmark segments. Surprisingly, however, the redemption peak in Spain is found in November. In the case of Germany and France, the highest redemptions will be at the beginning of the year.

Figure 40. Supply forecasts and redemptions overview, EURbn

	Issuance 2013	Issuance 2014	Redemptions 2014	Net supply 2014
Australia	3.8	4.0	-	4.0
Austria	3.8	4.0	4.0	0.0
Belgium	3.5	4.0	-	4.0
Canada	4.5	10.0	-	10.0
Denmark	1.0	1.0	0.5	0.5
Finland	3.3	5.0	4.0	1.0
France	17.8	20.0	29.0	-9.0
Germany	16.6	18.0	31.0	-13.0
Ireland	3.0	3.0	3.0	0.0
Italy	8.3	8.0	2.0	6.0
Netherlands	3.3	4.0	6.0	-2.0
New Zealand	1.0	1.0	-	1.0
Norway	6.5	5.5	-	5.5
Portugal	0.8	0.5	3.0	-2.5
Spain	11.8	15.0	49.0	-34.0
Sweden	5.5	5.0	8.5	-3.5
Switzerland	0.0	1.0	2.0	-1.0
UK	1.0	4.0	11.0	-7.0
USA	0.0	0.0	2.0	-2.0
Total	95.2	113.0	155.0	-42.0

Source: Citi Research; Issuance 2013 up until 30/11/2013;

Market shrinkage should again be mostly pronounced in Spain and Germany

For 2014, we expect total EUR benchmark issuance of €113bn. The highest issuance volume should again be expected by France, Germany and Spain. The peripheral covered bond issuers should continue to play a rather important role and we think that their market share will remain stable in 2014 vs. 2013. Moreover, we expect the Canadian covered bond segment to play an even more important role. We expect slightly less supply coming from Norway and Sweden. In both countries,

national regulators are trying to make mortgage lending less attractive while at the same time the reliance on covered bond refinancing is seen as slightly less positive than in the past, especially in Norway. While New Zealand has become a further country that will issue covered bonds under a dedicated law, we don't expect a pick-up in supply. Taking our supply forecast and redemptions into account, we expect the market to shrink by €42bn in 2014. This should be mainly concentrated in Spain with market shrinkage of €34bn, followed by Germany (€13bn) and France (€9bn). For the non-Euro markets Australia, Canada and Norway we expect net positive supply in 2014.

Issuance forecast is mitigated by several factors

However, there are several factors that can result in lower or higher supply. In the following, we detail just a few of them:

Figure 41. LTRO Repayments until October 2013

ECB Repayment Analysis (EUR bn)															
Country	Nov-11			Dec-12					Change		Oct-13			Repayment	
	MRO	LTRO	DF	MRO	LTRO	DF	%EMU	3y	MRO	LTRO	MRO	LTRO	DF	EUR bn	%
Belgium	16	6	10	0	40	11	4%	36	-16	34	1075	14	2	26	70%
France	36	65	27	5	174	74	16%	158	-31	110	0	83	26	91	58%
Germany	4	18	58	3	70	40	6%	63	-1	52	0	9	12	61	96%
Greece	13	61	0	17	2	0	0%	2	5	-59	61	1	0	0	27%
Ireland	32	71	1	8	63	2	6%	57	-24	-8	5	35	1	28	48%
Italy	83	68	1	3	268	3	24%	243	-80	200	1	229	0	39	16%
Netherlands	63	94	169	7	140	158	12%	127	-55	46	4	70	93	4	3%
Portugal	12	34	1	4	49	4	4%	45	-8	15	6	44	2	5	11%
Spain	54	52	8	41	316	44	28%	287	-13	264	16	222	3	94	33%
Eurosystem	247	392	256	90	1036	262		1019	-158	643	91	653	51	382	38%
Core		151			291		26%	264		140		110		182	69%
Non-core		286			699		62%	634		413		532		167	26%
Total LTRO repayment (End October 2013)														357	35%

Source: ECB, Citi Research

Repayment speed of LTRO money

- Probed non-standard monetary operations by the ECB: The two outstanding LTROs by the ECB decreased the necessity for banks to refinance on the wholesale market. The repayment speed of LTRO money will be a key factor, especially for Southern European banks, which continue to hold most of the outstanding LTRO amount. This is especially the case for Italy, where banks still held €229bn in October 2013. In total, nearly 60% of LTRO money will still be held at the beginning of 2014. In general, banks from core-countries made use of LTRO to a much smaller extent than banks from non-core countries. A faster repayment speed should be a positive supply factor for 2014.

New LTRO expected

- Non-standard monetary operations in the future: a third LTRO? We think that a further fixed rate LTRO should be expected in the second half of 2014 but only for a one-year period, now that the ECB has announced that MROs will be conducted as fixed rate tender procedures with full allotment to at least 7 July 2015. This should have a lower impact on covered bond issuance than the 3y lasting first LTROs given the shorter expected maturity.

How attractive is the senior funding channel?

- The availability of senior funding: The spread compression during 2013 brought refinancing levels for senior bond issuance back to multi-year lows for many issuers. Although we don't see the near-term threat of issuance limits for covered bonds, the relative attractiveness for senior bond issuance has increased and should continue to be an important tool. This would imply that banks might decrease the use of secured funding.

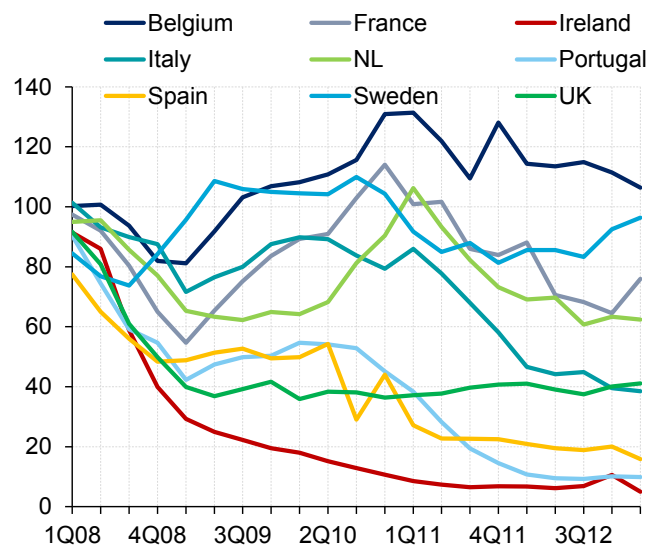
Will AQR affect refinancing levels?

- Asset quality review: At current stages, it is not clearly detailed what the Asset Quality Review (AQR) by the ECB will look like. This will go in hand with a stress test laid out by the European Banking Authority (EBA). As the ECB should take over supervision until November 2014, both steps need to be fulfilled before this date. If laid out rigorously – which will depend on the backstops implemented until then – the impact might be detrimental to funding levels of specific issuers – even for the secured funding channel.

Will SRM have an impact on funding distribution between sub/senior/covered?

- Single resolution mechanism: In 2013, European regulators agreed upon a common resolution mechanism for European banks. Although many questions remain, it has become quite clear that the risk of senior bail-in has increased. Hence, there might be a further concentration on covered bond issuance on the one hand and sub-debt as a 'bail-in buffer' on the other hand. The more details of SRM are published, the better one will be able to assess its impact on secured funding. A more rigorous configuration of SRM should have a slightly positive impact on covered bond issuance.

Figure 42. Gross residential mortgage lending, 2007=100



Source: EMF, Citi Research

Figure 43. Funding costs EUR vs USD



Source: Bloomberg, Citi Research

Will we see a rebound of mortgage lending activity?

- Mortgage lending activity: Over the last six years, gross residential mortgage lending activity decreased substantially, with only a few exceptions (e.g. Belgium and Germany). An economic recovery should be helpful in increasing lending to households. Note, however, that private non-financial sector debt remains high in a number of sectors and countries and continues to weigh on both willingness to lend and on credit demand. If mortgage lending picked up substantially covered bond funding might be supported. However, we don't think that this will happen.

How do the basis swaps develop?

- Basis swap: The development of the EUR basis swap with respect to USD, AUD, GBP, NOK and SEK will be detrimental for EUR benchmark covered bond issuance for entities from non-Euro countries, in our view. Over recent months, this has developed in favour of EUR issuance, especially versus USD. However, 2012 showed that unfavourable rates can be a detrimental factor when Swedish covered bond issuers avoided entering the EUR covered bond market and were active mostly in the domestic market.

**USD covered bond issuance of \$30bn
expected**

For the USD covered bond market, we expect an increase in issuance given the finalisation of the Canadian covered bond law and the usage of the USD market by Australian covered bond issuers. Year to date, issuance has totalled \$22bn which falls short of \$34bn in 2011 and \$39bn in 2012. We forecast USD covered bond issuance to total \$30bn in 2014, mainly from Canadian, Australian and Norwegian covered bond issuers. For the GBP market we expect substantially lower issuance compared to USD. However, after one year of lacking supply we would expect UK banks to come back in order to prepare for the end of FLS in January 2015. Hence, we forecast £5bn of sterling covered bond issuance by UK banks in 2014.

(3) 2014 Secondary market outlook & recommendations

Very low spreads and it can continue

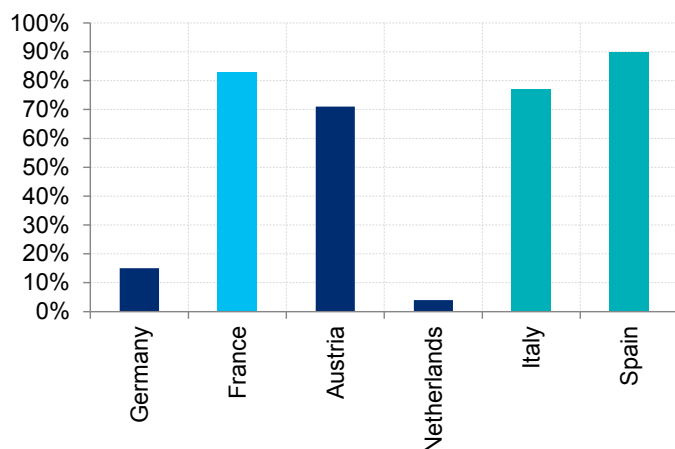
Summary: Spreads versus swaps reached a 5y-low in October of this year. The availability of covered bonds should decrease given our issuance forecast. This should be supportive for spreads vs swaps. High beta segments should profit most from it. Hence, we think that the compression trade will continue in 2014 although tightening potential has decreased substantially. Spreads versus sovereign bonds will mainly be a function of the economic recovery of European countries, rating actions and demand overhang in covered bond markets. In core covered bond segments, we continue to find most value in the 'fallen angels'. Apart from that, we think investors should increasingly try to chase value, not yields given the extremely low yield environment where investors are not properly compensated for taking risk.

Correlations to sovereign bonds and idiosyncratic factors

Correlations to sovereign remain high, ...

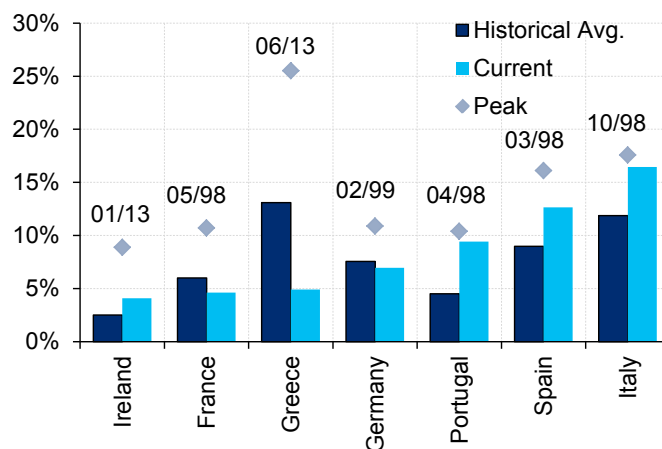
Covered bonds have mainly followed spread movements of sovereign debt in the past. This has especially been the case during times of financial turmoil. Hence, long-term correlations have remained very high in southern European countries with distressed sovereign debt markets. By looking at 1-year correlations, however, we can see that correlations between both asset classes can be very high even in semi-core and core countries.

Figure 44. 1y correlations between covered bonds and sovereign bonds



Source: Markit, Citi Research

Figure 45. Total exposure of MFIs to domestic general government as a % balance sheet



Source: Havers, ECB, Citi Research; Greek data starts of 01/01, rest from 01/98

...even in non-peripheral countries

For 2014, we forecast BTP and Bono spreads to Bunds to decrease steadily from currently 218bp to 175bp and from 244bp to 150bp. For OAT spreads, we generally expect range trading in 2014. In covered bonds, we think there's scope for the broad rally to continue with outperformance of the periphery vs core sectors such as France. However, as well as macro drivers supporting core fixed income paper in a 'lower for longer' scenario, covered bonds should also benefit from idiosyncratic factors.

Sluggish recovery = low recovery in lending = low need of secured funding

This should have several effects on the European covered bond market. On the one hand, we expect banks will continue to reduce balance sheets implying that funding needs will decrease. We suspect that this will be the case in most of the European banking systems. On the other hand, gross residential and commercial mortgage lending is not only at multi-year low levels in several countries but will probably stay

This is not a positive development for secondary market liquidity

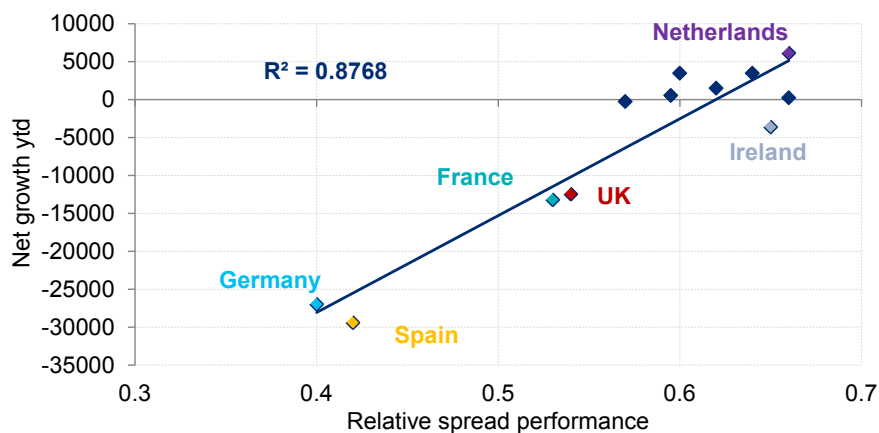
2013 showed that net shrinkage affects relative spread performance

there in the foreseeable future. Both findings imply that the need for secured refinancing will continue to be low in the longer term.

After decade-low net supply in 2013, we think another year of a shrinking covered bond market is lying ahead. Although this might hamper secondary market liquidity, it remains to be a supportive factor for secondary market levels. In the medium term spread compression can continue and lower levels can be reached, irrespective of implied risks within the different markets, in our view. However, we also think that the comprehensive asset quality review as well as the ECB stress test in 2014 has the potential to negatively affect covered bond markets. Hence, the next months should provide further opportunities to hunt for yield. The longer this lasts, the more we believe the investors should try to hunt for value than for yield.

2013 impressively showed that net supply is a main indicator of relative spread performance. Net supply is, of course, not the main determinant of absolute spread development. This has rather been driven by the ramifications of Draghi's extraordinary measures and their consequences for the European sovereign market. Moreover, recent data showed that Europe's economy has started to recover. Hence, investors have become willing to take more risk, which has led to spread compression within the sovereign and the covered bond market. That said, net (negative) growth of specific covered bond segments can give a clear explanation of relative spread performance.

Figure 46. Coherence between net growth and relative spread performance



Source: Citi Research; Relative spread performance = current spread / spread at the beginning of the year; net growth in EURmn

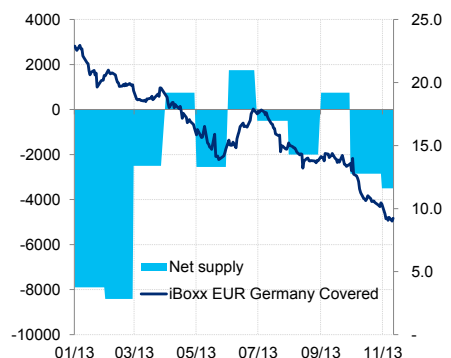
Coherence between net growth and relative spread performance is high

However, absolute spread movements don't follow net supply

For this, we calculated ytd net issuance for the specific segments. Note that year to date, market shrinkage is apparent for six segments. Although this might sound negligible within the 20 segments where EUR benchmark covered bonds are outstanding, it's among others the biggest and most mature markets – Germany, France, Ireland, Spain and UK – that are responsible for a total shrinkage of nearly €60bn ytd. Moreover, we looked at relative spread performance of iBoxx covered bond indices since the start of 2013. The result gives a very clear picture (R^2 of 0.88).

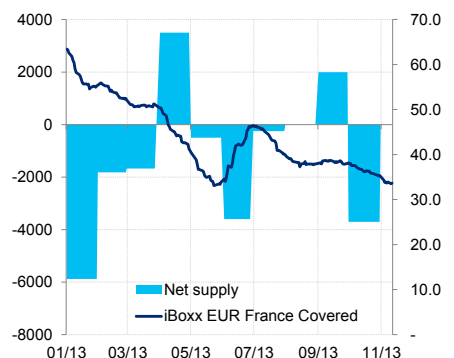
When looking at three exemplary markets below it can be seen that absolute spread development does not follow redemption peaks, which often resulted in a shrinking market. Also, in cases where new issuance outweighed redemptions (e.g. April in France or October in Italy) one cannot observe corresponding spread movements.

Figure 47. Net supply and spread performance: German covered bonds



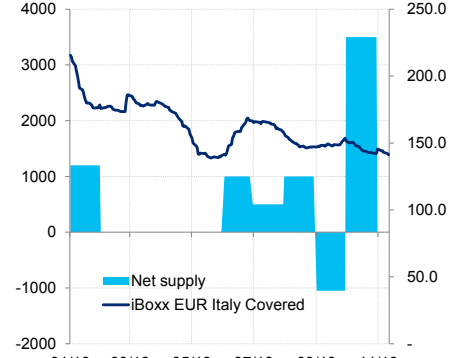
Source: Markit, Bloomberg, Citi Research; supply in EURmn, ASW-Spread in bp

Figure 48. Net supply and spread performance: French covered bonds



Source: Markit, Bloomberg, Citi Research; supply in EURmn, ASW-Spread in bp

Figure 49. Net supply and spread performance: Italian covered bonds



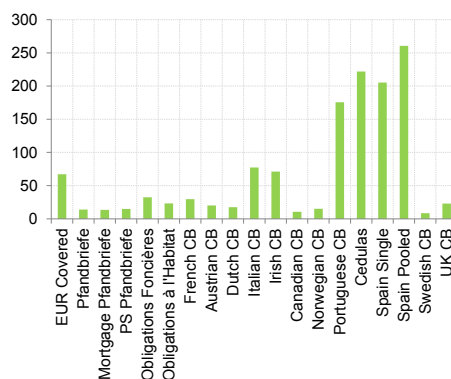
Source: Markit, Bloomberg, Citi Research; supply in EURmn, ASW-Spread in bp

EUR iBoxx performance and composition

Multi-cédulas have been trumps

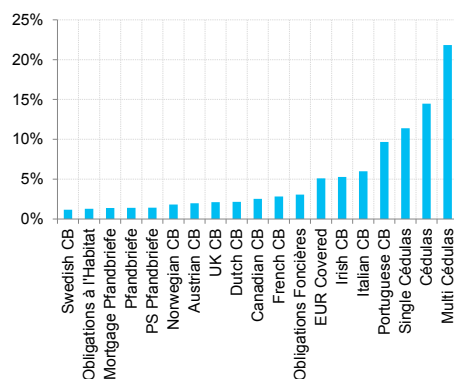
On an absolute basis and an absolute return basis, however, the biggest outperformer has been Spain, especially the multi-cédula segment. Portuguese covered bonds follow. Most impressively, however, is that there is no covered bond segment recording negative absolute spread performance or absolute returns. The following graphs summarize absolute spread performance, total return and average durations of the most important covered bond sub-indices markets going into 2014.

Figure 50. Absolute spread performance, ytd, bp



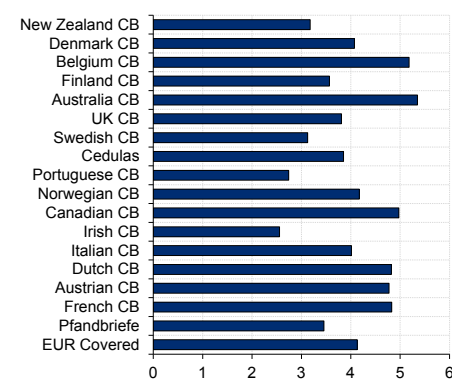
Source: Markit, Citi Research

Figure 51. Absolute performance, ytd, %



Source: Markit, Citi Research

Figure 52. Duration of covered bond indices, as of 26/11/2013

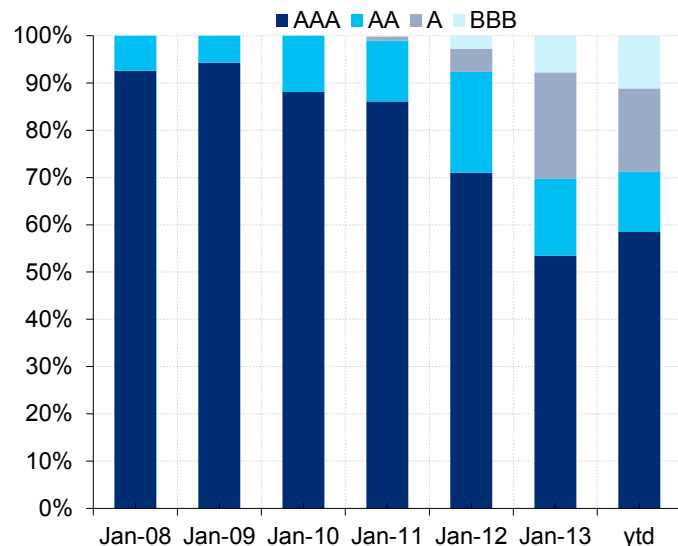


Source: Markit, Citi Research

Trends in the index composition should persist in 2014E as well

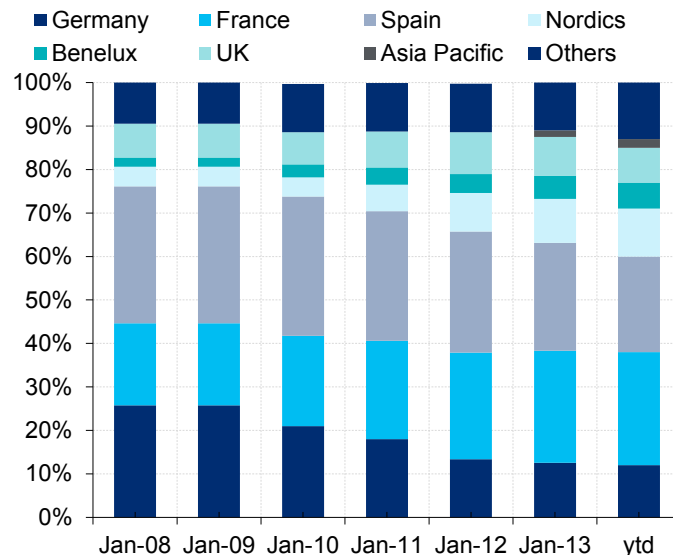
The iBoxx covered bond index composition has again slightly changed during 2013. Compared to the beginning of 2013, the share of AAA-rated covered bonds has increased again (iBoxx composite rating). This is due mainly to increased share of Australia, Canada and Belgium. At the same time, only very few bonds fell out of the index due to rating actions into sub-investment territory. On a country basis, German market share has again slightly decreased as well as the Spanish segment (from 26% to 22%). The French segment remains the most important covered bond segment within the covered bond index. For 2014, we expect the rating composition to remain stable with around 60% of the covered bonds included to be rated AAA. The trends in the geographical composition should also persist in 2014.

Figure 53. iBoxx EUR Covered Bond composition by rating



Source: Markit, Citi Research

Figure 54. iBoxx EUR Covered Bond composition by geography



Source: Markit, Citi Research

Germany

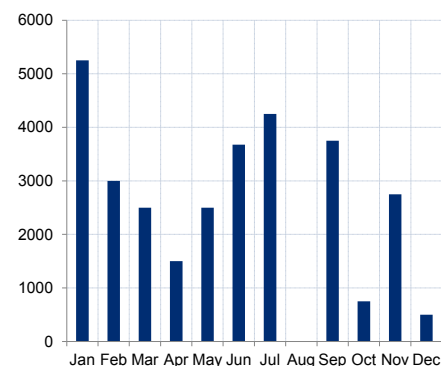
Figure 55. Top 5 redemptions of benchmark pfandbriefe in 2014 by issuer, EURmn

HYPFRA	4250
LBBW	3000
BYLAN	2875
DEXGRP	2500
WLBANK	2500

Source: Bloomberg, Citi Research

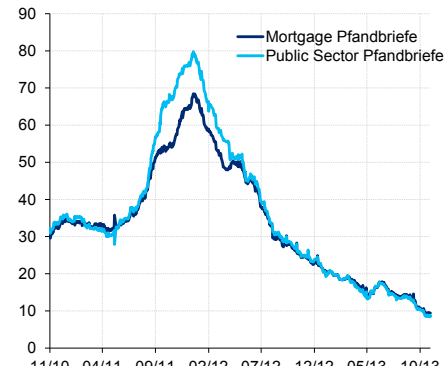
Since 2013, the volume of outstanding mortgage pfandbriefe is higher than the volume of public sector pfandbriefe. Given the issuance pattern recorded over the last years, we expect mortgage pfandbriefe to remain the most important asset class (benchmark issuance in 2013: 66% mortgage pfandbriefe). The jumbo-format seems to be history for German issuers: Year to date, only one of 26 transactions had a volume of more than or equal to €1bn. Highest redemptions will be recorded for HYPFRA and among others DEXGRP. Both issuers are in a wind-down scenario, hence no new issuance should be expected from these entities. Overall redemptions of €30.4bn is slightly skewed to the first quarter (€10.75bn). The niche markets aircraft and ship pfandbriefe as well as SME structured 'covered' bond should continue to play a minor role. We, however, expect Commerzbank to return with a further benchmark bond backed by SME loans in 2014. It remains to be seen if issuers start to increasingly use ECA loans as collateral for public sector pfandbriefe. Volume should, however, be limited. Moreover, we would suspect that the non-benchmark covered bond market continues to play a more prominent role for German pfandbrief issuers. Over the past, this share increased steadily.

Figure 56. EUR benchmark pfandbrief redemptions, 2014 by month, EURmn



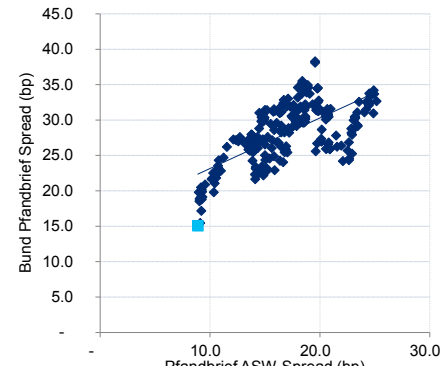
Source: Bloomberg, Citi Research

Figure 57. German pfandbrief indices, ASW-spread, bp



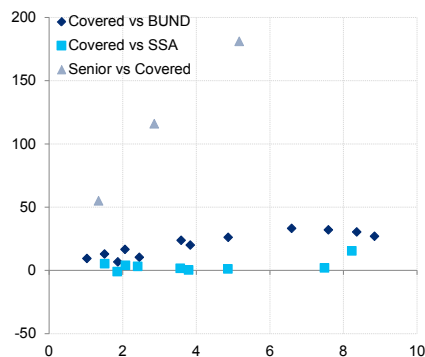
Source: Markit, Citi Research

Figure 58. Spreads to swaps and to German sovereign debt, bp, 1y history



Source: Markit, Citi Research; light blue=current

Figure 59. Yield spreads, Germany, bp



Source: Citi Research

Pfandbriefe versus Benchmark: Underweight

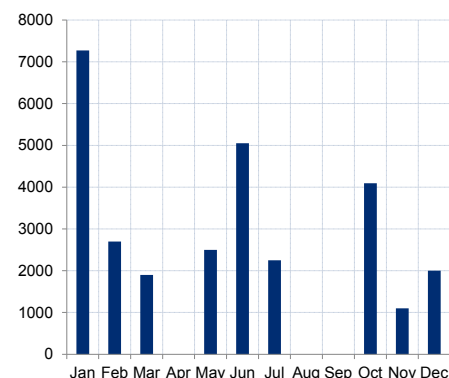
In the secondary market, there is no spread differentiation between mortgage and public sector pfandbriefe. We don't see any medium-term trigger for higher spread differentiation between both segments. Although net supply will continue to be substantially negative for public sector pfandbriefe, we don't think that potential effects will only be limited to the public sector segment. Pfandbriefe are at 5y lows in ASW terms on an index level. This year, ASW performance has been very directional with one month of cheapening during the general re-pricing of risk in June. Spreads to German government debt are also at their lowest levels since mid-2007. We think that both in ASW terms and bund-spread terms, German pfandbriefe are very expensive. We would therefore suggest switching into German SSA debt or bunds. This can partly be done without any give-up in case of SSA issuers (as an example, please see [The Morning Call - Front-end DSL trade, MPC Testimony, Covered bonds & EMU flow](#)). Within the iBoxx covered bond universe, we also recommend underweighting German pfandbriefe.

With respect to cover pool quality we don't think that substantial changes should be on the cards. Currently, the German property market develops dynamically but we don't think that this should have an impact on cover pools during 2014. Rating pressure should be given but limited. The AQR and the ECB stress test will probably be a main driver with respect to this topic.

France

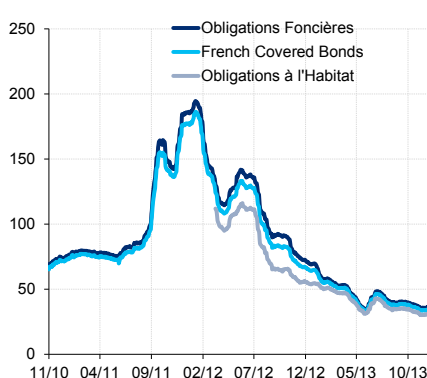
2013 has been the first year when the French benchmark covered bond market has been shrinking, with three of the biggest issuers being substantially less active or in wind-down scenario. Issuers increasingly made use of the issuance of covered bonds via Obligations à l'Habitat (its share increased steadily from 48% in 2010 to 67% in 2013). For 2014, we expected a consecutive year of net negative supply although it should be lower than in 2013. Highest redemptions are recorded for CFF, CRH and among others CIFEUR. The latter is in a wind-down scenario. Hence, we don't expect any new issuance from this entity. CRH issuance has been substantially lower in 2013 which we expect to continue in 2014. We expect CFF to return to the benchmark market. The issuer hasn't been active in the benchmark market as newly issued bonds would not have been eligible for ECB repo operations due to the composition of the cover pool. We expect this problem to be solved and forecast € benchmark issuance of €4bn in 2014 from this entity. Moreover, higher issuance volume by CAFFIL should be expected in 2014 (€1.5bn in 2013). This would result in €20bn of benchmark issuance which is slightly more than in 2013 and in negative net supply of €9bn, slightly less than this year.

Figure 61. EUR benchmark covered bond redemptions, 2014 by month, EURmn



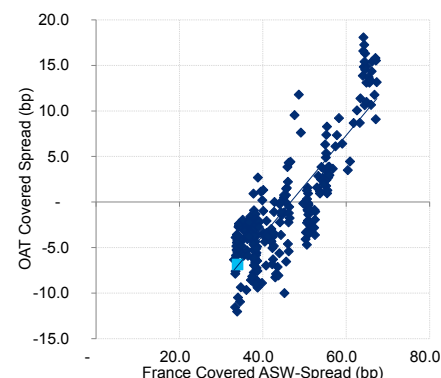
Source: Bloomberg, Citi Research

Figure 62. French covered bond indices, ASW-spread, bp



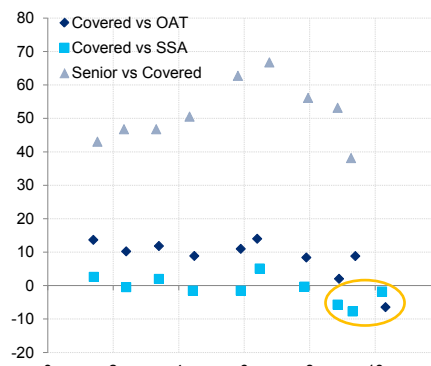
Source: Markit, Citi Research

Figure 63. Spreads to swaps and to French sovereign debt, bp, 1y history



Source: Markit, Citi Research; light blue=current

Figure 64. Yield spreads, France, bp



Source: Citi Research

**French covered bonds versus
Benchmark: Neutral**

In the secondary market, there is a slight spread differentiation between obligations à l'habitat and obligations foncières at an index level. On an issuer level this cannot be recorded or to a much lower extent. We don't see any near-term trigger for higher spread differentiation between both segments. However, we would prefer mortgage backed covered bonds to public sector backed bonds from the same issuer, especially when concentration to France is very high. We expect Moody's to follow S&P's rating action on the sovereign and downgrade it to AA+. Most of the covered bonds should continue to be highly rated (mostly Aaa). This is only one reason why we think that spreads to OAT could grind even tighter. In the past, we argued that net supply forecasts in both markets are one main driver to see covered bonds outperforming government bonds. This factor should persist in 2014. Apart from that, it's increasingly the difference in credit quality that should support covered bonds. On an ASW level, we don't think that substantial outperformance like that recorded in 2013 should be expected.

However, we think ASW-spreads can continue to grind tighter. In our opinion, one potential factor is the treatment of covered bonds within LCR. If covered bonds should be treated as Level 1 assets (against EBA recommendation) we think that this could boost demand, especially in the 2y to 7y tenor of French covered bonds. However, on an index level we recommend staying neutral French covered bonds.

Spain

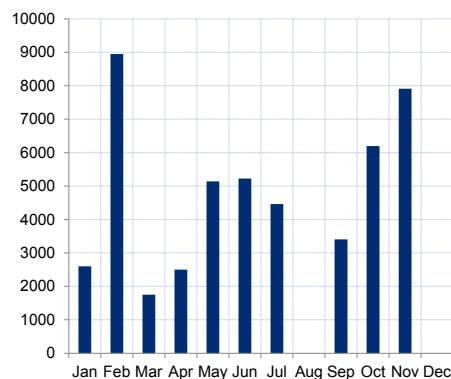
Spain is the segment that we expect to profit most from a shrinking covered bond segment in 2014. Overall, negative net supply of more than €30bn should be a main driver for spreads during the next 12 months. Redemptions are less skewed to the first quarter, as recorded in Germany and France. Highest quarterly redemptions are during the last three months of the year (€14bn). On an issuer level, the four biggest Spanish banks and AYT will be responsible for the bulk of redemptions (€34bn). As in France, 2014 will be the consecutive year of net shrinkage of the publicly placed benchmark market. We do not expect issuers to rely substantially on retained covered bond issuance, also because of an expected resumption of a decrease in eligible collateral. Cédulas backed by public sector loans or ECA loans are not expected. It remains to be seen if amendments to the covered bond law will be conducted that might provide issuers with the possibility of issuing SME-backed bonds. For bonos de hipotecarias we think issuance activity should not be ruled out.

Figure 65. Top 5 redemptions of benchmark covered bonds in 2014 by issuer, EURmn

SANTAN	8230
BBVASM	7848.5
AYTCED	6950
BKIASM	6025
CABKSM	4500

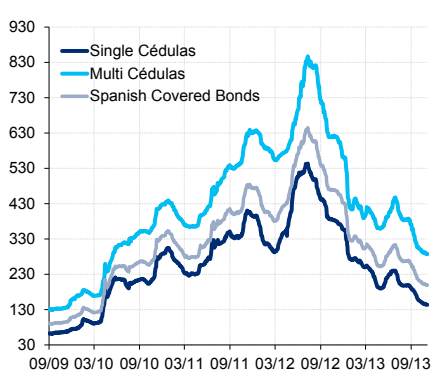
Source: Bloomberg, Citi Research

Figure 66. EUR benchmark covered bond redemptions, 2014 by month, EURmn



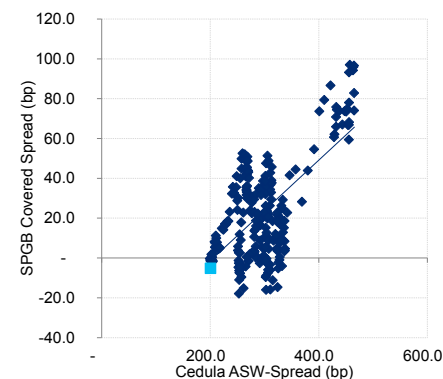
Source: Bloomberg, Citi Research

Figure 67. Spanish covered bond indices, ASW-spread, bp



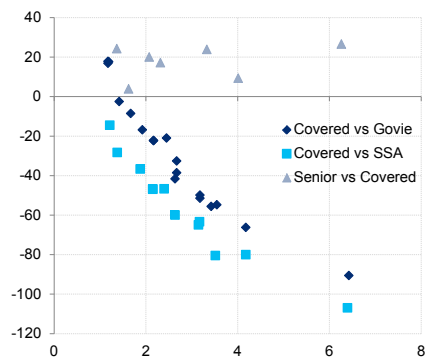
Source: Markit, Citi Research

Figure 68. Spreads to swaps and to Spanish sovereign debt, bp, 1y history



Source: Markit, Citi Research; light blue=current

Figure 69. Yield spreads, Spain, bp



Source: Citi Research

Spanish covered bonds versus Benchmark: Overweight

Figure 70. Top 5 redemptions of benchmark covered bonds in 2014 by issuer, EURmn

LLOYDS	4000
BACR	2450
RBS	2000
BKIR	1500
ERSTAA	1500

Source: Bloomberg, Citi Research; light blue: Ireland

UK covered bonds versus Benchmark: Neutral and Irish ACS versus Benchmark: Overweight

The compression trade within the Spanish covered bond segment will probably continue after the 16-month ongoing rally. One main driver apart from the substantial shrinkage of investable bonds from this segment is the ongoing consolidation within the Spanish covered bond segment. After the sale of several smaller banks that have been supported by FROB over recent years, FROB is now planning to sell NCG Banco by the end of the year. This will probably result again in a reduction of Spanish banks being active in the Spanish multi-cédula market. Irrespective of this particular sale, multi-cédulas continue to have highest outperformance potential while interest should continue to be elevated in the medium term. Single-cédulas are trading on lowest ASW levels since May 2010. Nevertheless, we think that the ongoing momentum of the 'low-for-longer' scenario, our SPGB spread outlook for 2014 and the very strong supply technicals will lead to further spread tightening versus swaps in the medium term.

We expect this to happen irrespective of the probable decrease in collateral quality. However, we don't think that spreads to SPGB will get back to all-time lows seen in March. Rather, we expect covered bonds to continue to trade sideways vs bonos. Although strong supply technicals speak for the outperformance of cédulas, the recovery of Spain might decrease the use as covered bonds as a collateralized hedge for a sovereign default. The main risks for Spanish covered bonds, in our opinion, are AQR and the ECB stress test. However, we think that this will not be as substantial as in other Southern European bank segments. Apart from that we continue to prefer cédulas to senior bonds in Spain.

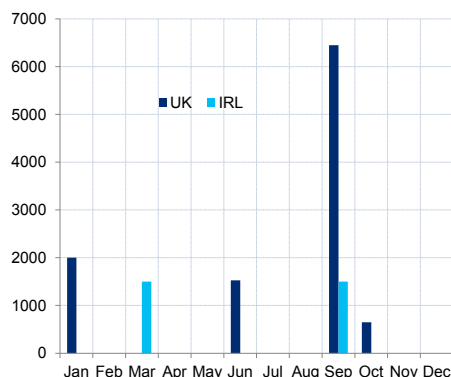
UK and Ireland

Although much smaller, the Irish covered bond issuers have been more active in 2013 than their UK peers. Only one benchmark issuance has been recorded from the UK. In 2014, we expect UK covered bond redemptions to be below €10bn. One factor is the still running tender offer by Lloyds for both €2bn bonds, which will mature in 2014. Hence, total redemptions from the UK will lie between €11bn and €7bn. In any case, we think that net supply from UK issuers will be negative in 2014. This is still due to the effects of the Funding for Lending Scheme. However, as the program is planned to end in January 2015, we think that issuers will already start to return to the wholesale market and issue covered bonds in EUR and GBP. In Ireland, the segment will lose one further issuer: ERSTAA's last outstanding public sector ACS is going to mature. Nevertheless, we think that new supply can even out total redemptions of €3bn. Irish covered bond issuers will probably continue to profit from the general positive mood with respect to Ireland. Average property prices have stopped falling, the period of extraordinary financial assistance for the country has ended and we think that an upgrade of the sovereign by Moody's is on most people's cards.

UK covered bonds should be able to grind slightly tighter on an ASW basis. However, this should not happen at same speed as recorded in 2012. Nevertheless, the fact that supply forecast is again muted will be a main driver for spreads vs swaps. Rating pressure is rather limited, in our opinion. However, if UK banks were to be downgraded by Moody's, about one-third of UK covered bonds would not have enough leeway to withstand this and would be downgraded as well. In case of S&P, enough leeway is still given. It remains to be seen if (and when) the extraordinary support for the UK property market might end and what effect it might have on collateral quality. In the near term, we don't expect any negative effects on cover pool quality. We recommend weighting UK covered bonds neutral against the benchmark. Irish covered bonds have been performing relatively strongly over the last year and we see further tightening potential versus swaps. Although we don't expect strong supportive technicals given the low redemptions, the segment might

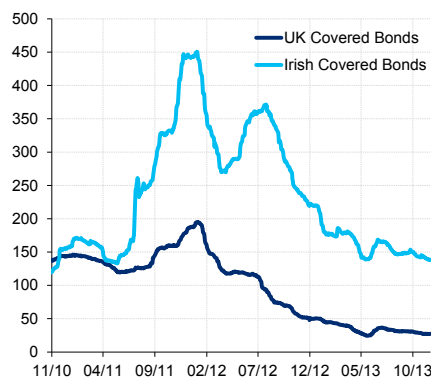
be positively affected by further rating upgrades in case of Moody's. Given the general recovery and the possibility for Ireland to return to investment-grade by all rating agencies, we expect more investors to move back into Irish debt. Moreover, the 'collateralized hedge' versus exposure to sovereign bonds should lose attractiveness. Hence, we think that Irish ACS will probably not be able to outperform sovereign debt in 2014. The biggest threat for ACS issuers in our eyes is the AQR as capital needs seem to be given ([Bank of Ireland \(BKIR.I\)](#)).

Figure 71. EUR benchmark covered bond redemptions, 2014 by month, EURmn



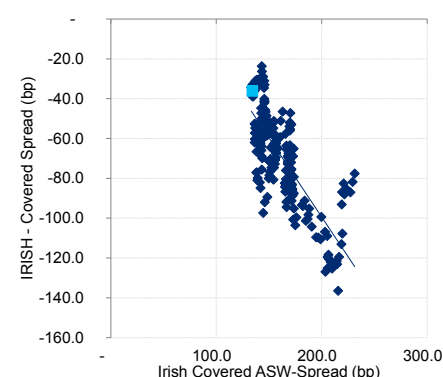
Source: Bloomberg, Citi Research

Figure 72. UK and Irish covered bond indices, ASW-spread, bp



Source: Markit, Citi Research

Figure 73. Irish ACS spreads to swaps and to Irish sovereign debt, bp, 1y history



Source: Markit, Citi Research; light blue=current

Austria, the Netherlands and Belgium

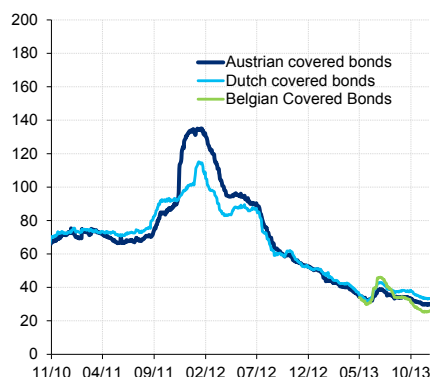
Figure 74. Top 5 redemptions of benchmark covered bonds in 2014 by issuer, EURmn

ABNANV	2000
INTNED	2000
ACHMEA	1500
KA	1000
BAWAG	1000

Source: Bloomberg, Citi Research; light blue: Austria

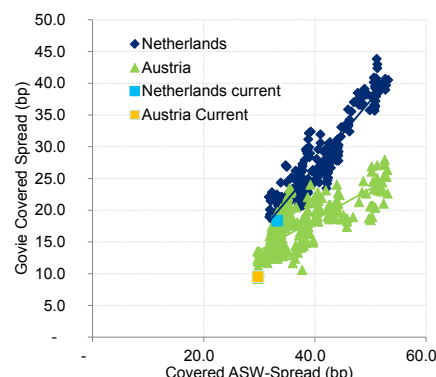
The Austrian, the Dutch and the Belgian covered bond segments are rather small but an interesting diversification possibility away from pfandbriefe and French covered bonds. For the Dutch segment, we expect slightly negative net supply in 2014, while the Belgian market should continue to grow by around €4bn which has already been the case in 2013. This year, the Dutch segment was growing slightly, due mainly to very low redemptions. Austrian net supply was flat in 2013. For 2014, we expect Hypo Noe Group to place its inaugural benchmark covered bond backed by mortgage loans. Moreover, we think that conditional pass-through structures might see follow-up issuance from the Netherlands, especially from the already proved NIBC. In Belgium, the segment will consist of three issuers when going into 2014. Hence, we expect slightly more benchmark supply than in 2013 coming from Belgium.

Figure 75. Austrian, Dutch and Belgian covered bond indices, ASW-spread, bp



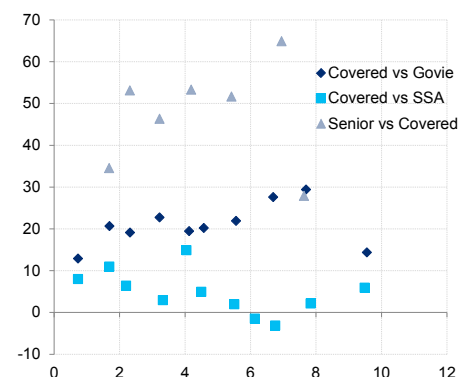
Source: Markit, Citi Research

Figure 76. Spreads to swaps and to Austrian / Dutch sovereign debt, bp, 1y history



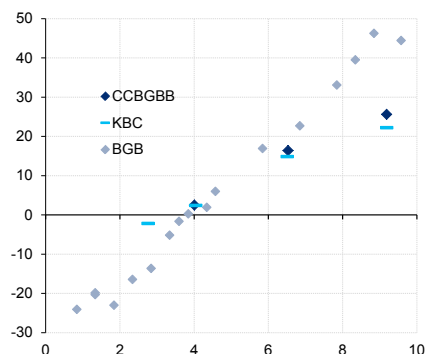
Source: Markit, Citi Research;

Figure 77. Yield spreads, Netherlands, bp



Source: Citi Research;

Figure 78. Belgian covered bonds and OLOs, ASW, bp



Source: Citi Research

Austrian covered bonds versus Benchmark: Overweight, Dutch and Belgian covered bonds versus Benchmark: Neutral

The Austrian covered bond market slightly outperformed the Dutch segment over the last 12 months on an ASW-basis. We think that both segments can grind tighter in the medium term. However, ASW spread potential is higher in non-core and peripheral segments. In Austria we would recommend these bonds with limited/no exposure to unhedged CHF positions. In the Netherlands, property prices seem to have bottomed out, which is in general a positive for the high credit quality of Dutch cover pools. We continue to prefer SNSSNS to other Dutch covered bond programs. Compared to the underlying sovereign debt, Austrian and Dutch covered bonds still offer a pick-up versus sovereign bonds. We don't expect this spread to tighten substantially further, mainly as both sovereigns are still highly rated and significant net negative supply cannot be recorded for both covered bond segments. For the Austrian banking system we would expect some challenges ahead of the AQR and the ECB stress test. Dutch banks should be slightly less vulnerable. In the medium term, however, we recommend continuing to overweight Austrian and remaining neutral Dutch covered bonds.

The Belgian market has performed well since inaugural issuance at the end of 2012. On an ASW basis we think that slightly further tightening will be on the cards in the medium term. We think that Belgian covered bond issuers are less challenged from AQR than their Austrian and Dutch peers. Compared to OLOs, we think covered bonds are trading too expensive, especially at the long end of the curve. In such cases, we would prefer to be in OLOs. With respect to index weighing, we continue to be neutral on Belgian covered bonds in the medium term.

Italy and Portugal

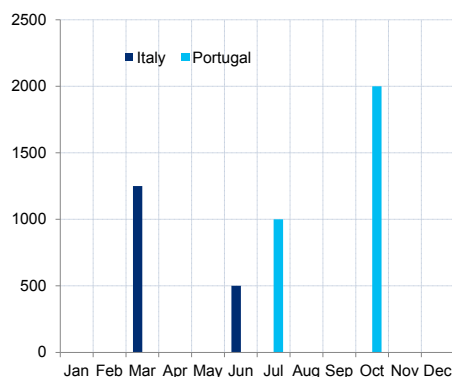
The Italian segment is expected to grow substantially given the low amount of redemptions in 2014. We forecast net positive supply of €6bn. Tier 2 banks successfully returned to covered bond market in 2013. We see it as very positive that CdP will return to the covered bond market – not as an issuer – but as an anchor investor for Italian covered bonds in 2014. The state owned entity takes on a similar role to the ECB during the covered bond purchase programs in 2009 and 2011. The biggest Italian issuers don't have any publicly placed benchmark covered bonds that will mature in 2014. However, retained funding is expected to decrease substantially. This has been a substantial amount, mostly issued in 2012. Hence, collateral availability should not be any problem for Italian issuers. In Portugal, we expect net negative issuance in 2014 given the decreased funding needs of Portuguese banks. For both segments, we think that issuers are keeping an eye on potential issuance of partial pass-through covered bonds given the ongoing trend of rating pressure (Italy) or low rating levels (Portugal).

Figure 79. Top 5 redemptions of benchmark covered bonds in 2014 by issuer, EURmn

BPIM	1250
CRDEM	500
BCPPL	1000
CXGD	1000
SANTAN	1000

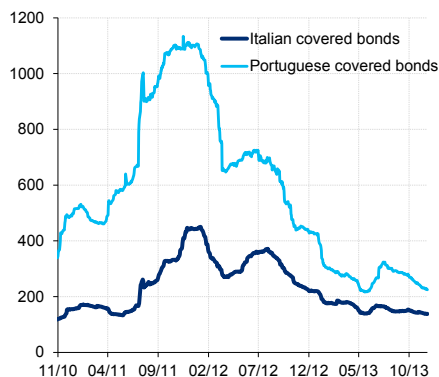
Source: Bloomberg, Citi Research; light blue: Portugal

Figure 80. EUR benchmark covered bond redemptions, 2014 by month, EURmn



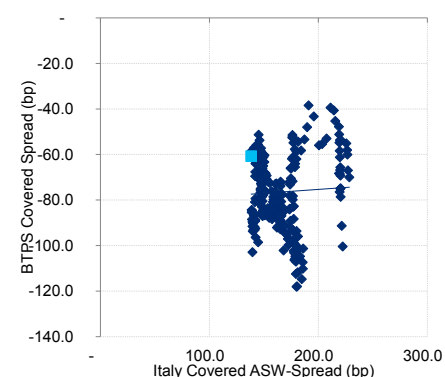
Source: Bloomberg, Citi Research

Figure 81. Italian and Portuguese covered bond indices, ASW-spread, bp



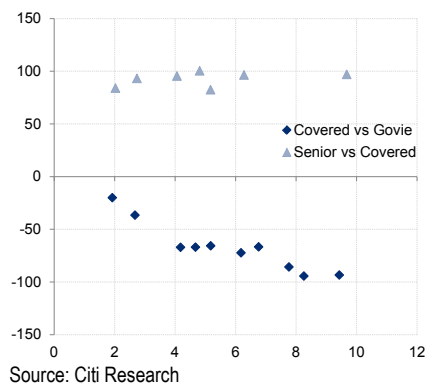
Source: Markit, Citi Research

Figure 82. Spreads to swaps and to Italian sovereign debt, bp, 1y history



Source: Markit, Citi Research; light blue=current

Figure 83. Yield spreads, Italy, bp



Italian and Portuguese covered bonds versus Benchmark: Overweight

Secondary market levels of both segments were among the best performing in 2014. Note, however, that especially the Portuguese covered bond segment has become extremely small and liquidity is much lower in this segment. On an ASW basis, OBG traded on lower levels three years ago while Portuguese covered bonds reached ASW levels of May 2010 in May and November this year. Compared to underlying sovereign debt, OBG continue to trade at lower ASW levels on an index level. However, some lower-rated Italian covered bonds trade cheaper than BTPs. We think that OBG BTPs spread has seen its lows in 2013 and we do not expect to reach them in 2014. However, it's probably too soon to see an extreme reversal of the trend between OBG and BTPs. Tier 1 covered bonds should continue to trade more expensive than BTPs in the medium term, in our view. On an index level, we recommend overweighting OBG against the benchmark over the next few months. We think that Italian banks will be challenged most by the AQR and the stress test. Hence, OBGs might also be affected by headline risk the more details will be published. Moreover, rating volatility should persist with ongoing pressure on Italian banks. In case of Moody's, we expect near-term rating pressure to be lower given the change to its rating methodology.

Portuguese covered bonds should also continue to perform against swaps, we believe. Hence, we also recommend overweighting the Portuguese covered bond segment against the benchmark. However, we expect liquidity to remain low. We also recommend staying in secured paper vs PGB as the latter is still rated sub-investment grade by most agencies and we don't expect this to change in the medium term.

Scandinavia

Figure 84. Top 5 redemptions of benchmark covered bonds in 2014 by issuer, EURmn

SWEDA	3750
NDASS (SWE)	1250
SHBASS	1500
NDASS (FI)	2000
POHBK	1250

Source: Bloomberg, Citi Research

Redemptions in 2014 are only recorded for Sweden and Finland in the covered bond space. In Denmark, the senior secured market will also record the redemption of one bond. We think the most significant positive net supply will be found in Norway, although issuance activity should be similar to this year and therefore lower than during the years before. In Finland and Denmark, we expect slightly positive net supply. Redemptions are highest in Sweden (€8.5bn). Hence, we expect net shrinkage of this segment by €3.5bn during 2014. As mentioned before, issuance activity will mainly be a function of the basis swap between domestic currencies and the euro. At current levels, €-issuance has become more attractive for many Scandinavian issuers recently. Swedbank will record highest redemptions in 2014.

Figure 85. EUR benchmark covered bond redemptions, 2014 by month, EURmn

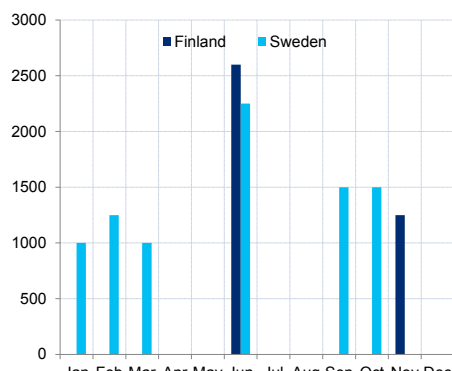


Figure 86. Scandinavian covered bond indices, ASW-spread, bp

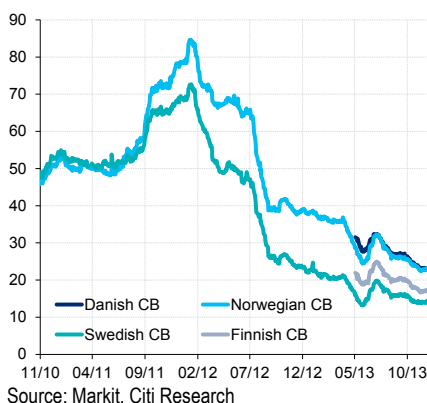


Figure 87. Spreads to swaps for Finnish and Norwegian covered bond issuers, bp

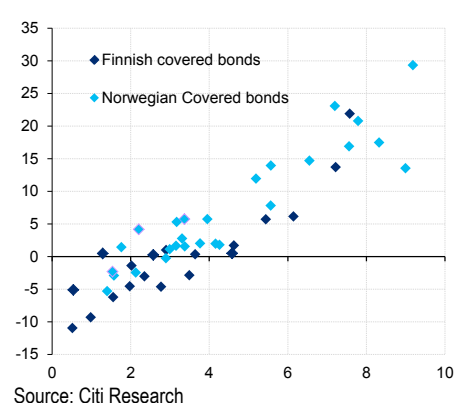
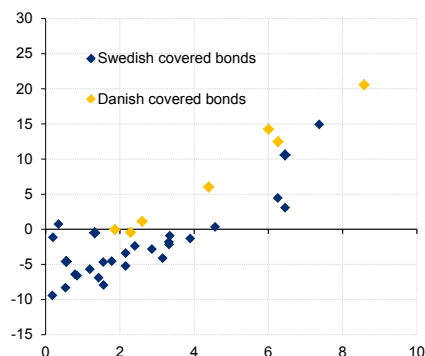


Figure 88. Spreads to swaps for Swedish and Danish covered bond issuers, bp



Source: Citi Research

Finnish covered bonds versus
Benchmark: Overweight, Swedish and
Norwegian covered bonds versus
Benchmark: Neutral

The Scandinavian covered bond markets continue to trade very similar and the spread between highest- and lowest-yielding names is relatively small. We don't see any reasons why this should change in the medium term. All segments are perceived to be safe-havens – especially during times of turmoil due to the European debt crisis. On an ASW basis, all segments are performing well and we think that this will continue albeit on a lower scale in the medium term than in 2013.

Finnish covered bonds still offer a decent pick-up over Finnish government bonds. Hence, we prefer the secured paper, especially the highest-yielding names within the segment. Although being part of the Euro area, Finnish covered bonds have shown that they haven't underperformed other Scandinavian issuers during Euro area turmoil on an ASW basis. This is why we continue overweighting Finnish covered bonds on an index level. Norwegian covered bonds still offer a pick-up versus their Swedish peers. The issuers' cover pools provide the highest quality in comparison to the average European cover pool quality. This is the main reason why we have been overweight this segment until recently. However, we changed our stance on this market due to current attempts by Norwegian politicians to become more lax on lending standards.

We think that the main threat to Norwegian covered bonds stems from the housing market. Hence, we don't see it as a positive that politicians discuss lowering LTV standards for new loans. This might not have a negative near-term effect per se, but it is not a positive signal. That's why we remain neutral on Norwegian covered bonds in the medium term. Swedish covered bonds are trading very expensive compared with their peers. Although we are convinced of the very high quality of the covered bond programs, we don't see much higher performance potential, which is why we recommend being neutral this segment.

Covered Bond Rating Overview

Figure 89. Ratings of selected covered bond issuers

Australia	S&P/Moody's/Fitch/DBRS	DGHYP	AAA/-/-/-	SNSSNS	--/A1/AA+/-
ANZ	--/Aaa/AAA/-	DHY	--/Aa2/-/-	New Zealand	S&P/Moody's/Fitch/DBRS
CBAU	--/Aaa/AAA/-	DKRED	--/Aa2/-/-	ANZNZ	--/Aaa/AAA/-
NAB	--/Aaa/AAA/-	PBBGR	AA+/Aa2/-/-	ASBBNK	--/Aaa/AAA/-
WSTP	--/Aaa/AAA/-	DPB	--/Aaa/AAA/-	BZLNZ	--/Aaa/AAA/-
Austria	S&P/Moody's/Fitch/DBRS	HSN	--/Aa3/-/-	WSTP	--/Aaa/AAA/-
BACA	--/Aaa/-/-	HYPFRA	--/Aa3/-/-	Norway	S&P/Moody's/Fitch/DBRS
BACA (m.)	--/Aa1/-/-	INGDIB	--/Aaa/-/-	DNBNO	AAA/Aaa/AAA/-
BAWAG	--/Aa1/-/-	LBBW	--/Aaa/-/-	EKBOL	--/Aa2/-/-
ERSTBK	--/Aaa/-/-	HESLAN	--/Aaa/-/-	SPABOL	--/Aaa/AAA/-
HYNOE	--/Aaa/-/-	MUNHYP	--/Aaa/-/-	SVEGNO	--/Aaa/-/-
KA	--/Aa2/-/-	SPKKB	--/Aaa/-/-	Portugal	S&P/Moody's/Fitch/DBRS
RFLBNI	--/Aaa/-/-	HVB	--/Aa1/AAA/-	BCPPL	--/Ba1/BBB-/AL
RFLBST	--/Aaa/-/-	WLBANK	AAA/-/-/-	BESPL	--/Baa3/-/AL
VORHYP	--/Aaa/-/-	Germany (ps)	S&P/Moody's/Fitch/DBRS	BPIPL	A-/*-/Baa3/BBB+/-
Belgium	S&P/Moody's/Fitch/DBRS	HVB	AAA/Aaa/-/-	CXGD	--/Baa3/BBB/A
KBC	--/Aaa/AAA/-	BYLAN	--/Aaa/AAA/-	SANTAN (PT)	BB+/*-/Baa3/BBB/AL
CCBGBB	AAA/-/AAA/-	BHH	--/Aa1/AA/-	Spain	S&P/Moody's/Fitch/DBRS
Canada	S&P/Moody's/Fitch/DBRS	DGHYP	AAA/-/-/-	BBVASM	A-/A3/-/AH
RY	AAA/Aaa/AAA/AAA	DKRED	--/Aa1/-/-	BKIASM	BBB/Ba1/-/-
CM	--/Aaa/AAA/-	PBBGR	AA+/Aa1/-/-	BKTSM	A/A3/-/-
Denmark	S&P/Moody's/Fitch/DBRS	DPB	--/Aaa/-/-	CABKSM	AA-/A3/-/-
DANBNK	AAA/-/AAA/-	DEXGRP	A+/-/-/-	CAIXAC	BBB/Ba2/-/-
Finland	S&P/Moody's/Fitch/DBRS	HSN	--/Aa2/-/-	CAJARU	BBB-/Ba2/BBB+/-
AKTIA	--/Aa3/-/-	PBBGR	AA+/Aa1/-/-	CAZAR	A/Baa1/*-/A/-
AKTIA	--/Aaa/-/-	HYPFRA	--/Aa3/-/-	CRUNAV	--/A3/-/-
NDASS	--/Aaa/-/-	LBBW	--/Aaa/AAA/-	KUTXAB	AA-/A3/-/-
POHBK	AAA/Aaa/-/-	HESLAN	--/Aaa/-/-	NOVAGA	BBB+/Ba2u/BBB+/-
SAMBNK	--/Aaa/-/-	MUNHYP	--/Aaa/-/-	POPSM	--/Baa2/-/A
France	S&P/Moody's/Fitch/DBRS	NDB	--/Aaa/AAA/-	SABSM	--/A3/*-/A
ACACB	AAA/Aaa/AAA/-	WLBANK	AAA/-/-/-	SANTAN	--/A3/A/-
ACASCF	AAA/Aaa/-/-	Ireland	S&P/Moody's/Fitch/DBRS	Sweden	S&P/Moody's/Fitch/DBRS
AXASA	--/Aaa/AAA/-	AIB	A/Baa2/A/-	LANSBK	AAA/Aaa/-/-
BNPPCB	AAA/-/AAA/-	BKIR	--/Baa2/-/AL	NDASS	AAA/Aaa/-/-
BNPSCF	AAA/-/AA+/-	DEPFA	BBB/A3/A/-	SBAB	AAA/Aaa/-/-
BPCECB	AAA/Aaa/-/-	ERSTAA	--/A3/-/-	SEB	--/Aaa/-/-
BPCOV	AAA/-/-/-	Italy	S&P/Moody's/Fitch/DBRS	SHBASS	--/Aaa/-/-
CAFFIL	AA+/Aaa/AA+/-	BACRED	A/-/-/-	Switzerland	S&P/Moody's/Fitch/DBRS
CDEE	AAA/Aaa/-/-	BANCAR	--/Baa1/*-/BBB+/-	UBS	--/Aaa/AAA/-
CFF	AAA/Aaa/AAA/*-/A	BPEIM	--/Baa2/-/-	CS	--/Aaa/AAA/-
CIFEUR	--/Aa2/AA+/-	BPIM	--/Baa2/BBB+/-	United Kingdom	S&P/Moody's/Fitch/DBRS
CMARK	AA+/Aaa/-/-	CRDEM	--/A2/*-/A+/-	ABBEY	AAA/Aaa/AAA/-
CMCICB	AAA/Aaa/AAA/-	ISPIIM	--/A2/-/-	BACR	AAA/Aaa/AAA/-
CRH	--/Aaa/AAA/-	MONTE	--/Ba1/A/-	BRADBI	AAA/Aa1/AA+/-
GE	AAA/Aaa/-/-	PMIIM	--/Baa2/*-/BBB+/-	COVBS	--/Aaa/AAA/-
HSBC	AAA/Aaa/-/-	UBIIM	--/A2/*-/A+/-	LLOYDS	AAA/Aaa/AAA/AAL
SOCSCF	AA+/Aaa/-/-	UCGIM	AA/A2/A+/-	NRKLN	AAA/Aaa/AAA/-
SOCSEFH	--/Aaa/AAA/-	Netherlands	S&P/Moody's/Fitch/DBRS	NWIDE	AAA/Aaa/AAA/-
Germany (m.)	S&P/Moody's/Fitch/DBRS	ABNANV	AAA/Aaa/AAA/A	RBS	--/Aaa/AAA/-
AARB	--/Aaa/AAA/-	ACHMEA	--/Aa2/AAA/-	YBS	--/Aa2/AA+/-
HVB	--/Aa1/AAA/-	NIBCAP (PT)	AAA/-/AAA/-	USA	S&P/Moody's/Fitch/DBRS
BHH	--/Aa1/AA+/-	NIBCAP	--/A+/-	BAC	A+/A1/AA/-
DB	AAA/Aaa/-/-	INTNED	AAA/Aaa/AAA/-	JPM	A+/-/AA/-

Source: Bloomberg; m.=mortgage, ps = public sector

Covered Bond Rating Overview – Multi Cédulas

Figure 90. Ratings of selected Multi-Cédulas

AYTCED	ISIN	S&P/Moody's/Fitch	CEDTDA	ISIN	S&P/Moody's/Fitch
AYTCED 4.75 04/12/2018	ES0370148019	A+/A3 /*-/BBB	CEDTDA 4.375 03/03/2016	ES0317043000	A-/A3 /*-/BBB
AYTCED 4 07/04/2014	ES0312360003	A+/Baa1 /*-/BBB	CEDTDA 4.125 29/11/2019	ES0317045005	BBB-/Baa1 /*-/BBB
AYTCED 4 07/04/2014	ES0312360011	A+/Baa1 /*-/BBB	CEDTDA 3.875 23/05/2025	ES0317046003	BBB-/Baa1 /*-/BBB
AYTCED 4 18/11/2014	ES0312362009	A+/A3 /*-/BBB	CEDTDA 3.5 20/06/2017	ES0317047001	BB+/Baa1 /*-/BB+
AYTCED 4.25 18/11/2019	ES0312362017	A-/A3 /*-/BBB	CEDTDA 4.25 10/04/2031	ES0371622020	BBB-/Baa1 /*-/BBB
AYTCED 3.75 31/03/2015	ES0312358007	BBB-/Baa1 /*-/BBB	CEDTDA 4.125 10/04/2021	ES0371622012	BBB-/Baa1 /*-/BBB
AYTCED 4 31/03/2020	ES0312358015	BBB-/Baa1 /*-/BBB	CEDTDA 4 23/10/2018	ES0371622038	A-/A3 /*-/BBB
AYTCED 3.75 30/06/2025	ES0312342019	BBB-/Baa1 /*-/BB+	CEDTDA 4.25 28/03/2027	ES0371622046	BBB-/A3 /*-/BBB
AYTCED 3.5 14/03/2016	ES0312298013	BBB-/A3 /*-/BBB			
AYTCED 3.75 14/12/2022	ES0312298021	BBB-/Baa1 /*-/BBB	IM CEDULAS	ISIN	S&P/Moody's/Fitch
AYTCED 4 24/03/2021	ES0312298054	BBB-/Baa1 /*-/BBB	IMCEDI 4.5 11/06/2014	ES0347859003	--/Baa1 /*-/BBB
AYTCED 4.25 14/06/2018	ES0312298070	BB+/Baa1 /*-/BB+	IMCEDI 4 19/11/2014	ES0347852008	A-/WR/--
AYTCED 4 20/12/2016	ES0312298104	A-/A3 /*-/BBB	IMCEDI 3.75 11/03/2015	ES0347848006	BBB-/Baa3 /*/--
AYTCED 4 21/03/2017	ES0312298112	BBB-/A3 /*-/BBB	IMCEDI 3.5 15/06/2020	ES0347849004	BB+/-/--
AYTCED 4.75 25/05/2027	ES0312298120	BB+/Baa1 /*-/BBB	IMCEDI 3.5 02/12/2015	ES0362859003	BBB-/Baa1 /*/--
AYTCED 4.75 15/06/2016	ES0312298229	AA-/--/--	IMCEDI 4 31/03/2021	ES0347784003	--/A3 /*-/BBB
AYTCED 4.25 29/07/2014	ES0312298237	A+/Baa1 /*/--	IMCEDI 4.25 09/06/2016	ES0347785000	BBB-/Baa1 /*-/BB+
AYTCED 4.5 02/12/2019	ES0312298245	A-/Baa2 /*/--	IMCEDI 4.5 21/02/2022	ES0349045007	--/Baa1 /*-/BBB
AYTCED 3.75 25/05/2015	ES0312298252	AA-/Baa2 /*/--	PITCH	ISIN	S&P/Moody's/Fitch
			PITCH 5.125 20/07/2022	ES0334699008	A-/A3 /*/--

Source: Bloomberg

Covered Bond Rating Changes November 2013

Figure 91. Rating actions in the covered bond universe

Issuer	Program	Country	Agency	From	To	Reason
Bank of Ireland	Mortgage	Ireland	Moody's	Baa3	Baa2	Substantial increase in overcollateralisation; moreover TPI was raised to "Improbable"
AIB Mortgage Bank	Mortgage	Ireland	Moody's	Baa3	Baa2	Substantial increase in overcollateralisation; moreover TPI was raised to "Improbable"
ING Belgium	Mortgage	Belgium	Moody's		(P)Aaa	Inaugural covered bond rating for the newly established covered bond program
Caisse Francaise de Financement Local	Public Sector	France	S&P	AAA	AA+	The downgrade follows the downgrade of the Reupublic of Francce recently.
Credit Mutuel Arkea SCF	Public Sector	France	S&P	AAA	AA+	The downgrade follows the downgrade of the Reupublic of Francce recently.
Société Générale SCF	Public Sector	France	S&P	AAA	AA+	The downgrade follows the downgrade of the Reupublic of Francce recently.
Société Générale LdG	Public Sector	Luxembourg	S&P	AAA	AA+	The downgrade follows the downgrade of the Reupublic of Francce recently.
Banco Santander	Mortgage	Spain	Fitch	A (neg)	A (sta)	The outlook of the issuer has been revised from negative to stable.
Caja Laboral	Mortgage	Spain	Fitch	A- (neg)	A- (sta)	The outlook of the issuer has been revised from negative to stable.
Cajas Rurales Unidas	Public Sector	Spain	Fitch	BBB (neg)	BBB (sta)	The outlook of Spain has been revised from negative to stable.
DnB NOR Boligkreditt	Mortgage	Norway	Fitch	AAA	WD	The issuer has requested to withdraw the covered bond rating by Fitch
Sandnes Bank Boligkreditt	Mortgage	Norway	Fitch	AA-	AA	Upgrade reflects changes to the cover pool and a revision of the D-cap
ING Belgium	Mortgage	Belgium	Fitch		AAA (exp)	Inaugural covered bond rating for the newly established covered bond program
Cooperative Bank	Mortgage	UK	Fitch	A-	BBB+	The rating action follows the downgrade of the IDR to B from BB-

Source: Bloomberg

Redemptions December 2013 and January 2014

Figure 92. Redemption payments: December 2013 and January 2014

Issuer Name	Ticker	Coupon	Maturity	Announce	Amount (EURmn)	Country
CIF Euromortgage SA	CIFEUR	4.5	12/10/2013	11/26/2003	1260	FR
AYT Cédulas Cajas 5	AYTCED	4.5	12/04/2013	11/27/2003	1000	ES
Nationwide Building Society	NWIDE	3.875	12/05/2013	11/28/2006	2000	GB
Stadshypotek AB	SHBASS	3.75	12/12/2013	12/05/2006	2000	SE
Banco Bilbao Vizcaya Argentaria	BBVASM	4.125	01/13/2014	01/04/2011	1600	ES
DEPFA Deutsche Pfandbriefbank	PBBGR	4.5	01/15/2014	11/27/1998	1250	DE
Bank of Scotland PLC	LLOYDS	3.875	01/15/2014	11/07/2006	2000	GB
BNP Paribas Home Loan SFH	BNPPCB	4.125	01/15/2014	01/08/2009	1500	FR
Deutsche Genossenschafts-Hypothekenbank	DGHYP	4.25	01/16/2014	01/09/2004	1500	DE
LBBW	LBBW	1.75	01/17/2014	01/10/2011	1500	DE
Corealcredit Bank AG	COREAL	4.25	01/20/2014	01/11/1999	1000	DE
Banco de Sabadell SA	SABSM	3.125	01/20/2014	01/11/2010	1000	ES
Berlin Hyp AG	BHH	4	01/24/2014	01/16/2007	1250	DE
Credit Agricole Home Loan SFH	ACACB	2.625	01/28/2014	01/20/2011	2250	FR
Cie de Financement Foncier SA	CFF	4.25	01/29/2014	01/14/2004	3520	FR
Swedbank Hypotek AB	SWEDA	2	01/31/2014	10/26/2010	1000	SE

Source: Citi Research

Covered Bond Performance

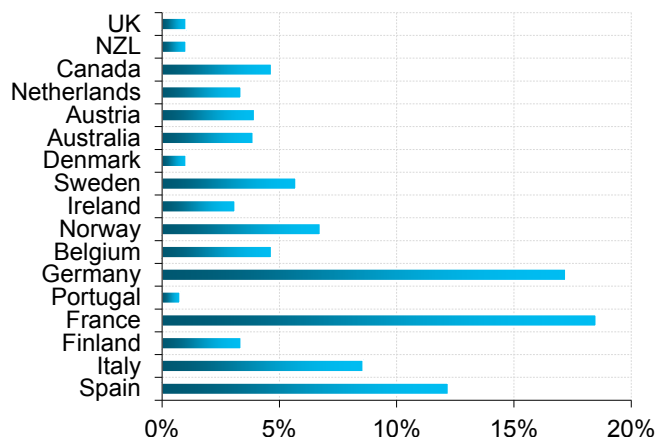
Figure 93. iBoxx Covered Bond Indices: Total Return in November 2013, %

Segment	Absolute	Δ 1m	Δ ytd	Δ 1y
Australian Covered Bonds	99.00	0.4%	--	--
Austrian Covered Bonds	136.76	0.3%	1.6%	1.8%
Belgian Covered Bonds	99.31	0.4%	--	--
Canadian Covered Bonds	127.03	0.3%	2.0%	2.4%
Danish Covered Bonds	99.92	0.3%	--	--
Dutch Covered Bonds	145.57	0.3%	1.7%	2.0%
EUR Covered	198.01	0.4%	4.1%	4.9%
Finnish Covered Bonds	100.18	0.2%	--	--
French Covered Bonds	212.20	0.3%	2.3%	2.6%
Irish Covered Bonds	144.87	0.3%	4.1%	4.9%
Italian Covered Bonds	129.28	0.7%	5.1%	5.8%
Luxembourg Covered Bonds	101.29	0.4%	--	--
Mortgage Pfandbriefe	193.46	0.3%	1.1%	1.3%
New Zealand Covered Bonds	100.19	0.2%	--	--
Norwegian Covered Bonds	136.65	0.3%	1.5%	1.7%
Obligations à l'Habitat	130.26	0.2%	1.2%	1.2%
Obligations Foncières	144.21	0.3%	2.5%	2.9%
Pfandbriefe	187.63	0.3%	1.2%	1.3%
Portuguese Covered Bonds	146.03	1.1%	8.3%	9.8%
Public Sector Pfandbriefe	185.81	0.2%	1.2%	1.4%
Spanish Covered Bonds	200.83	0.7%	11.5%	14.3%
Spanish Multi Covered Bonds	140.85	0.9%	16.7%	21.5%
Spanish Single Covered Bonds	131.88	0.6%	9.3%	11.2%
Swedish Covered Bonds	132.93	0.2%	1.0%	1.1%
Swiss Covered Bonds	99.87	0.2%	--	--
UK Covered Bonds	144.90	0.3%	1.8%	2.0%

Source: Markit, Citi Research

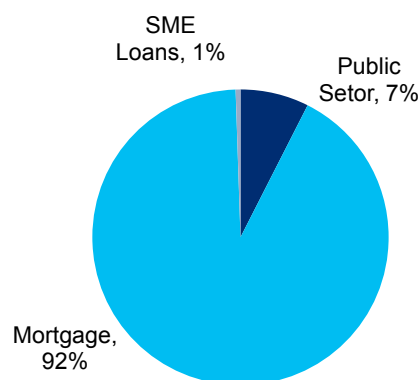
Primary Market 2013: EUR benchmark covered bonds

Figure 94. Geographical distribution, %



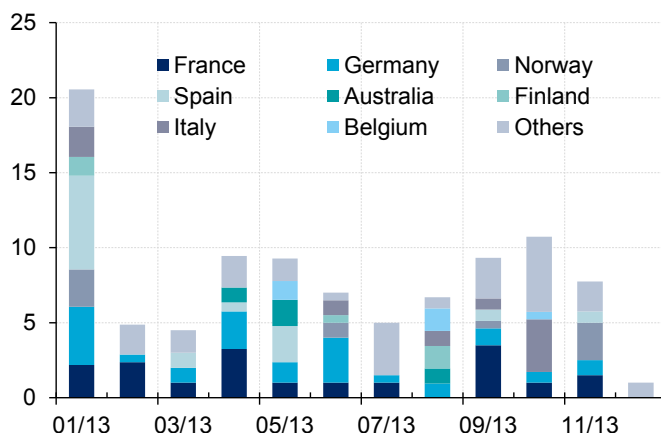
Source: Citi Research

Figure 95. Distribution by Collateral, %



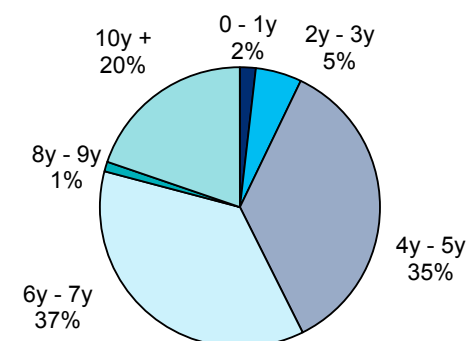
Source: Citi Research

Figure 96. Issuance by month



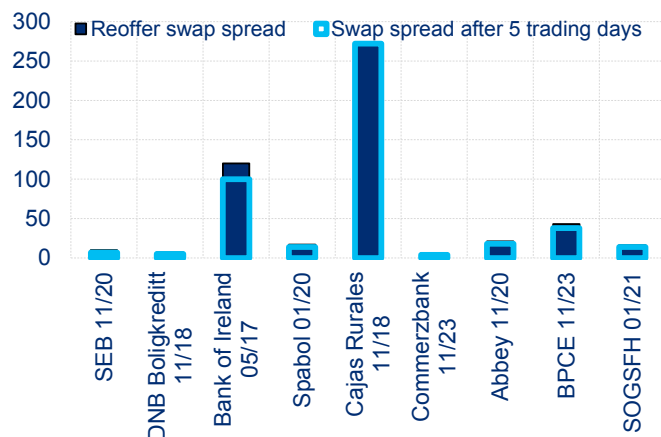
Source: Citi Research

Figure 97. Issuance by maturity, %



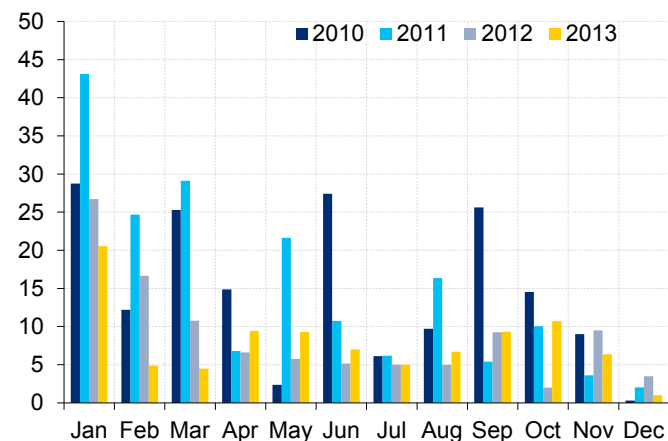
Source: Citi Research

Figure 98. Selection of primary deals' performance after 5 trading days



Source: Citi Research

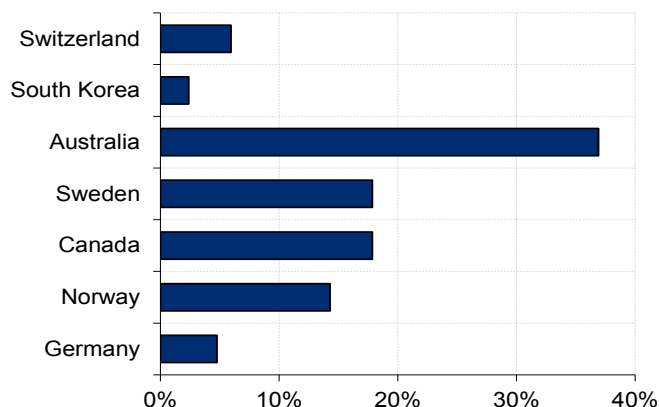
Figure 99. Historical new issuance, EURbn



Source: Citi Research

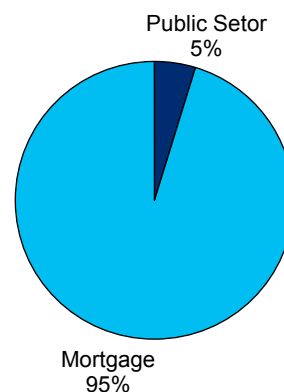
Primary Market 2013: USD benchmark covered bonds

Figure 100. Geographical distribution, %



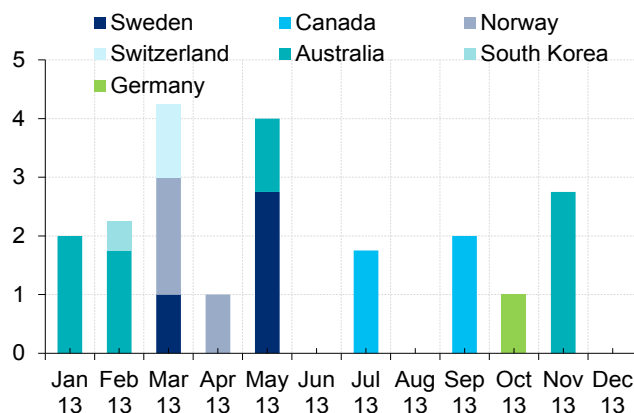
Source: Citi Research

Figure 101. Distribution by Collateral, %



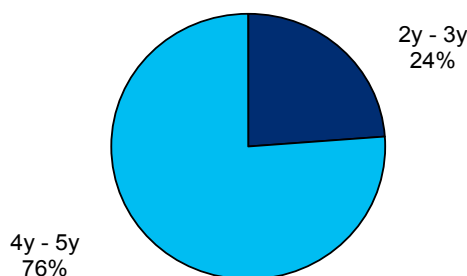
Source: Citi Research

Figure 102. Issuance by month



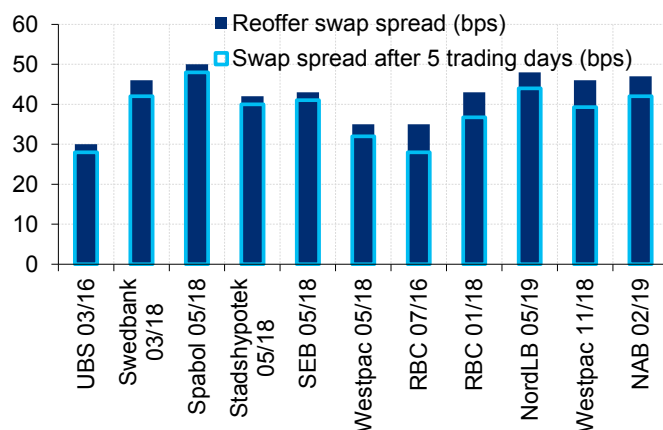
Source: Citi Research

Figure 103. Issuance by maturity, %



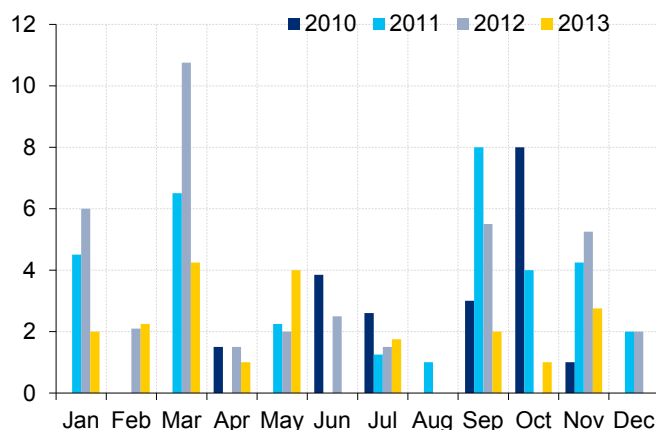
Source: Citi Research

Figure 104. Selection of primary deals' performance after 5 trading days



Source: Citi Research

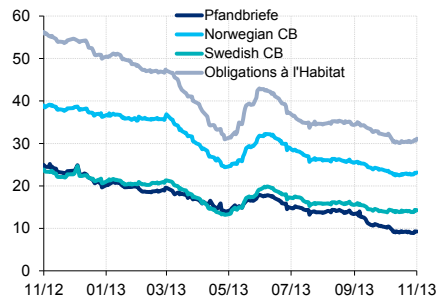
Figure 105. Historical new issuance, USDbn



Source: Citi Research

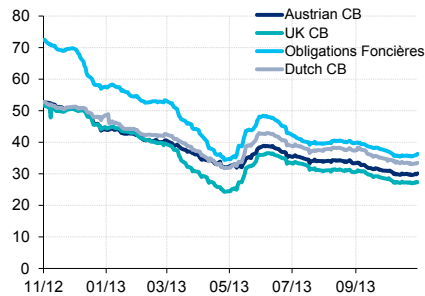
Secondary Market 2013: EUR Benchmark covered bonds

Figure 106. Secondary Market Performance, ASW-Spreads, bp



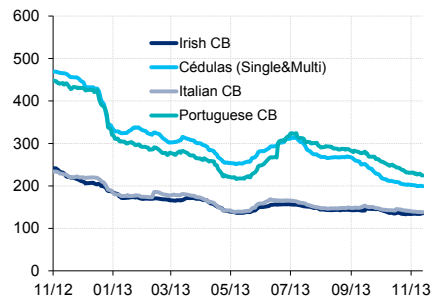
Source: Citi Research, Markit

Figure 107. Secondary Market Performance, ASW-Spreads, bp



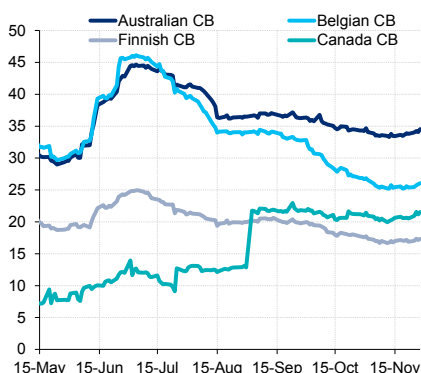
Source: Citi Research, Markit

Figure 108. Secondary Market Performance, ASW-Spreads, bp



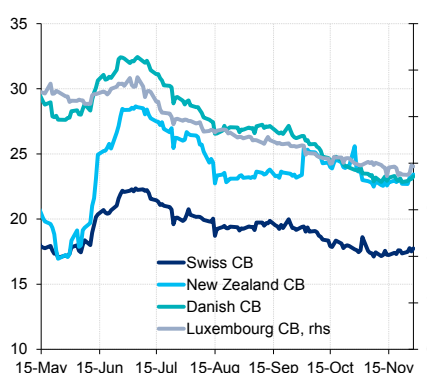
Source: Citi Research, Markit

Figure 109. Secondary Market Performance, ASW-Spreads, bp



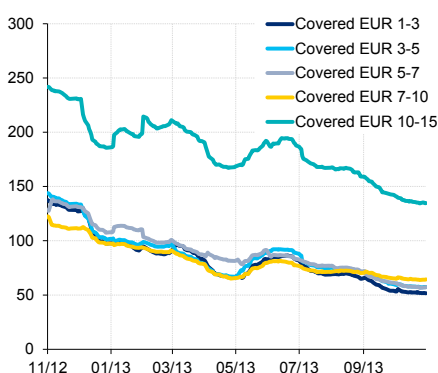
Source: Citi Research, Markit

Figure 110. Secondary Market Performance, ASW-Spreads, bp



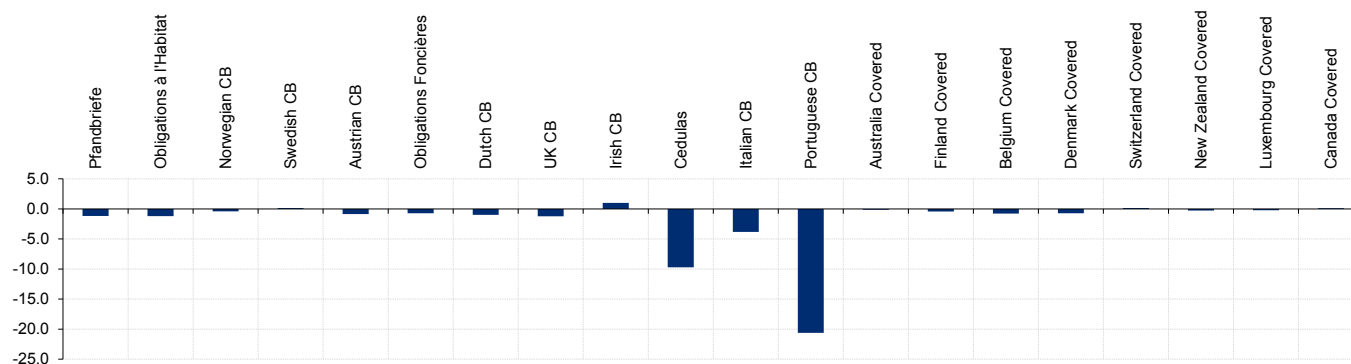
Source: Citi Research, Markit

Figure 111. Secondary Market Performance, ASW-Spreads, bp



Source: Citi Research, Markit

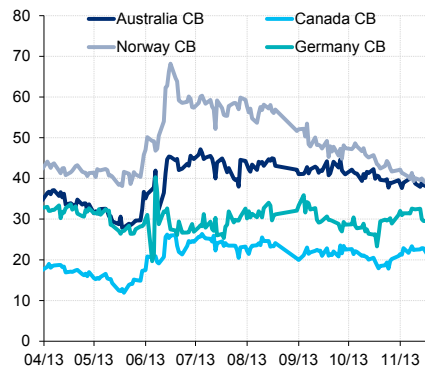
Figure 112. Spread performance over the last month



Source: Markit, Citi Research

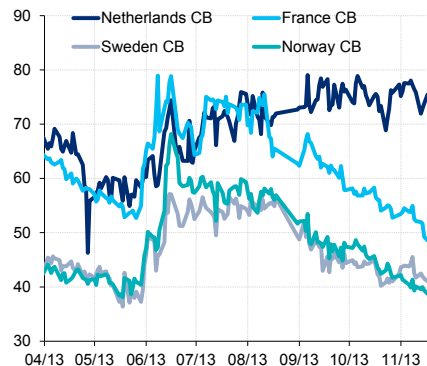
Secondary Market 2013: USD Benchmark covered bonds

Figure 113. Secondary Market Performance, ASW-Spreads, bp



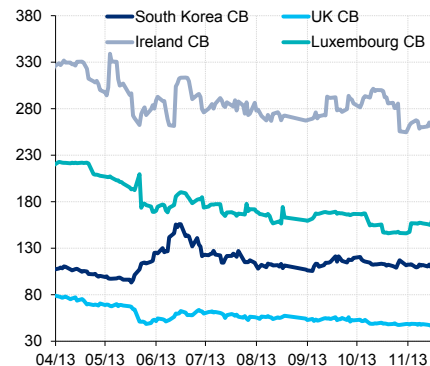
Source: Citi Research, Markit

Figure 114. Secondary Market Performance, ASW-Spreads, bp



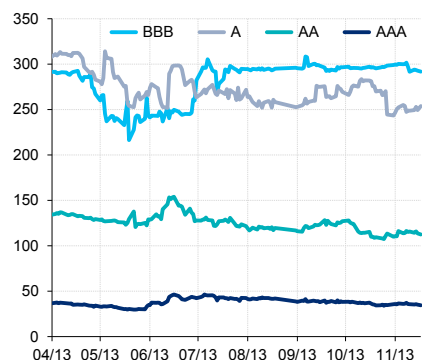
Source: Citi Research, Markit

Figure 115. Secondary Market Performance, ASW-Spreads, bp



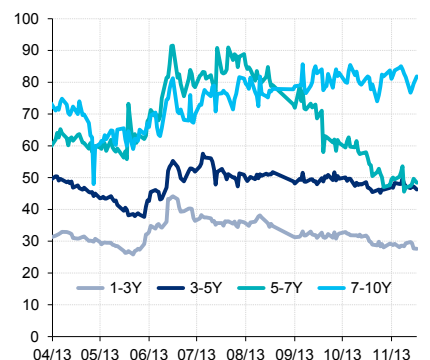
Source: Citi Research, Markit

Figure 116. Secondary Market Performance, ASW-Spreads, bp



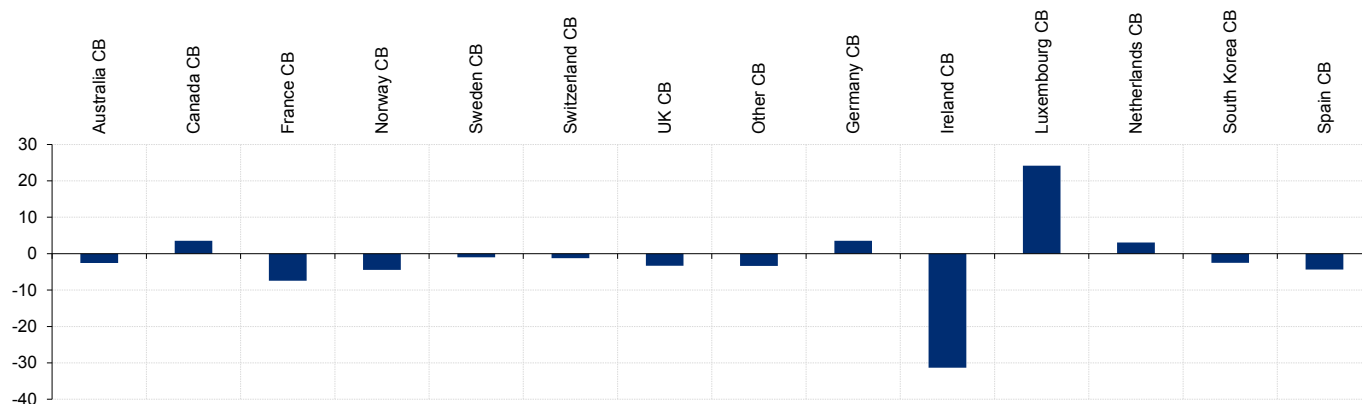
Source: Citi Research, Markit

Figure 117. Secondary Market Performance, ASW-Spreads, bp



Source: Citi Research, Markit

Figure 118. Spread performance over the last month



Source: Markit, Citi Research

Appendix A-1

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