

## UK Rates Strategy

### Gilt-Bund widening: fade or run?

- **Historically significant levels:** The 10yr gilt-Bund spread has widened by over 15bp in the last two weeks to 103bp currently. The spread is now at its widest level for the last five years. A move above 100bp has been hard to sustain in the past: it failed in September and also marked a turning point back in 2010 - Figure 1.
- **Further widening ahead?** We believe that the 100bp level may *not* act as a turning point this time. The reasons behind the recent widening – upside surprises to UK/US data, ECB rate cut, euro area deflation fears and expectations of a forecast change by the BoE at Wednesday's quarterly Inflation Report – expose the diverging fundamental drivers between gilts and Bunds.
- **Trade update:** We are maintaining our existing recommendation to be long Bund Aug23 vs gilt Sep23 (entered at 85bp on [24 October](#)). We are keeping the target of 140bp to reflect the rationale which is long-term fundamentals. However, it now seems prudent to revise the stop higher to +85bp from +58bp at inception.

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Figure 1. The 10yr gilt-Bund spread has reached the widest level for five years



Source: Citi Research, Bloomberg.

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

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# Gilt-Bund widening: fade or run?

In this note, we briefly review the outlook for the 10yr gilt-Bund spread now that it has reached the top of its 5yr range. The recent widening has been fundamentally driven, in our view, and further widening is likely over the longer-term.

## Historically significant levels

The 10yr gilt-Bund spread is at the 5yr wides

The 10yr gilt-Bund spread has widened by over 15bp in the last two weeks to 103bp currently. The spread is now at its widest level for the last five years. A move above 100bp has been hard to sustain in the past: it failed in September and also marked a turning point back in 2010 - Figure 2.

## Further widening ahead?

The recent widening has been driven by fundamentals

We believe that the 100bp level may *not* act as a turning point this time. The reasons behind the recent widening – upside surprises to UK/US data, ECB rate cut, euro area deflation fears – expose the diverging fundamental drivers between gilts and Bunds (Figure 3).

## Quarterly Inflation Report – risk or support?

The BoE are widely anticipated to reveal more hawkish forecasts in Wednesday's Inflation Report

The BoE are likely to raise their growth forecasts, lower their inflation forecasts and bring forward the date at which the jobless rate hits the 7% threshold. Anticipation of this change has probably been weighing on gilts. The fact that this has been so widely anticipated may mean that the event itself could actually trigger a near-term correction in the gilt-Bund spread. Much will depend on Carney's emphasis. However, we expect any correction to be short-lived.

## What about technical supports and the seasonals?

The impact of gilt seasonals on the gilt-Bund spread is unreliable

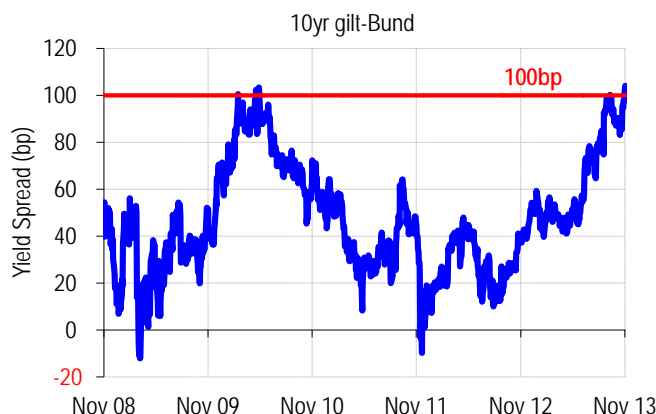
Other potential risks to widening positions in the near-term are the gilt 'seasonals'. Namely, the 7 December coupon payments, the 15yr+ index extension, low issuance into year-end and seasonal demand from pension funds. However, as discussed in [Trading implications of the gilt seasonals](#), the impact of these seasonals on the gilt-Bund spread is historically unreliable.

## Trade update: maintain gilt-Bund wideners, tighten stop

We maintain our long-term target of 140bp for the gilt-Bund spread

We are maintaining our existing recommendation to be long Bund Aug23 vs gilt Sep23 (entered at 85bp on [24 October](#)). We are keeping the target of 140bp to reflect the rationale which is long-term fundamentals. However, it now seems prudent to revise the stop higher to +80bp from +58bp at initiation.

Figure 2. The 10yr gilt-Bund spread has reached 5yr wides



Source: Citi Research, Bloomberg.

Figure 3. Drivers behind the recent widening in 10yr gilt-Bund

	Chg	Main driver
11-Nov	+3.1	
08-Nov	+2.6	US NFP 240k vs median 120k
07-Nov	+1.0	ECB rate cut
06-Nov	-0.4	
05-Nov	+3.0	UK PMI Services 62.5 vs median 60.0
04-Nov	-0.8	
01-Nov	+1.3	
31-Oct	+9.0	EMU HICP 0.7% YoY vs median 1.1%

Source: Citi Research, Bloomberg.

## Appendix A-1

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