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Western Europe

European Interest Rate Strategy

ECB: Targeting Real Interest Rates

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- Lower real yields are necessary to ease monetary conditions in the Eurozone and to break the dichotomy between lending to the public rather than to the private sector.
- This can be achieved by QE and more specifically by concentrating the monetary firepower on peripheral duration, in order to maximise the reduction in credit risk premia.
- For investors, this translates into excess returns from overweight EGBI allocations in addition to this year's impressive performance.
- Trade Ideas:
  - Lower real yields (= lower nominal yields);
  - Duration extension in EGB periphery;
  - Keep exploiting RV on the EUR curve, but…

ECB: Targeting Real Interest Rates

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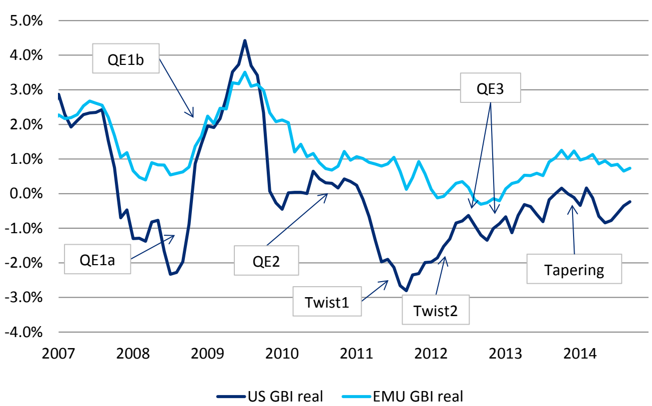
When we compare the powerful policy stimulus achieved by the FED with its sequential QE programmes to the ECB's repeated attempts of delivering policy impulses within the burdens set by the Treaty, we need to take two key variables into account: the real rate of interest and the real-effective exchange rate.

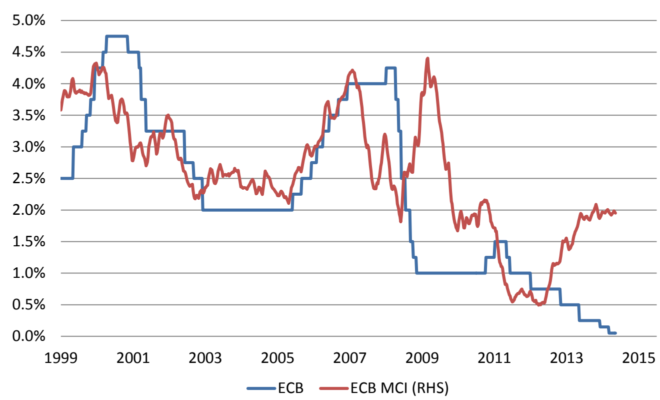
Figure 1 shows the evolution of the yield on US and EMU government bonds indices (GBI) deflated by the CPI and the HICP, respectively. Note how the real yield environment has been significantly more expansionary in the US than at any time during the crisis in the Eurozone. In the US, the problem of nominal rate rigidity near the zero-lower bound (ZLB) has been overcome by avoiding a deflationary spiral through a nominal devaluation of the dollar. In the Eurozone, the ECB has focused on the exchange rate only recently, failing to prevent real devaluation forces affecting several member countries in the meantime. As a result, the tightening in monetary conditions implied by the Euro REER and the real interest rate that started at the end of 2012 has come to a halt (Figure 2)

Figure 1. Quantitative easing and real yields



Source: Bloomberg and Citi Research

Figure 2. Monetary conditions are still tight



Source: BOE, ECB, Citi Research

Absent a real interest rate that is nearly-symmetrical around zero, the equilibrium between savings and investments at full employment may never be reached, thus forcing the economy on a lower level of output and trend growth. And even if equilibrium is reached, it may be at rates of interest so low that financial instability may arise. This state of the world, which several authors[1] call the "secular stagnation hypothesis" might be exacerbated by adverse demographic dynamics[2] and sub-optimal R&D investment, both failing to boost productivity growth.

Focusing on the Eurozone, we observe that for a constant level of yoy-inflation (and probably also inflation expectations), the level of real interest rates will depend not only on the level of risk-free yield on government securities, but also on the level of liquidity, term and credit premia. Admittedly, the ECB has successfully worked on

[1] Summers, Lawrence (2014), "Reflections on the New Secular Stagnation Hypothesis", VOX

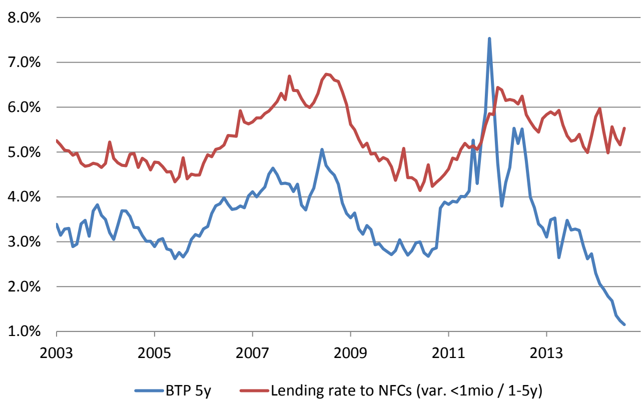
[2] European Rates Strategy (2014), "Low-for-Longer: Not Even at Half-Time"

minimising these premia, initially focussing on liquidity under Mr Trichet[3] and then on term and credit risk under Mr Draghi.

However, the level of real interest rates is still too high in the Eurozone in our view. The good news is that more can be done via unconventional monetary policy: The ECB could artificially force nominal yields on peripheral EGBs to converge even more towards core issuers, thus minimising heterogeneity and sovereign credit premia and producing de facto a unified Euro sovereign curve. Inflation expectations may get a boost as a welcome collateral effect, reflecting both the anticipation of currency depreciation and faster growth rates.

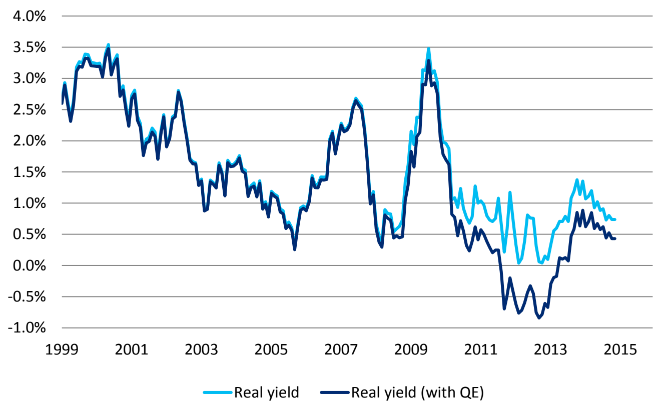
The bad news is that capital regulation[4] may still be too restrictive and banks might still find it more profitable to lend to the public sector instead of the private sector, even at ultra-low EGB yields. This crowding out effect is an additional complication in the process of balancing savings and investments described above. Figure 3 shows the situation for a large economy like Italy, where 5y BTPs yielded on average 1.61% in 2014, while banks were reporting private sector lending rates above 5.4% on average.

Figure 3. Lending to the private and the public sectors



Source: BOI, Citi Research

Figure 4. QE does matter for real yields in the Eurozone



Source: Bloomberg and Citi Research

For a constant term and inflation premium, we can quantify the real-yield effect of sovereign QE by shifting the average nominal yield on peripheral EGBIs, i.e. changing the credit premium. Using the four largest issuers as an example (covering 80% of the EMU GBI), halving spreads to Germany would result in a 30bp decline in EMU average real yield (Figure 4). In total return terms, this would approximately result in an additional 5.6%, on top of this year's impressive performance[5].

The impact of this theoretical QE impulse can be appreciated when comparing real yields prior to the crisis with real yields during the crisis (Figure 4): From January 1999 to September 2008, the QE would have accounted for a marginal 5bp compression in spreads (vs an average real yield of 1.86%). From September 2008 to September 2014, the average spread compression in this theoretical QE example would increase to a sizeable 54bp (vs average real yield of 1.12%).

[3] We believe his contribution to this particular issue is often underestimated

[4] SSA/Covered Bond Monthly (2014), "LCR, CBPP3, AQR: Working Through the Alphabet Soup"

[5] European Rates Strategy (2014), "ECB: The Balance Sheet & EGB Returns"

However, even if the ECB managed to significantly reduce credit risk premia – i.e. EGBI's average yield would drop from 1.06% to Germany's level of 0.52% – in order to deliver a monetary stimulus comparable to the US, we would still need either higher inflation or even lower nominal risk-free yields.

Policy Implications & Investment Strategy

There are two main policy implications resulting from our analysis:

1. The ECB should concentrate on reducing credit risk premia, in our view: QE via EGBs is very different from QE on USTs. We believe the ECB should construct the programme in such a way as to maximise the effect on credit spreads. For example: a 4-year purchase programme, according to ECB's capital contribution, but without the need to simultaneously buy all EGBs or the need to buy equal dv01s (Figure 5). From a Treaty perspective, we think that proportional notional amounts need to be ensured, but this would not preclude the ECB from buying let's say the long-end of Italy together with German Bubills.

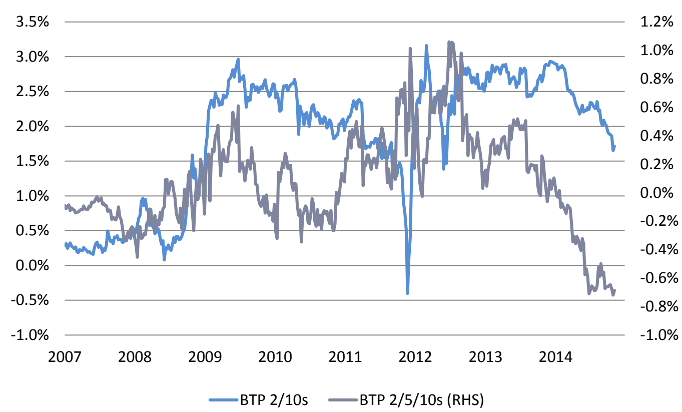
2. The ECB should concentrate on increasing inflation expectations: Typically, we might expect inflation premia to rise after QE. If needed, the ECB could even think of committing to a higher inflation target, but in theory the long-term costs of higher inflation and the loss of inter-temporal fiscal discipline seem to outweigh the benefits of more efficient policy operations at the ZLB[6].

Figure 5. Target QE – A practical example

Issuer	Notional (bn)	Mod Dur	dv01 (mm)	Target Dur	Target dv01 (mm)
France	295	7.3	214	5.0	148
Germany	244	7.1	173	2.0	49
Italy	297	6.5	194	10.5	312
Spain	163	6.2	101	10.5	172
Total	1000	6.8	681	6.8	680

Source: Citi Research

Figure 6. Duration extension past 5y on the BTP curve



Source: Bloomberg and Citi Research

In conclusion, we like the following trades:

- **Lower real yields (= lower nominal yields):** Assuming a very mild inflation profile for 2015 (our economists forecast HICP to rise mildly to a 0.9% average from 0.5% in 2014, but with a substantial revision to global inflation), the level of real yields should be the main driver for nominal risk-free yields. In that sense, we have also recently revised our 2015 projection for Bunds[7]. As mentioned above, in absence of meaningful inflation risk premia, we believe the optimal strategy for ECB would be to simultaneously remove term and credit premia from

[6] McCallum, Bennett (2011), "Should Central Banks Raise Their Inflation Targets? Some Relevant Issues", Richmond FED Economic Quarterly

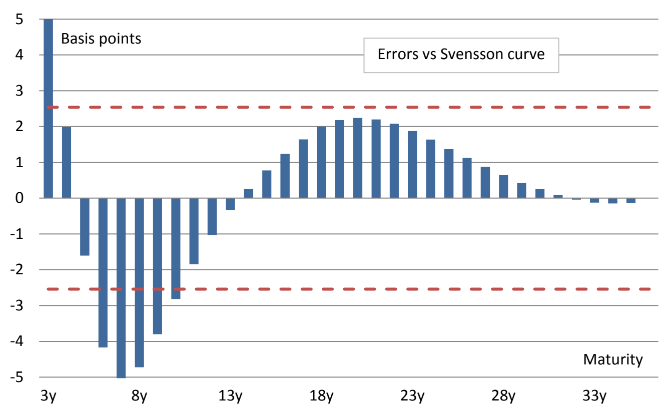
[7] European Rates Strategy (2014), "Bund: Where Now?"

the EGB space. The probability of negative risk-free rates even for intermediate maturities should not be underestimated in our view.

- **Duration extension in EGB periphery:** A dv01-based QE – as compared to a naïve notional-based QE – implies potential profits not only from a collapse of sovereign risk premia, but also from this measure's strong flattening bias. To some extent, a dv01-based QE is comparable to a peripheral "operation twist". This strategy also makes sense when looking at BTP's curvature (Figure 6). In particular, we still like longs in BTP Aug-21 vs Sep-19 (current spread is 57bp, trade entered on 9 September 2014).

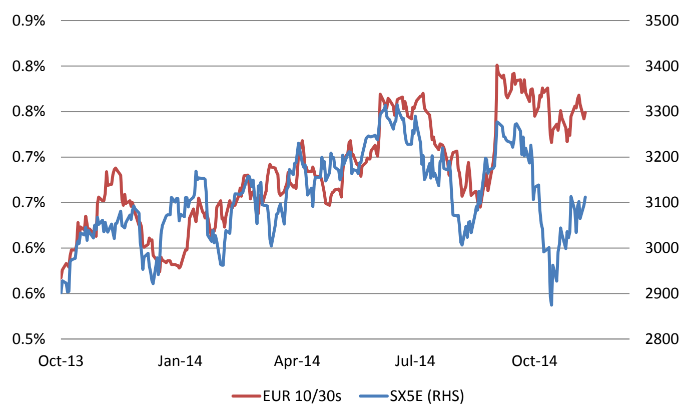
- **Keep exploiting RV on the curve, but…:** One of the stylised facts of the crisis is the "hump" in the 15-20y sector (Figure 7), a distortion that reflects heavy positioning in forward-steepeners as well a legacy of ASW-strategies that are being carried mainly by ALMs since the 2004-2007 era of low spreads and low volatility. Our preferred strategy to play that theme has been EUR 10y2y/12y3y (+13bp ytd in addition to a positive roll-down of approximately 6bp). While the roll-down profile still looks very attractive, we need to be aware of the sensitivity of steepener-type of trades to equity valuation (Figure 8). Furthermore, the opportunity cost of constructing carry positions on the EUR curve is increasing as the USD and GBP curves now offer much more interesting opportunities in our view[8].

Figure 7. Identifying rich & cheap sectors on the swap curve



Source: Bloomberg and Citi Research

Figure 8. Low-for-longer steepeners? A view on stocks...



Source: Bloomberg and Citi Research

[8] European Rates Strategy (2014), "Forwards and Forward Guidance"

Appendix A-1

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