

European Interest Rate Strategy

OAT: The Long-End after the Downgrade

- Fitch's downgrade of France has modified the composition of the ECB AAA curve, which is often used for regulatory reporting.
- The recent underperformance of OAT 30y needs to be seen in the context of the current regulatory situation and the future behavior of Dutch insurance companies.
- The importance of France as liquidity provider at the long-end of the EGB curve should not be underestimated.
- TRADE IDEA: Buy OAT Nov-18 and OAT May-45 vs sell OAT May-23 @-4bp. Target +40bp, stop -15bp.

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OAT: The Long-End After the Downgrade

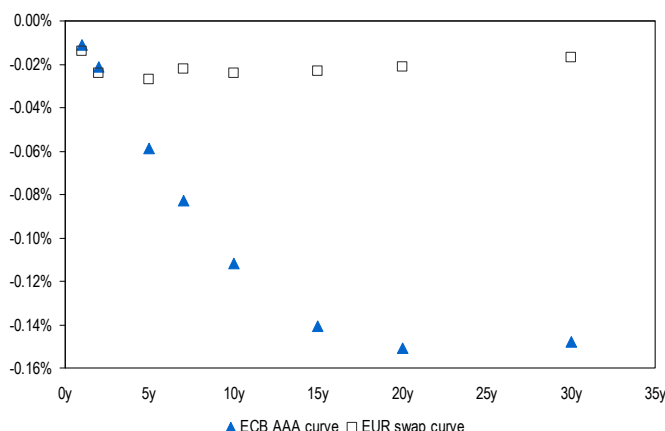
The ECB AAA curve is often used for regulatory purposes

Changing composition of the ECB AAA curve suggests a higher PV of liabilities

There has been some attention to the potential future market impact of Fitch downgrading the Republic of France from AAA to AA+ (Friday 12 July) and the subsequent removal of French government bonds from the ECB AAA curve¹. This particular yield curve is important in deriving discounting factors for computing and reporting regulatory solvency ratios for Dutch insurers under IGD.

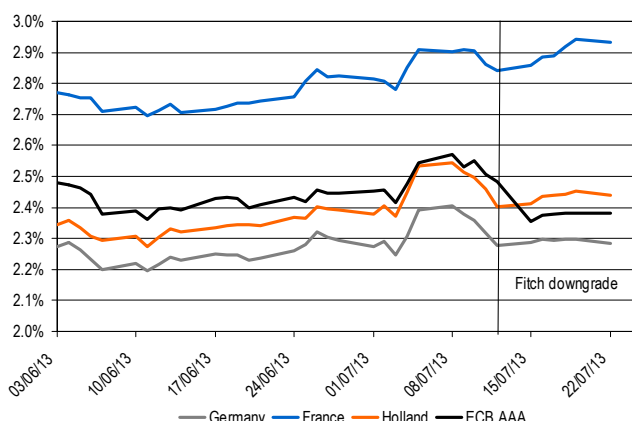
The ECB AAA curve has artificially collapsed following the removal of French government bonds on 15 July 2013. Due to the low level of interest rates at the front-end of the curve and the liquidity of OATs at longer maturities, the AAA curve has bull flattened by 13bp in the 2/30y sector as a consequence of Fitch's downgrade (Figure 1). At the same time, the effect on the performance of OATs vs other EGB markets is evident, but not yet dramatic (Figure 2): Over the course of last week, the OAT 2/30s curve has steepened by 10bp, with the swap and the Bund curves steeper by only 2bp and the Guilder curve by 5bp.

Figure 1. Changes to the ECB AAA curve post-OAT downgrade



Source: Citi Research

Figure 2. Selected EGB curves (2/30s)



Source: Citi Research

Impact on OAT curve is overestimated

Given the very large size of the Dutch insurance sector² with total assets running at around 80% of GDP, it is not completely irrational to expect an even larger negative impact on the long-end of the OAT curve. However, we need to take into account the following key factors:

- French government bonds are a heavyweight of the long-end of the EGB market with a 40% weight in a composite Citi quasi-AAA 10y+ sub-index and a 20% weight in the Citi EGBI 10y+ benchmark. Hedging large liability portfolios without the liquidity provided by OATs can become a serious issue. This is evidenced by the relative stability the OAT stock held by non-resident investors.
- The historically low interest rate environment makes it expensive for insurers to run large guaranteed schemes. Annuity insurance and collective pension products together account for 60% (or EUR 177bn) of lifers' portfolio³. Guarantees offered by Dutch insurers – running between 3.5% and 3.75% – are high by international standards. The long-end of the OAT curve offers an attractive pool of liquid spreads (average ASW in the 20-50y sector is 95bp) that

¹ <http://www.ecb.int/stats/money/yc/html/index.en.html>

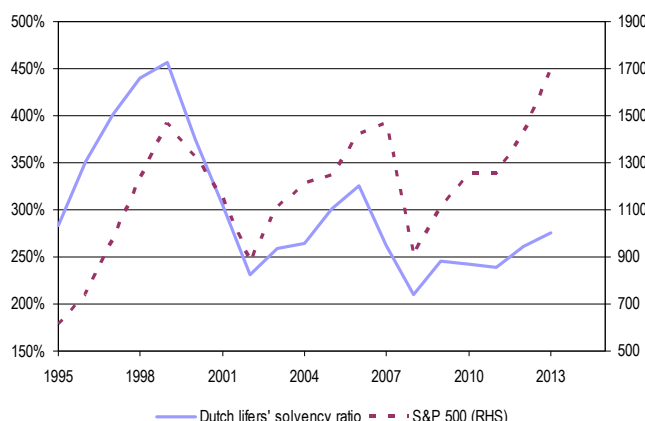
² According to DNB, the total present value of Dutch insurance companies' investments is EUR 421bn of which 51% in fixed income securities (end Q1 2013).

³ "Overview Financial Stability – Spring 2013", DNB.

can be employed to efficiently cover the 100/125bp gap between guaranteed rates and 30y swap rates (2.45%).

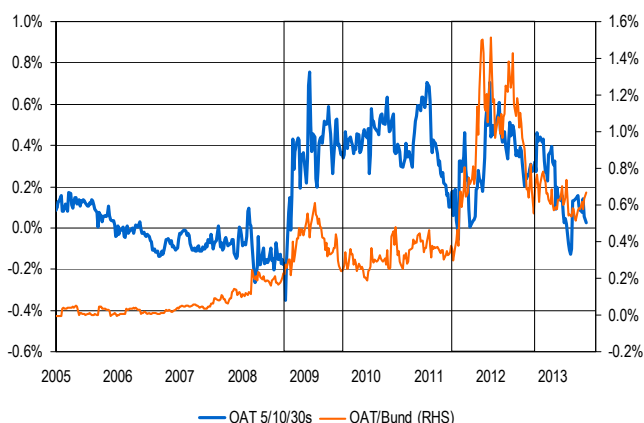
- Dutch insurance companies have recently softened the dependency of their liability valuation process on the value and the credit rating of French government bonds. In July 2012, several large Dutch insurers⁴ have modified their ECB AAA curve with the UFR-methodology introduced by the regulator (DNB). This step has softened the strong relationship between the present value of insurance liabilities and the OAT yield curve.
- In contrast to Dutch pension funds, insurers have a much better solvency position. As of Q1 2013, the DNB reports a solvency ratio of 275% for the life insurance sub-sector (30bn margin vs 10.9bn required solvency margin). The sequential introduction of regulation has reduced the sensitivity of solvency ratios to risky assets, thus helping to stabilize the sector (Figure 3).

Figure 3. Solvency ratio vs risky assets



Source: Citi Research

Figure 4. Positive carry OAT/Bund widener



Source: Citi Research

Investment Strategy & Trade Ideas

Carry positive proxy for OAT/Bund wideners

We like to fade the recent underperformance of OAT 30y. One strategy that looks interesting from several points of view is the OAT 5/10/30s butterfly. Selling 10s to buy 5s and 30s @-4bp starts to look like a good risk/reward on the chart and rolls positively on the French ASW curve to the tune of +2bp/year. Furthermore, the trade seems to be somewhat sensitive to the evolution of OAT/Bund spreads (Figure 4), jumping by 40/50bp in both 2009 and 2011 spread widening episodes. We still expect OATs to widen vs Bunds in the second half of this year. In terms of supply, there is nothing from France until the 5th of September, while we have Guilder 30y tomorrow (target 1.5-2.5bn together with 10s) and 2bn of Bund 30y next week.

TRADE: Buy OAT Nov-18 and OAT May-45 vs sell OAT May-23 @-4bp. Target +40bp, stop -15bp.

⁴ For example, DeltaLloyd has reported this change in their Annual Report for 2012.

Appendix A-1

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