

Global Rates Strategy

Where We Disagree With What's Priced In

- **Positioning for what's not priced in** – This note highlights where our latest global yield, curve and cross-market forecasts differ from the forwards. We provide a one page summary of trades to take advantage of these divergences.
- **What else is in this note** – In the appendix we include a summary of the key rates forecasts, highlight the biggest forecast moves, and look at the implied cross-market spread trajectories. We also provide a one page summary of the relevant underlying economics.
- **Where to find the detailed underlying forecasts** – For a comprehensive set of global economic and yield forecasts, together with accompanying in depth economic and political analysis, please see our [Global Economic Outlook and Strategy - April 2014](#), on which this note is based.
- **10yr yields** – The positive spread between our 10yr UST forecasts and the forwards peaks around 35bps in 15Q1, while our 10yr Bund forecasts are only about 10bps lower than what is priced in. Both are about 10bps lower than last month. Globally, we are forecasting most underperformance of ACGBs vs what is priced in, followed by USTs. We think market mispricing (i.e. underpricing) of outperformance is greatest in BTPs. The forecast underperformance of gilts over and above what is priced in is unchanged from last month. We continue to expect 10yr BTPs and Bono yields to fall over the forecast horizon: the market is pricing in yield rises.
- **2s10s curve** – The market is underpricing steepening globally, in our view, except in the UK where the forward curve looks too steep (but only in 15H2). The underpricing of steepening is most pronounced in the US.
- **Spreads to the US** – We expect 10yr USTs to underperform Germany by up to 40bps more than is priced in. Compared to last month we see less underperformance of USTs vs JGBs, and more outperformance of USTs vs ACGBs. We expect the US to outperform Australia by 20-40bps more than is priced in, over the forecast horizon, and to underperform Japan by 15-20bps more than is priced in out to 1Q15. The divergence between our forecasts and the forwards is very similar in UST and gilts, implying limited upside in the 10yr UST/gilt spread.
- **Spreads to Germany** – We expect the outperformance of Germany vs the UK and Japan, over and above what is priced in, to increase with time. We expect Germany to outperform the US. The potential for Bund outperformance of USTs is much greater in 10s than in 2s, in our view. We expect 2yr gilts to underperform by more than we expect Schatz to outperform the forwards: express short UK/long Germany trades at the front end, rather than in 10s. We see scope for 20bps more outperformance of Italy and Spain compared to last month.

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

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Forecasts vs the forwards: mind the gaps¹

This note highlights where we disagree with what is priced in and we present corresponding trades. We use charts to compare our latest yield, curve and cross-market forecasts to the forwards, and in the appendix provide a summary of the forecasts and underlying economics.

Summary of analysis

10yr yields

10yr yields

- We have revised down our **Treasury** and **Bund** forecasts from last month, with Bunds falling by 10bps/quarter more than USTs on average. The spread between our 10yr UST forecasts and the forwards peak around 35bps in 15Q1.
- Out of **USTs, JGBs, gilts and ACGBs** we forecast most underperformance of ACGBs, peaking in 3Q15.
- We expect greater underperformance of **ACGBs** than we did last month. This is a function of unchanged forecasts in the face of lower forwards.
- Forecast **gilt** underperformance, over and above what is priced in, is unchanged from last month.
- The forecast underperformance of **JGBs**, peaking at 30bps in 3Q15, is also unchanged from last month.
- We continue to disagree with the rise in yields priced into the forwards in **Italy and Spain**. We expect 10yr BTPs and Bono yields to *fall* over the forecast horizon.

Where are the largest divergences
between our forecasts and the forwards?

Largest gaps between our forecasts and the forwards

- Globally, we forecast most underperformance of **ACGBs**, followed by **USTs**.
- Only in **Bunds** do we see yields as too high relative to the forwards, and even here the gap only averages about 10bps over the forecast horizon.
- **Within Europe** however the divergences between what is priced in and our forecasts are larger. We expect **France** to outperform more than Germany. We foresee the greatest forecast/forward gap in **BTPs and Bonos**, and we expect Italy to outperform by more than Spain.

Our forecasts imply most scope for **USTs**
outperformance vs **ACGBs** and most
scope for underperformance vs **Bunds**
(or **BTPs** if including peripherals)

Spreads to the US

- Compared to last month you can see that we see less underperformance of **USTs vs JGBs**, and more outperformance of **USTs vs ACGBs**.
- We expect the US to outperform **Australia** by 20-40bps more than is priced in, over the forecast horizon, and to underperform **Japan** by 15-20bps more than is priced in out to 1Q15. The implied underperformance of **ACGB vs JGBs** is greatest in coming quarters.
- We expect 10yr USTs to underperform **Germany** by up to 40bps more than is priced in. (This is much greater vs Italy or Spain)
- The divergence between our forecasts and the forwards is very similar in **UST and gilts**, implying limited upside in the 10yr UST/gilt spread, i.e. our forecasts are on top of the forwards.

¹ Throughout we use the relevant Citi par bond curve to calculate the forwards. These do not deviate materially from FWC on Bloomberg.

Germany to outperform, except against
peripherals

Spreads to Germany

- We expect the outperformance of Germany vs the **UK and Japan**, over and above what is priced in, to increase with time.
- We also expect Germany to outperform the **US** by around 40bps more than the forwards, but this outperformance reaches its maximum in 4Q14. We see much more potential for Bund outperformance of USTs in 10s than we do in 2s.
- The forwards' underestimation of the outperformance of **BTPs vs Bunds** is also expected to increase with time. We expect 20bps more outperformance of Italy and Spain compared to last month and for Italy to underperform Spain by less than is priced in.
- We anticipate only marginal outperformance of **France vs Germany**, relative to what is priced in (i.e. France to underperform by less than is priced in relative to Germany). Last month we had modest outperformance of Germany vs France, relative to what was priced in.
- We expect **2yr gilts** to underperform by more than we expect **Schatz** to outperform the forwards. Express short UK/long Germany trades at the front end rather than in 10s

Not enough steepening priced into most
curves

2s10s curves

- **US:** We expect the UST curve to steepen by up to 40bps more than is priced in from Q4, mainly driven by 10s. Although we expect more steepening than is priced in, the implied mispricing is smaller than last month.
- **Germany:** Although we think the market is overestimating the sell-off in 10yr Bunds (by approximately 20bps by 4Q15) we think the forwards overestimate the sell-off in 2yrs by almost double this amount. In other words, the market is underpricing the steepening of the German curve in our view.
- **Japan:** In Japan we expect more steepening than is currently priced in. We think the market is underestimating the rise in 10yr JGB yields from 4Q14 onwards, but only moderately so in 2s.
- **Italy and Spain:** The forwards imply modest flattening. We expect steepening. (We expect both 2 and 10yr yields to fall outright, while the market is pricing in healthy yield rises.)
- **UK:** Forward curve too steep further forward. We think the forwards are underestimating the magnitude of the rise in yields by >30bps. The gap between our forecasts and the forwards is more pronounced in 2s than 10s
- **Australia:** The market is not pricing in sufficient steepening. The forwards are not pricing in enough of a rise in 10yr yields in our view, but the rise in front end forwards don't start to lag our forecasts significantly until 1Q15.

Read on for a summary of trades ideas...

Read on for a summary of trades implied by the comparisons of our forecasts and what is priced in²...

² The appendix summarises our forecasts and condenses the economic backdrop to our forecasts to one page.

Positioning for what's not priced in: a summary

Below is a summary of trades implied by the comparisons of our forecasts and what is priced in.

Bullish duration

Bullish duration

- **If you're outright bullish:** buy BTPs (or OATs if rating-sensitive)

Bearish duration

Bearish duration

- **If you're outright bearish:** sell ACGBs
- **If you want to sell the US:** do it in 10s rather than 2s

Cross-market

Cross-market

- **If you want to be long Germany vs the US:** do it in 10s rather than 2s
- **If you want to be short the UK vs Germany:** do it in 2s, not 10s
- **If you want to be short the US cross-market:** -USTs vs JGBs
- **If you want to be long the US cross-market:** +USTs vs ACGBs

Peripherals

Peripherals

- **If you are bullish duration outright** then BTPs are the obvious candidate
- **If you like peripheral risk but are more wary of market direction** then buy BTPs vs Bunds
- **If more defensive on peripherals** then look at BTP (or Bono) steepeners
 - The forwards imply modest flattening of the BTP curve: our European team is forecasting steepening
- **Or for a temporary defensive trade,** look at boxing BTP steepeners with Bund flatteners
 - The flattening priced into the BTP curve is greater than the underpricing of steepening in the Bund curve

Curves

Curves

- Steepeners in Germany or the US
 - We expect the UST curve to steepen by up to 40bps more than is priced in from Q4, mainly driven by 10s
 - Too little steepening is priced into the German curve too
- Box existing 10yr -US/+Europe trades with DV01-weighted +2yr US/-Europe positions
- Look at EUR 2s10s flatteners in swaps 9-18m forward vs USD steepeners
- Expressing this conditionally is also an option, though using CMS would remove the timing element
- Steepeners in Japan and Australia (but not the UK)

Read on for the chart-based analysis...

Read on for a summary of what has changed since last month, and the analysis on which the above is based.

What has changed from last month?

We have revised down our Treasury and Bund forecasts from last month, with Bunds falling by 10bps/quarter more than USTs on average.

Figure 1. Summary yield forecasts

Average 10yr yield	14H2	15H1	15H2
US	3.15	3.43	3.53
Germany	1.60	1.70	1.80
UK	3.25	3.53	3.68
Australia	4.55	4.73	4.95
Japan	0.78	1.00	1.13

Source: Citi Research. See 30 April Global Economic Outlook and Strategy

Figure 2. Last month's summary forecasts for comparison

Average 10yr yield	14H2	15H1	15H2
US	3.23	3.55	3.73
Germany	1.75	1.90	2.00
UK	3.33	3.53	3.68
Australia	4.55	4.73	4.95
Japan	0.78	1.00	1.13

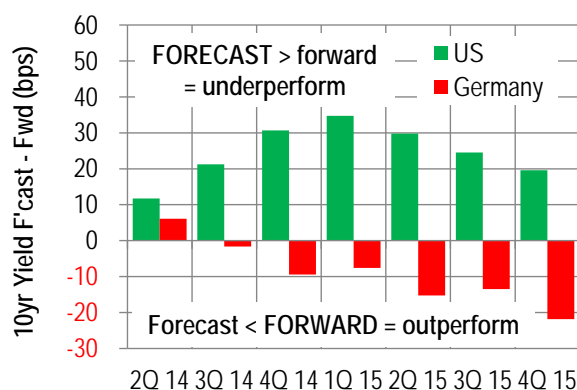
Source: Citi Research

The spread between our 10yr UST forecasts and the forwards peak around 35bps in 15Q1 (Figure 3) while the (relatively small) divergence of our Bund forecasts from the forwards increases with time.

More bullish on Bunds and less bearish on USTs from last month

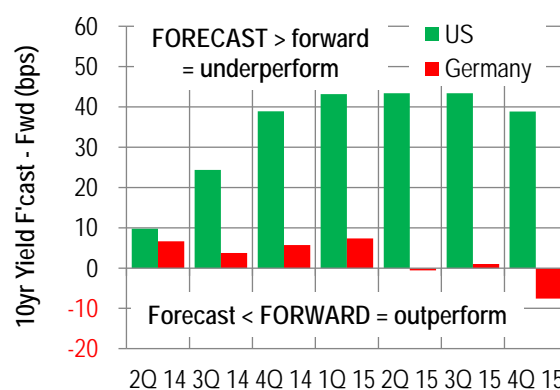
Comparing the gap between what is priced in and our current forecasts (Figure 3) with the gap last month (Figure 4) shows a more bullish view on Bunds and less bearish view on USTs. In effect the y-axis has just been shifted upwards by 10bps.

Figure 3. US and Germany: 10yr forecasts vs the forwards



Source: Citi Research

Figure 4. Last month's forecast/forward gaps for comparison



Source: Citi Research

Out of JGBs, gilts and ACGBs we forecast most underperformance in ACGBs, peaking in 3Q15 (Figure 5).

10yr ACGBs

We expect greater underperformance of ACGBs than last month (compare Figure 5 and Figure 6). This is a function of unchanged forecasts in the face of lower forwards.

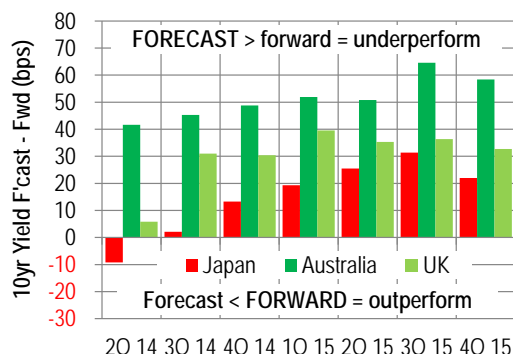
10yr gilts

The forecast underperformance of gilts (Figure 5) is unchanged from last month (Figure 6).

10yr JGBs

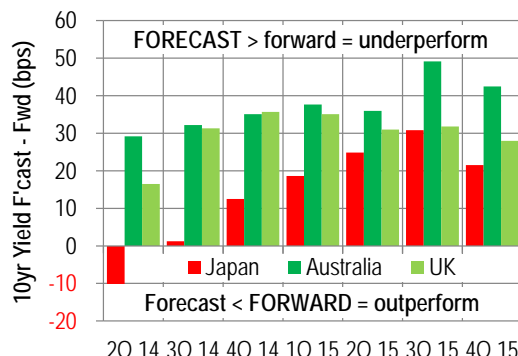
The expected underperformance of JGBs, peaking at 30bps in 3Q15, is unchanged.

Figure 5. Japan, Australia and UK: 10yr forecasts vs the forwards



Source: Citi Research

Figure 6. Last month's forecast/forward gaps for comparison



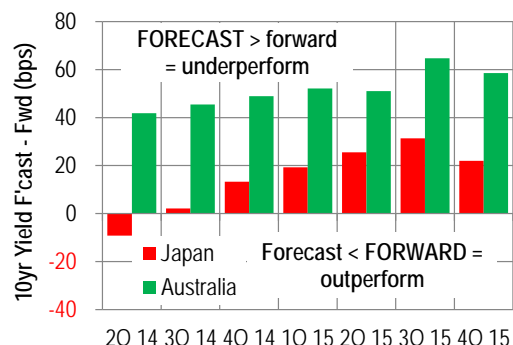
Source: Citi Research

Where are the largest forecast/forward gaps now?

Globally, we forecast most underperformance by ACGBs, followed by USTs

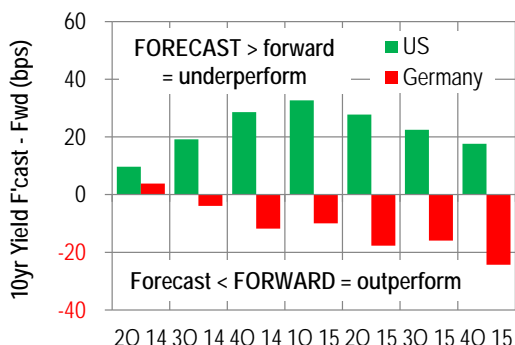
Globally, we forecast most underperformance in ACGBs (Figure 7), followed by USTs (Figure 8). Only in Bunds do we see yields as too high relative to the forwards, and even here the gap only averages about 10bps over the forecast horizon (Figure 8).

Figure 7. Japan and Australia: 10yr forecasts vs the forwards



Source: Citi Research

Figure 8. US and Germany: 10yr forecasts vs the forwards

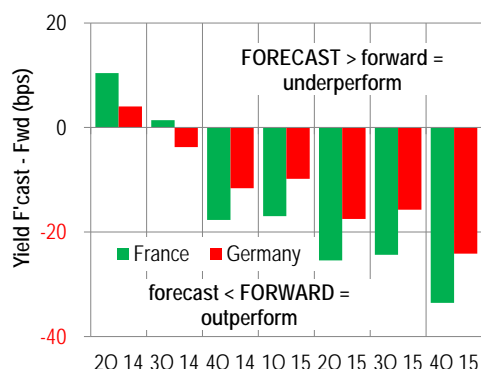


Source: Citi Research

Within Europe the divergences between what is priced in and our forecasts are larger

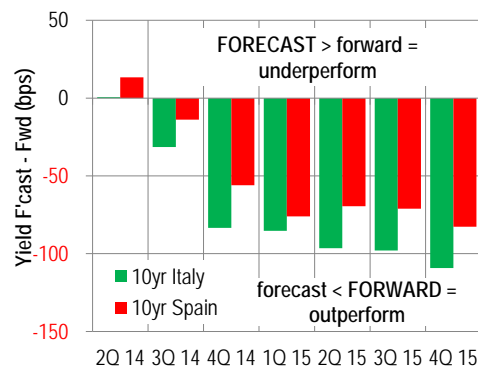
Within Europe, however, the divergences between what is priced in and our forecasts are larger. We expect France to outperform by more than Germany (Figure 9). We foresee the greatest forecast/forward gap in BTPs and Bonos (Figure 10) and expect Italy to outperform by more than Spain.

Figure 9. France and Germany: 10yr forecasts vs the forwards



Source: Citi Research

Figure 10. Italy and Spain: 10yr forecasts vs the forwards



Source: Citi Research

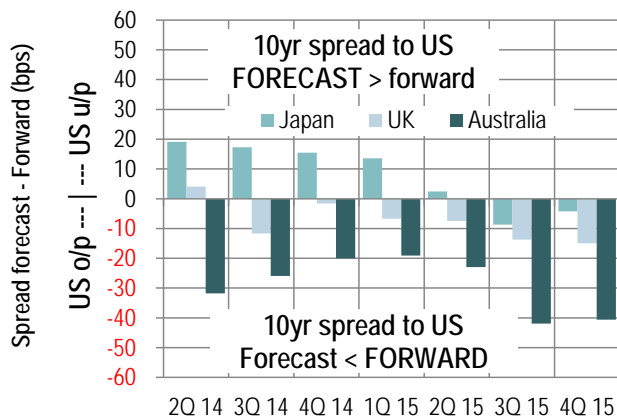
Spreads to the US

Where we disagree with forward pricing of US cross-market spreads

Below we look at the forecast/forward divergences from the perspective of spreads to USTs.

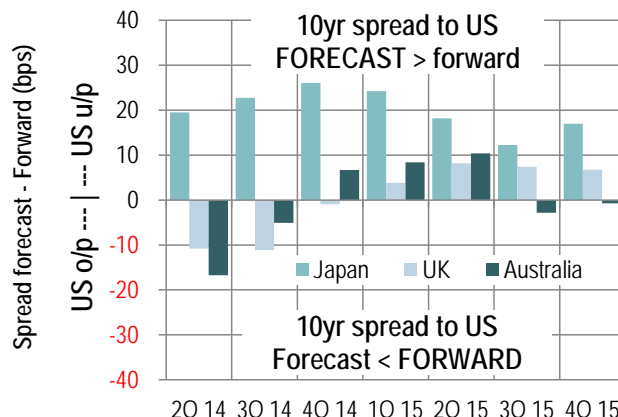
Comparing this month (Figure 11) to last month (Figure 12) you can see that we see less underperformance of USTs vs JGBs, and more outperformance of USTs vs ACGBs.

Figure 11. Forecast spreads to the US vs what's priced in



Source: Citi Research

Figure 12. Last month's US cross-market forward/forecast gaps

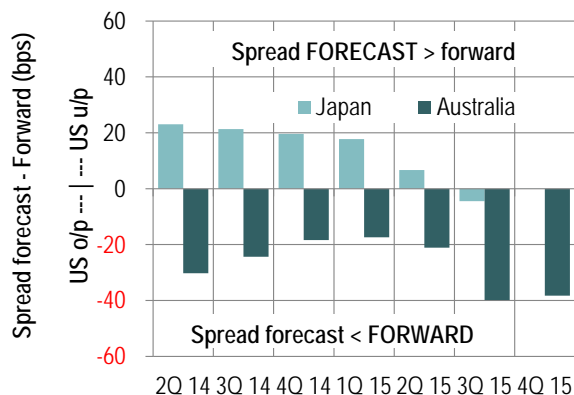


Source: Citi Research

US/Australia and US/Japan

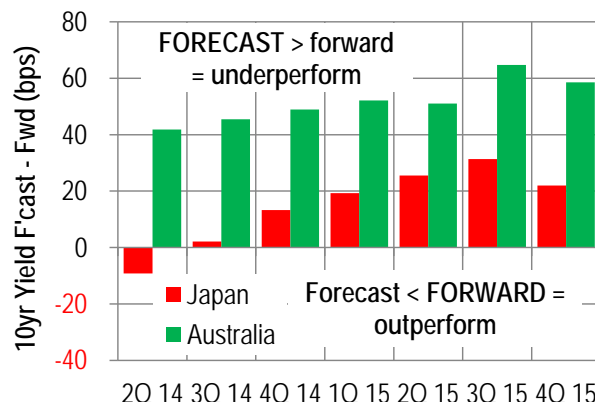
We see that we expect the US to outperform Australia by 20-40bps more than is priced in, over the forecast horizon (Figure 13), and to underperform Japan by 15-20bps more than is priced in out to 1Q15. The implied underperformance of ACGB vs JGBs is greatest in coming quarters (Figure 13). Figure 14 is reproduced from earlier to show the source of this relative underperformance of ACGBs.

Figure 13. Forecast UST spread to JGBs and ACGBs vs what's priced in



Source: Citi Research

Figure 14. Japan and Australia: 10yr forecasts vs the forwards

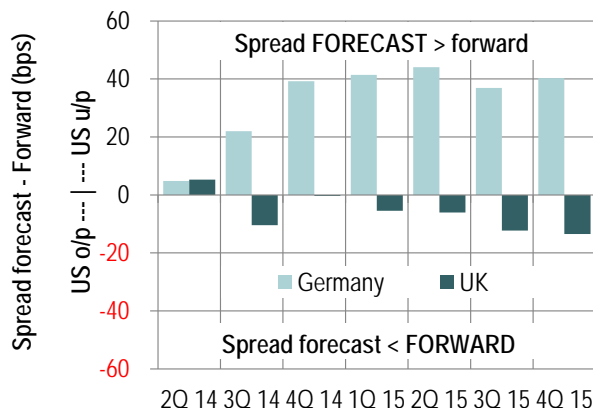


Source: Citi Research

UST/Bund and gilt/Bund

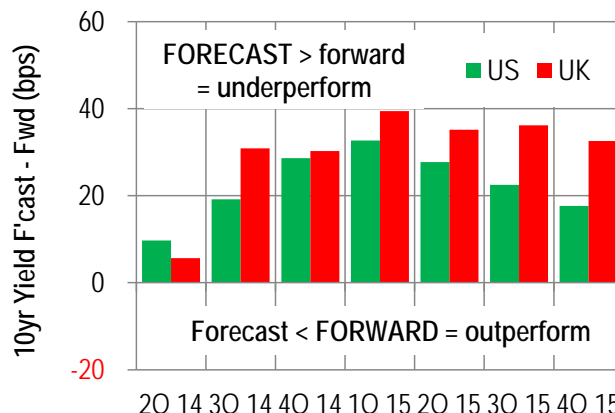
Figure 15 highlights the forecast underperformance of the US vs Germany, relative to what is currently priced in. It also shows that the divergence between our forecasts and the forwards is very similar in UST and gilts, implying very limited upside in the 10yr UST/gilt spread.

Figure 15. Forecast UST spread to gilts and Bunds vs what's priced in



Source: Citi Research

Figure 16. US and UK: 10yr forecasts vs the forwards



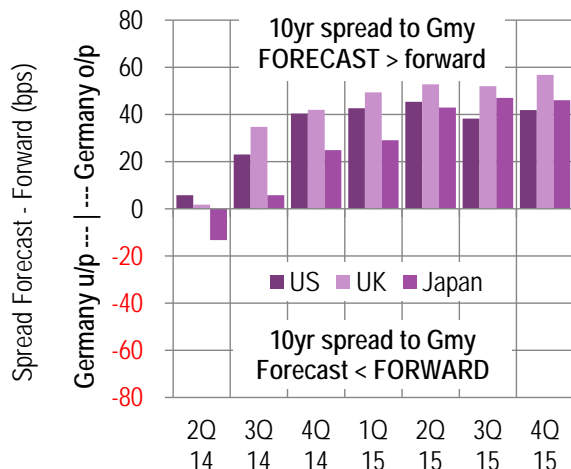
Source: Citi Research

10yr spreads to Germany

Spreads to US, UK, Japan, France, Italy and Spain

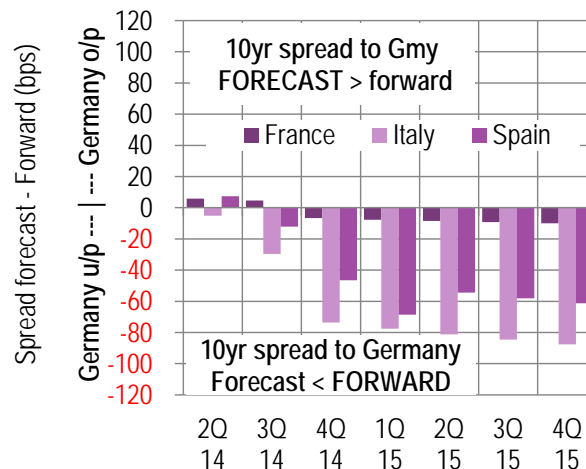
We expect the outperformance of Germany vs the UK and Japan, over and above what is priced in, to increase with time (Figure 17, below left). Versus the US however, the forecast/forward divergence vs Germany is relatively constant around 40bps from 4Q14 to 4Q15.

Figure 17. Spreads to Germany (US, UK and Japan) vs what's priced in



Source: Citi Research

Figure 18. Spreads to Germany (France, Italy and Spain) vs forwards



Source: Citi Research

We expect 20bps more outperformance of Italy and Spain compared to last month

The forwards' *underestimation* of the outperformance of BTPs vs Bunds also increases with time (Figure 18, above right). We expect 20bps more outperformance of Italy and Spain compared to last month³.

³ The net supply imbalance is also in favour of Italy. See the latest *European Rates Weekly*.

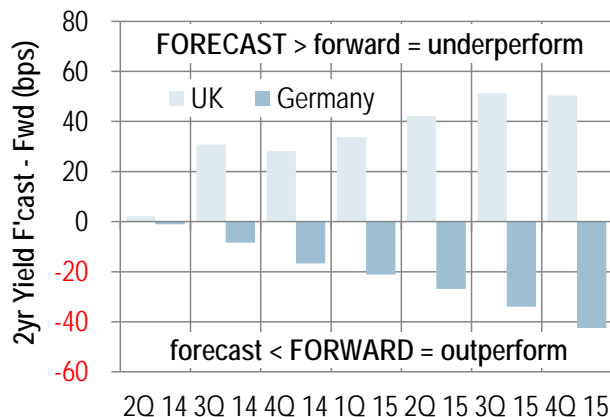
-UK/+Germany: do it in 2s, not 10s

Express short UK vs Germany in 2s, not 10s

Figure 19 compares the gap between our Schatz and 2yr gilt forecasts and the respective forwards. As you can see, we expect 2yr gilts to underperform by more than we expect Schatz to outperform the forwards.

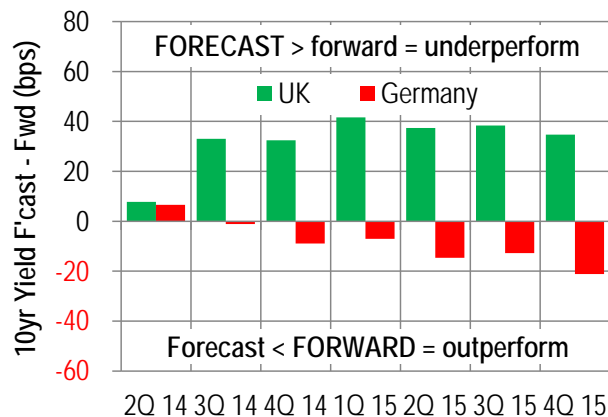
Figure 19 and Figure 20 together imply expressing short UK/long Germany trades at the front end rather than in 10s.

Figure 19. UK and Germany: 2yr forecasts vs the forwards



Source: Citi Research

Figure 20. UK and Germany: 10yr forecasts vs the forwards



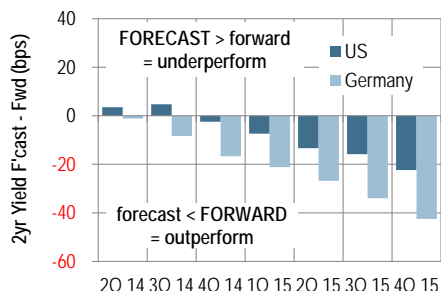
Source: Citi Research

-US/+Germany: do it in 10s

Express short US vs Germany in 10s

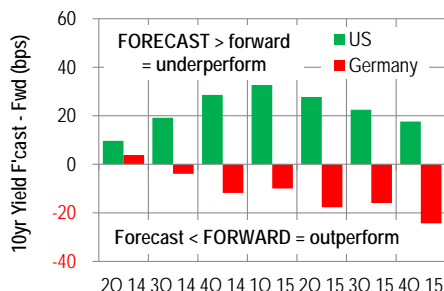
The gap between the outperformance of 2yr USTs and Schatz, over and above what is priced in (Figure 21), is smaller than the gap between our Bund and UST forecasts and the respective forwards in 10s (Figure 22). In other words, we see much more potential for Bund outperformance in 10s than we do in 2s. We see around 40bps more upside to the 10yr UST/Bund spread (Figure 23) than is currently priced in.

Figure 21. US and Germany: 2yr yield forecasts vs the forwards. We expect Schatz to outperform the forwards by more than 2yr USTs



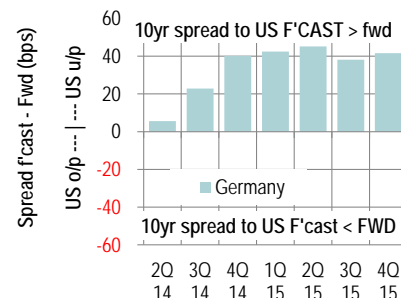
Source: Citi Research

Figure 22. US and Germany: we expect 10yr Bunds to outperform the forwards and 10yr USTs to underperform the forwards



Source: Citi Research

Figure 23. 10yr US/Germany spread prices in insufficient underperformance of the US



Source: Citi Research

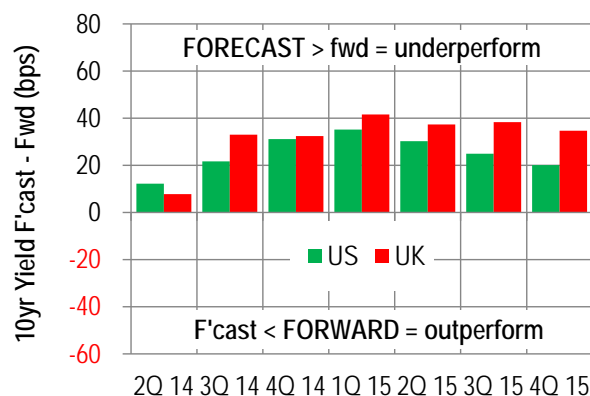
-UK/+US: don't do it in 10s

Express short UK/long US views in 2s rather than 10s. (We much prefer short 2yrUK vs Europe or short 10yr US vs Europe though.)

While we forecast a similar underperformance of 10yr USTs and gilts, over and above what is priced in (Figure 24), at the front end of the curve it is a different story. Here we see the front end of the UST curve pricing the trajectory of yields broadly correctly, but the front end of the gilt market significantly underestimating the sell-off in our view.

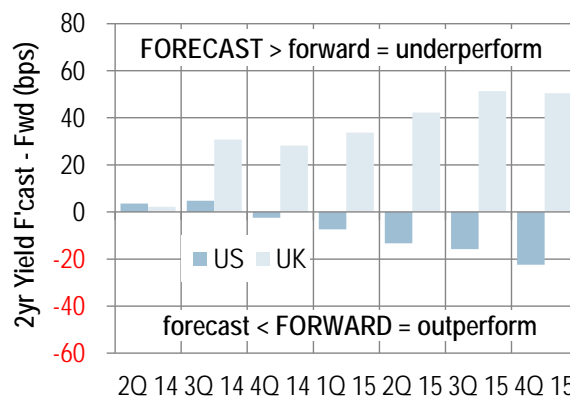
So while we see little juice in 10yr UK/US trades, the 2yr –UK/+US cross-market trade is considerably more interesting, though principally driven by the gilt leg⁴.

Figure 24. US and UK: 10yr forecasts vs the forwards



Source: Citi Research

Figure 25. US and UK: 2yr forecasts vs the forwards



Source: Citi Research

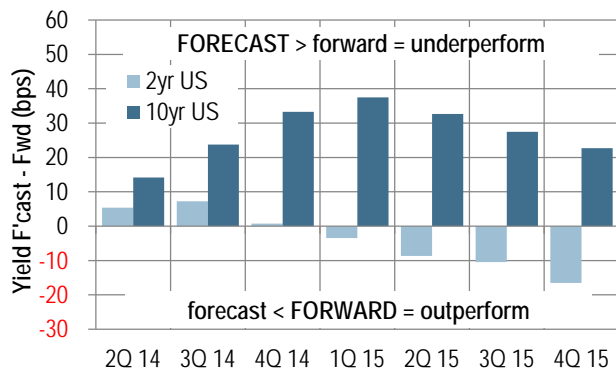
Curve: US - too little steepening priced in

Too little steepening is priced into the US curve

We expect the UST curve to steepen by up to 40bps more than is priced in from Q4, mainly driven by 10s: the forwards underestimate the rise in 10yr UST yields by 20-30bps, and the forwards overestimate the 2yr sell-off by only a small amount over the next year (see Figure 26 below left).

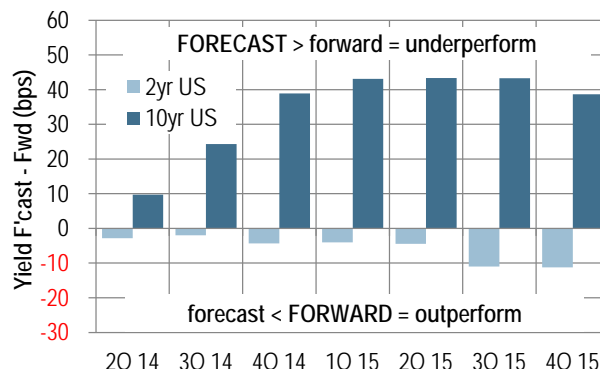
Although we expect more steepening than is priced in (Figure 26) the implied mispricing is smaller than it was last month (Figure 27): we forecast less underperformance of 10s than last month (but similar – small - outperformance of 2s).

Figure 26. 2 and 10yr UST forecasts vs the forwards



Source: Citi Research

Figure 27. Last month's forward/forecast comparison



Source: Citi Research

⁴ And you have to be happy that the current relatively benign view of the Fed continues.

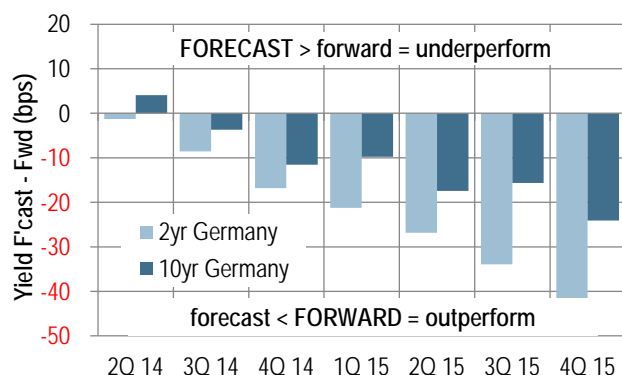
Curve: Germany – forwards underestimate steepening

Insufficient steepening is priced into the German curve

As you can see, the gap between our Schatz forecasts and the forwards (Figure 28) is only a little wider than last month (Figure 29), but we now see increased scope for Bunds to outperform the forwards.

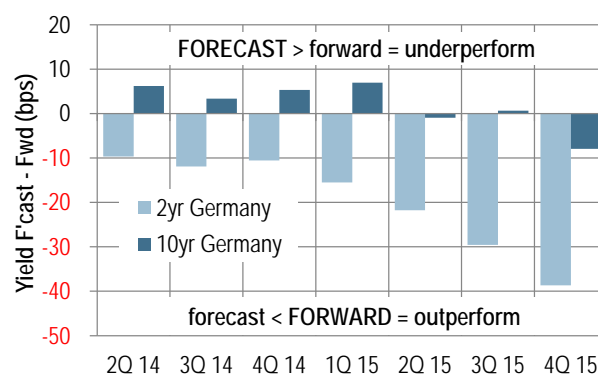
Although we think the market is overestimating the sell-off in 10yr Bunds (by approximately 20bps by 4Q15) we think the forwards overestimate the sell-off in 2yrs by almost double this amount (Figure 28). In other words, we believe the market is underpricing the steepening of the German curve by about 20bps.

Figure 28. 2 and 10yr Bund forecasts vs the forwards



Source: Citi Research

Figure 29. Last month's forward/forecast comparison



Source: Citi Research

US and Germany curve trades

Trade ideas

While the forwards underestimate the steepening of both the US and German curves, this is much greater for the US than Germany. Hence, consider options 2-4 as an alternative to the obvious steepeners.

1. Steepeners in Germany or the US.
2. Box existing 10yr -US/+Europe trades with DV01-weighted +2yr US/-Europe positions.
3. Look at EUR 2s10s flatteners in swaps⁵ 9-18m forward vs USD steepeners.
4. Expressing No.3 conditionally is also an option, though using CMS would remove the timing element.

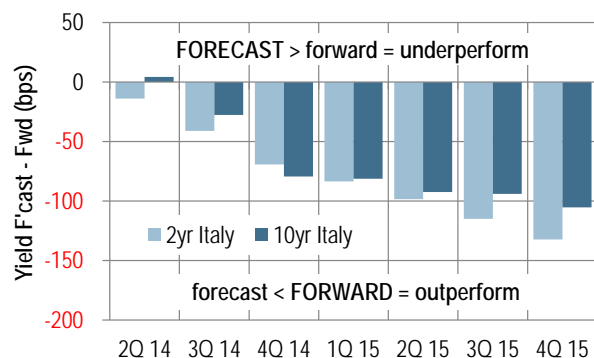
⁵ Our US and European swap spread forecasts are largely unchanged over the forecast horizon.

Curve: Italy and Spain – steepening, not flattening

The forwards imply modest flattening of the BTP curve. We expect steepening.

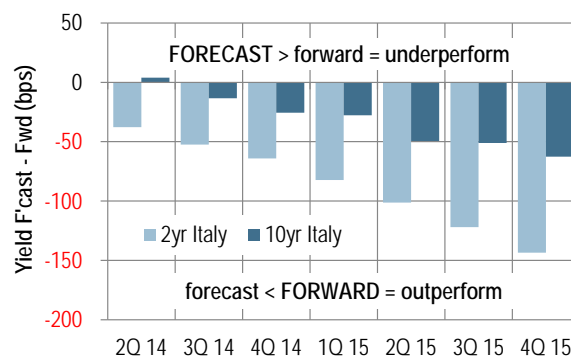
We expect Italy to significantly outperform the forwards (Figure 30) by more than we did this time last month (Figure 31). Our European team strongly disagrees with the rise in yields priced into the forwards in Italy. They expect both 2 and 10yr yields to fall outright, while the market is pricing in healthy yield rises.

Figure 30. 2 and 10yr BTP forecasts vs the forwards



Source: Citi Research

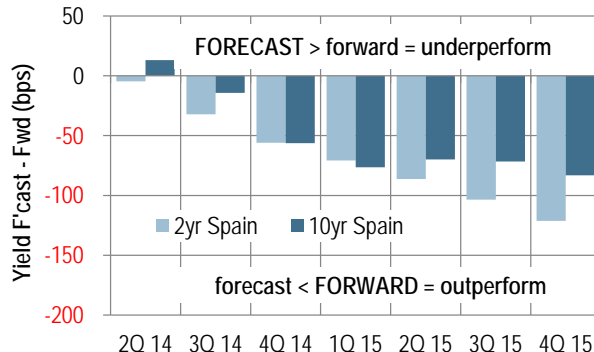
Figure 31. Last month's forward/forecast comparison



Source: Citi Research

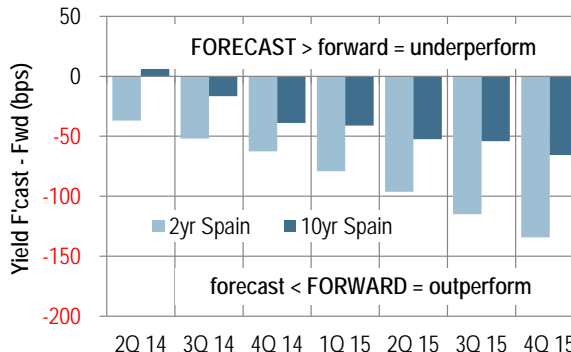
It is a similar picture in Spain (Figure 32) but the revision from last month is less (Figure 33).

Figure 32. 2 and 10yr Bono forecasts vs the forwards



Source: Citi Research

Figure 33. Last month's forward/forecast comparison



Source: Citi Research

Trade ideas:

Italy and Spain trades

Front-foot trades

More defensive trades

1. If you are bullish duration outright then BTPs (or Bonos) are the obvious candidate.
2. If you are more wary of market direction but like peripheral risk, then buy them vs Bunds.
3. If more defensive on peripherals then look at BTP (or Bono) steepeners⁶
4. Or for a temporary defensive trade, look at boxing BTP steepeners with Bund flatteners (the flattening priced into the BTP curve is greater than the underpricing of steepening in the Bund curve).

⁶ The forwards price an unchanged 2s10s BTP curve out to 15Q1 (and then 10bps or so of flattening over the year). Our European strategy team's BTP forecasts show a steepening of around 20bps in the coming 2 quarters. But the trades that drop out of the forecasts are only part of the story and other factors have to be considered, e.g. Alessandro Tentori's analysis of QE suggested flatteners: "Curve flatteners on the BTP curve could therefore make sense under the scenario of continued QE-type bid for BTPs" (Rates Weekly *ECB: Thoughts on Asset Purchases*, 16 April).

Steepening underpriced in Japan and Australia, not UK

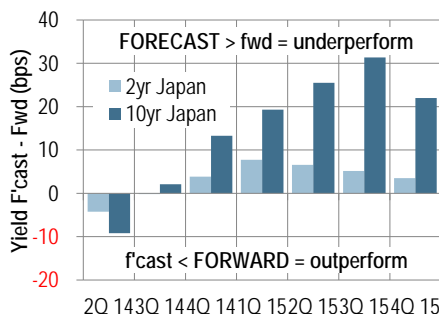
Japan – curve analysis and implied trade

Japan (Figure 34, below left): we think the market is underestimating the rise in 10yr JGB yields from 4Q14 onwards, but only moderately in 2s. That points to steepeners.

Australia – analysis and implied trades

Australia (Figure 35, below middle): the forwards are not pricing in enough of a rise in 10yr yields in our view, but the rise in front end forwards don't start to lag our forecasts significantly until 1Q15. That points to steepeners in cash or up to 9m forward in swaps, assuming broadly stable swap spreads.

Figure 34. JGB forecasts vs the forwards



Appendix: Summary of forecasts + backdrop

Below, for reference, we provide a summary of the economic backdrop to our latest forecasts. For the full details for each country, and all the background economic and political analysis please see our [Global Economic Outlook and Strategy - April 2014](#) and the *Euro Economics Weekly*, 2 May, from which the below is taken.

Figure 37. Average 10yr yield forecasts

Average 10yr yield	14H2	15H1	15H2
US	3.23	3.55	3.73
Germany	1.75	1.90	2.00
UK	3.33	3.53	3.68
Australia	4.55	4.73	4.95
Japan	0.78	1.00	1.13

Source: Citi Research

Growth backdrop

- **Global** growth forecasts: 3.1% (unch) 2014, 3.5% (+0.1%) 2015.
- **US** growth to rebound to 3%+ QoQ SAAR in Q2 and beyond as adverse weather effects fade.
- **UK** is our biggest above consensus forecast. 3.5% for 2014 (highest since 2003) and 3.6% for 2015. Solid growth (0.8% QoQ in Q1) expected to accelerate in Q2 as construction rebounds from adverse weather in Q1. US and EA forecasts slightly above consensus; China slightly below.
- **EA** growth forecasts revised up by 0.2-0.3% for 2015-2017 (but inflation upgrade only 0.1-0.2%). Forecasts: 1.3% 2014 and 1.8% 2015.
- **Japan:** growth forecasts 0.9% for 2014, and 1.0% for 2015.

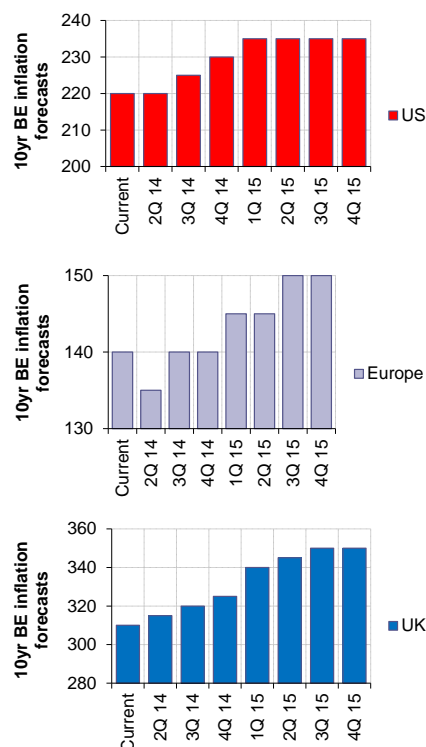
Central bank actions

- **US:** Fiscal drag is dissipating and financial conditions are a significant tailwind for growth but first hike still **mid-2015**.
- **Europe:** ECB cut in **June** (small possibility of May). €1tn QE later this year (but limited size of private markets means the main focus is likely to be on government debt).
- **UK:** **November** base case for first hike (on hold until the recovery is more firmly entrenched) with rates rising to 2.50% by end-2015 before pausing. Gilt/Bund could reach 170bps later this year as the ECB add stimulus just as the MPC start to tighten.
- **Japan:** We are pushing back our base case for further BOJ easing from mid-year to the **autumn**: need to wait and see whether likely Q2 weakness after consumption tax hike is lasting.

The ECB is the biggest blip on the radar

- **Background** – Economic activity is strengthening gradually, but inflation remains persistently low. With ample slack and the ongoing disinflationary impact of the currency (6% trade-weighted appreciation of the Euro since the start of 2013), headline CPI is likely to stay below 1% throughout 2014 and 2015, well below the ECB's 2% target. Furthermore, the EA is potentially just one adverse shock away from tipping into deflation.
- **Action expected** – With private sector bank credit still negative, a large output gap and the strong currency, we see a compelling rationale for the ECB to deliver further monetary policy accommodation in the next couple of months. QE will perhaps be linked to a further downgrade of official inflation forecasts at the September or December meetings, although the ECB could act in between.
- **QE impact** – QE will loosen financial conditions but stimulus unlikely to come from significantly weaker currency given the large c/a surplus and portfolio and FDI inflows. (Also, while FX weakness in days around the QE announcement has been the classic response, the medium-term effect has been highly variable). A reported ECB internal study (*Frankfurter Allgemeine* 4 April) suggests €1tn of asset purchases (10% of GDP) would lift CPI by 0.2-0.8%. This is consistent with Fed and MPC studies.

Figure 38. 10yr US, European and UK inflation breakeven forecasts



Source: Citi Research

Figure 39. Global 10yr yield forecasts and largest changes from spot

	US	Germany	UK	Japan	Australia	France	Italy	Spain
Current	2.70	1.50	2.69	0.61	3.95	2.00	3.13	3.06
2Q 14	2.85	1.60	2.85	0.55	4.40	2.10	3.20	3.25
3Q 14	3.05	1.60	3.20	0.70	4.50	2.10	3.00	3.10
4Q 14	3.25	1.60	3.30	0.85	4.60	2.00	2.60	2.80
1Q 15	3.40	1.70	3.50	0.95	4.70	2.10	2.70	2.72
2Q 15	3.45	1.70	3.55	1.05	4.75	2.10	2.70	2.90
3Q 15	3.50	1.80	3.65	1.15	4.95	2.20	2.80	3.00
4Q 15	3.55	1.80	3.70	1.10	4.95	2.20	2.80	3.00
Max bp change	+85	+30	+101	+54	+100	+20	+7	+19
Max % change	31%	20%	38%	89%	25%	10%	2%	6%

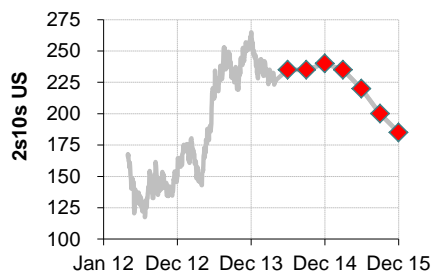
Source: Citi Research. Quarter averages. Please see [Global Economic Outlook and Strategy - April 2014](#).

Figure 40. Key cross-market spread forecasts and largest moves from spot

	UST/Bund	UST/JGB	Gilt/Bund	UST/ACGB	OAT/Bund	BTP/Bund	Bono/Bund	BTP/Bono
Current	120	209	119	125	50	163	156	7
2Q 14	125	230	125	155	50	160	165	-5
3Q 14	145	235	160	145	50	140	150	-10
4Q 14	165	240	170	135	40	100	120	-20
1Q 15	170	245	180	130	40	100	102	-2
2Q 15	175	240	185	130	40	100	120	-20
3Q 15	170	235	185	145	40	100	120	-20
4Q 15	175	245	190	140	40	100	120	-20
Max widening	+55	+36	+71	+30				
Max narrowing					-10	-63	-54	-27

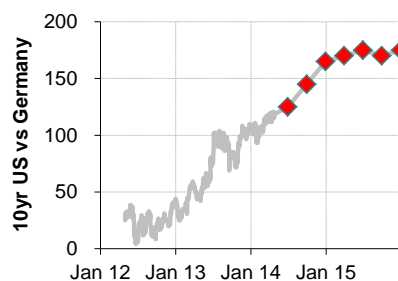
Source: Citi Research. Quarter averages. Please see [Global Economic Outlook and Strategy - April 2014](#).

Figure 41. UST flattening



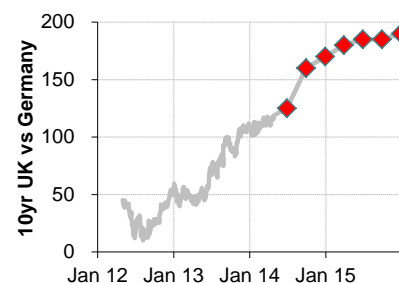
Source: Citi Research

Figure 42. 10yr UST/Bund widening



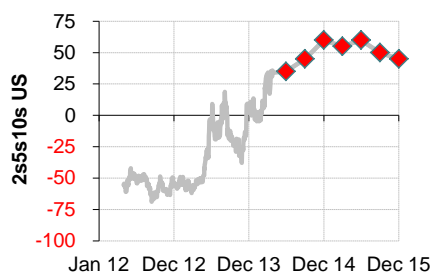
Source: Citi Research

Figure 43. 10yr Gilt/Bund widening



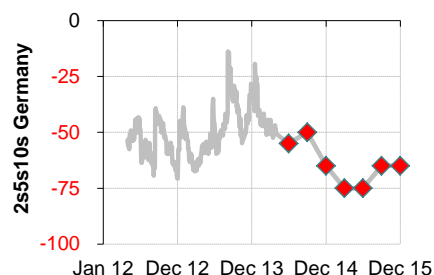
Source: Citi Research

Figure 44. Modest underperformance of 5yr UST on the curve



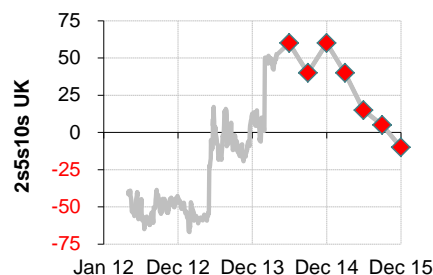
Source: Citi Research

Figure 45. Outperformance of 5yr Germany on the curve still peaking at -75 (-90 previously)



Source: Citi Research

Figure 46. 5yr gilts underperformance giving way to sharp outperformance vs 2s and 10s



Source: Citi Research

Figure 47. Latest yield forecasts (quarterly averages, unless otherwise stated)

	Current	2Q 14	3Q 14	4Q 14	1Q 15	2Q 15	3Q 15	4Q 15
US	Policy Rate (Fed Funds) End Quarter	0.25	0.25	0.25	0.25	0.25	0.75	1.00
	3m LIBOR	0.22	0.20	0.20	0.20	0.35	0.65	1.05
	2yr Treasury Yield	0.43	0.50	0.70	0.85	1.05	1.25	1.70
	5yr Treasury Yield	1.74	1.85	2.10	2.35	2.50	2.65	2.85
	10yr Treasury Yield	2.70	2.85	3.05	3.25	3.40	3.45	3.55
	30yr Treasury Yield	3.46	3.55	3.65	3.80	3.85	3.90	3.90
	2s10s Treasuries	227	235	235	240	235	220	185
	2yr Sw ap Spread (Sw ap - Bond)	11	12	12	12	12	12	12
	10yr Sw ap Spread (Sw ap - Bond)	11	13	15	15	15	15	15
	30yr Sw ap Spread (Sw ap - Bond)	-1	-3	-5	-5	-5	-5	-5
Euro Area	30yr Mortgage Yield	4.40	4.55	4.80	5.10	5.20	5.40	5.45 5.55
	10yr Breakeven Yield	220	220	225	230	235	235	235
	Policy Rate	0.25	0.10	0.10	0.10	0.10	0.10	0.10
	Overnight Rate (EONIA)	0.33	0.25	0.00	0.00	0.00	0.00	0.00
	3m EURIBOR	0.32	0.20	0.15	0.15	0.15	0.15	0.15
	2yr Schatz	0.17	0.15	0.10	0.05	0.05	0.05	0.05
	5yr Bobl	0.59	0.60	0.60	0.50	0.50	0.50	0.60
	10yr Bund	1.50	1.60	1.60	1.60	1.70	1.70	1.80
	30yr Bund	2.37	2.40	2.35	2.35	2.45	2.45	2.55
	2s10s Germany	133	145	150	155	165	165	175
Japan	10yr BTP/Bund	163	160	140	100	100	100	100
	10yr Bono/Bund	156	165	150	120	102	120	120
	2yr BTP/Schatz	61	60	50	40	40	40	40
	2yr Bono/Schatz	55	60	50	45	45	45	45
	10yr OAT/Bund	50	50	50	40	40	40	40
	10yr Sw ap Spread (Sw ap - Bond)	23	25	20	20	20	20	20
	10yr Breakeven Yield	140	135	140	140	145	145	150
	Policy Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10
	3m LIBOR	0.14	0.15	0.15	0.15	0.15	0.15	0.15
	2yr JGB	0.09	0.05	0.10	0.15	0.20	0.20	0.20
UK	5yr JGB	0.19	0.15	0.20	0.30	0.35	0.40	0.40
	10yr JGB	0.61	0.55	0.70	0.85	0.95	1.05	1.10
	30yr JGB	1.70	1.65	1.75	1.85	1.90	1.95	2.00
	2s10s JGBs	52	50	60	70	75	85	90
	2yr Sw ap Spread (Sw ap - Bond)	11	10	12	14	15	15	15
	10yr Sw ap Spread (Sw ap - Bond)	18	15	20	22	25	25	30
	Policy Rate	0.50	0.50	0.50	0.75	1.25	1.50	2.00
	3-Month Libor	0.53	0.55	0.55	1.00	1.55	1.70	2.10
	2yr Gilt	0.70	0.85	1.30	1.50	1.80	2.10	2.40
	5yr Gilt	1.93	2.15	2.45	2.70	2.85	2.90	3.05
Australia	10yr Gilt	2.69	2.85	3.20	3.30	3.50	3.55	3.65
	30yr Gilt	3.45	3.55	3.70	3.75	3.85	3.90	4.00
	2s10s Gilts	199	200	190	180	170	145	110
	10yr Sw ap Spread (Sw ap - Bond)	7	10	15	15	20	20	25
	10yr Breakeven Yield	310	315	320	325	340	345	350
	Policy Rate	2.50	2.50	2.50	2.50	2.75	3.25	4.00
	3-Month Libor	2.70	2.60	2.60	2.75	2.95	3.45	4.25
	2yr ACGB	2.74	2.80	2.95	3.15	3.50	3.70	4.05
	5yr ACGB	3.30	3.75	3.95	4.10	4.35	4.45	4.65
	10yr ACGB	3.95	4.40	4.50	4.60	4.70	4.75	4.95
	2s10s ACGB	121	160	155	145	120	105	90
	10yr Sw ap Spread (Sw ap - Bond)	29	35	40	40	45	45	50

Source: Citi Research. Please see [Global Economic Outlook and Strategy - April 2014](#).

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Appendix A-1

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