

Euro Rates Strategy

Unchanged ECB, but Rich in Carry

- The Eonia curve is pricing in no chance of a rate cut at the October ECB meeting.
- Extracting expectations about the main refinancing rate is impossible in the current regime of super-high liquidity.
- In terms of the deposit facility rate, the market is approximately pricing in a 15% probability of a 25bp cut by March.
- From a trading perspective, we think there is value in setting up strategies that profit from either a deposit or a refi rate cut and a very long period of very low interest rates. In that respect, being lent Eonia or receiving 1y-EUR rates on forwards have a similar carry rich risk/reward profile.

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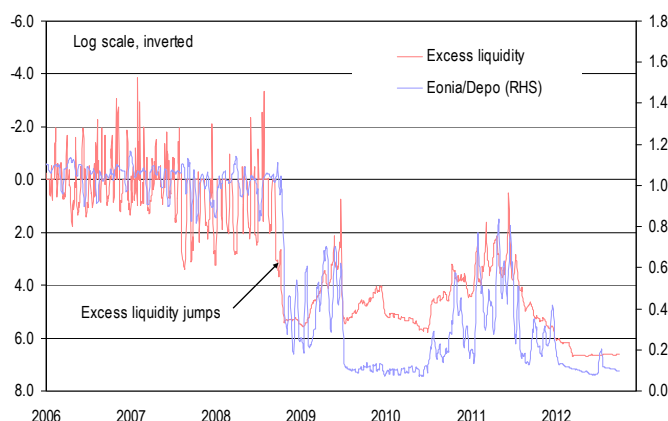
Unchanged ECB, but Rich in Carry

The Eonia market is not pricing in unchanged rates the October ECB meeting as the reserve period is in line with the 1-week fixing. However, given the level of excess liquidity in the system, we can only extract expectations with regard to the deposit rate and not the main refinancing rate (Figure 1). Adding this basis dimension makes the spectrum of possible strategies more complex.

The most likely scenario – as described by [Citi's economics team](#) – is for both the main refinancing and the deposit rate to stay on hold in October. The official call is then for a 25bp cut in refi at the December ECB (narrowing the corridor to 50bp) followed by a dual 25bp cut in the refi and the depo in early 2013 (refi/depo spread unchanged at 50bp with depo at -0.25%).

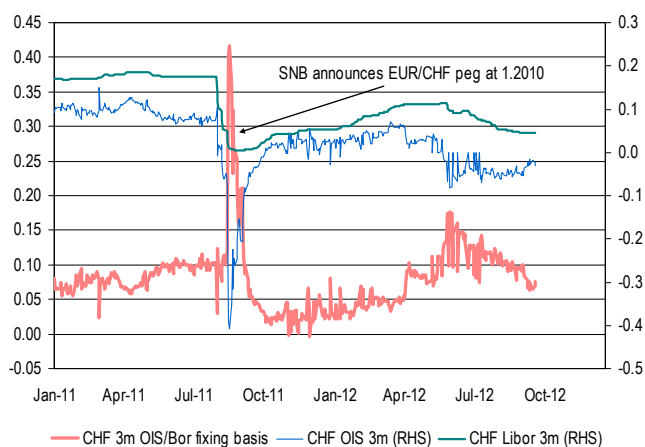
Looking at the ECB curve, the probability of a deposit rate cut by Mar-13 is around 15%, depending on the expected Eonia fixing in the new state of the world. Therefore, our official scenario implies an active view against market expectations and delivers terminal risk/rewards of 1:3/1:4 with a deposit rate at -0.25% (again depending on the expected Eonia fixing).

Figure 1. Excess liquidity and Eonia fixing vs deposit rate



Source: ECB, Citi Research

Figure 2. FRA/OIS spreads with negative deposit rates



Source: Citi Research

Trade ideas

- **Eonia:** Being lent Eonia is a very good risk/reward trade. Only about 5bp are priced into March ECB, with a max of 4-5bp of downside, the upside is worth 15/20bp. Also receiving 12x24 Eonia @18 looks like a good risk reward under a scenario of very low rates for a very long time. Note that Eonia swaps are actually the instrument of choice for a negative deposit rate scenario (compare with FRA/OIS in Swissie prior to introduction of the FX-peg, Figure 2)
- **Euribor:** We maintain our strategy of [receiving EUR 3y1y](#) (currently @1.25%). The trade rolls down 75bp in 24 months (1y1y @50bp), with the additional gear of being exposed to a refi rate cut and to Japanese market conditions. For example JPY 1y1y dropped to 8-10bp in Jun-03.

Appendix A-1

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