

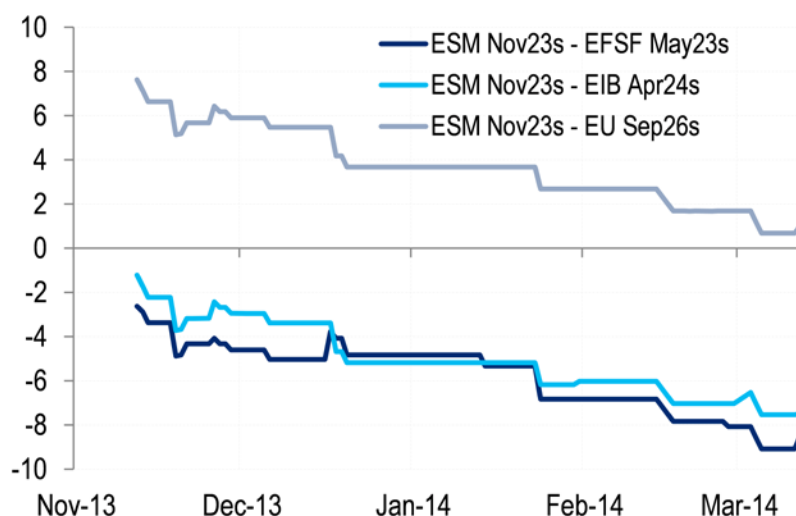
Euro SSA Strategy

RV Insights – ESM vs EIB And Why We Wouldn't Fade Recent Moves

- **Striking performance of the ESM** – One of the most notable spread performers this year has been the ESM. In the 10yr sector, the ESM has tightened from its launch spread of 19bp last November to trade around 12bp at the time of writing, notably outperforming peers such as EIB and the EU in the 10yr sector.
- **Fundamentals vs technicals** – Although the ESM is rated one notch lower and is a relatively new entrant to the European SSA market, we believe there are strong technical forces at work which help explain the recent price action – namely the “scarcity” premium the issuer appears to be adopting.
- **We wouldn't fade the move** – Given this, we would not fade recent moves and do not believe ESM-EIB spreads are range-bound. The ESM is less liquid and although we do not expect further significant performance, spreads can probably nudge tighter still vs peers.

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Figure 1. 10yr ESM vs peers (YYS spread differences, bp)



Source: Citi Research

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

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Relative value insights – ESM vs EIB

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At first, current valuations of the ESM vs EIB might look perplexing. Why should a lower rated issuer, with less credit history trade tighter than the better established EIB? We delve into this spread and conclude that this is yet another example of technicals dominating fundamentals.

ESM trades inside EIB

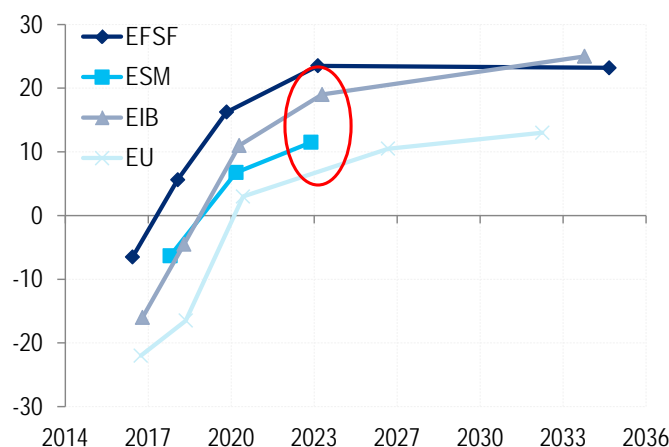
EU has outperformed peers

Striking performance of the ESM: One of the most notable spread performers this year has been the ESM. In the 10yr sector, the ESM has tightened from its launch spread of 19bp last November to trade around 11bp-12bp at the time of writing, outperforming peers such as EIB and the EU in the 10yr sector (Figure 2, Figure 3).

Technicals have dominated fundamentals

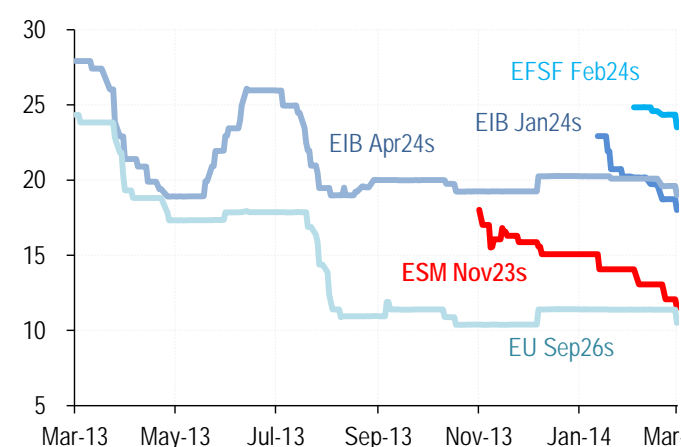
Fundamentals of ESM (Aa1) and EIB (Aaa): In structure, the ESM is similar to a multinational lending institutional, especially given the presence of paid-in capital (€80bn). However, fundamentally at Aa1, it is lower rated than peers such as EIB (AAA/Aaa). It also has a narrower mandate than EIB, a smaller network of guarantors (the euro area member states compared with EIB's EU member states) and has much less credit history. Fundamentally, these are some factors that help explain the rating differential (*Supranationals in focus – overview and opportunities*).

Figure 2. European Supranationals YYS (Spreads to swaps, bp)



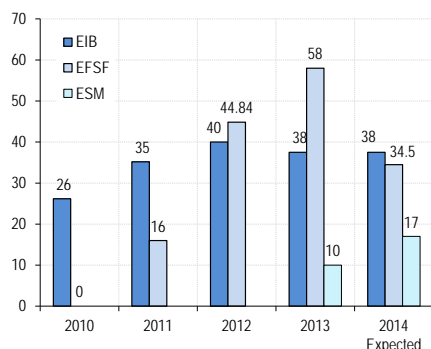
Source: Citi Research

Figure 3. 10yr Supra YYS Spreads (bp)



Source: Citi Research

Figure 4. EUR issuance by key supras (€bn)



Source: Investor Presentations, Citi Research

Supply by ESM: Yet we believe the powerful technical forces at work can explain the current price action and help justify arguments as to why current trends can probably continue. One important factor is the “scarcity” premium the ESM appears to be benefiting from (three bonds outstanding). In terms of the relative supply pipelines, the ESM is set to issue €17bn in 2014 (having completed €6bn already) which is much smaller than its peers for expected euro issuance this year (Figure 4).

Demand for ESM: Demand for ESM remains robust, with a healthy bid from the euro area as well as Asia. The last bond, and the first issue of 2014, was in the 7yr sector (at MS+7) when Asia accounted for 25% of the take-up.

Conclusion: technicals dominating, we wouldn't fade the move

The ESM continues to establish itself within the core SSA space with a secondary curve now inside EIB in the 7yr and 10yr sectors. Although the issuer is rated one notch lower, we think the ESM's scarcity premium helps explain the recent price action and the ordinal ranking of spreads to swaps. Given this, although we do not expect further significant performance, we would not fade the move vs EIB and indeed, we wouldn't be surprised if spreads nudged tighter still.

Appendix A-1

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