

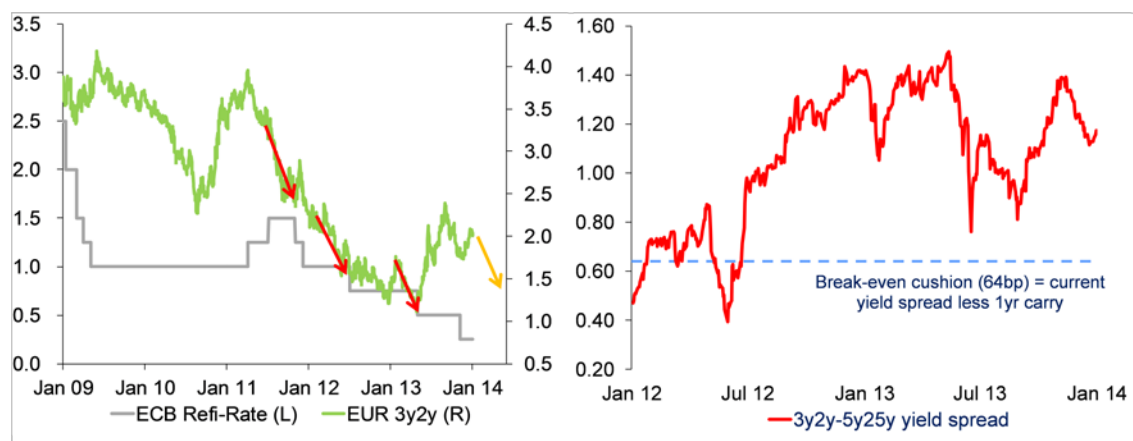
Euro Rates Strategy

EUR Swaps: time to scale into 5s30s steepeners using forwards

- **EUR 3y2y-5y25y steepeners:** We recommend receiving the 5yr point of the euro curve vs 30yrs using forward points (3y2y-5y25y steepeners) for two main reasons:
 - The current level of the 5yr point does not reflect our expectations of Euro Area fundamentals (low inflation outlook) and ECB policy (Citi's expects the ECB to cut the refi-rate to 0% by June 2014 and to launch a 1yr fixed rate LTRO in 2H14).
 - A large amount of 30yr supply from core EMU issuers in 1Q14 (€11bn of gross supply vs only €3bn of coupons in this sector) could put upward pressure on long-end yields, especially for euro swaps as a large portion of 30yr bond supply (such as the new 30yr DSL and 30yr Bund) is likely to be bought vs swaps, in our view.
- Our favourite way to position for this is to receive EUR 3y2y and pay EUR 5y25y due to the optimal level of carry (and vol-adjusted carry) in this part of the swap curve. We stress that these are not the only points on the swap curve that are likely to perform based on our expectations, therefore we suggest having a look at the carry and vol-adjusted carry tables in the *Appendix* section of this document for other structures which maybe better suited to individual investor portfolios.
- **Trading strategy:** Receive EUR 3y2y vs 5y25y at 117bp
 - Current = 117bp. Open = 117bp. Target = 150bp. Stop = 100bp.

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Figure 1. Left Chart: EUR 3y2y rallies ahead of ECB rates cuts as market expectations of a cut increase.
Right chart: the spread between the current yield level and the 1yr carry provides a healthy cushion



Source: Citi Research

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

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Scale into 5s30s steepeners using forwards

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Bottom line: We recommend receiving the 5yr point of the euro curve vs 30s using forward points for two main reasons: (1) the current level of the 5yr point does not reflect our expectations of Euro Area fundamentals and ECB policy and (2) a large amount of 30yr supply from core EMU issuers in 1Q14 could put upward pressure on long-end yields, especially for euro swaps as a large portion of 30yr bond supply is likely to be asset swapped.

Our favourite way to position for this is to receive EUR 3y2y and pay EUR 5y25y due to the optimal level of carry in this part of the swap curve. We stress that these are not the only points on the swap curve that are likely to perform based on our expectations, therefore we suggest having a look at the *Appendix* section of this document for other structures which maybe better suited to individual investor portfolios.

(A) Why we think the 5yr point is cheap

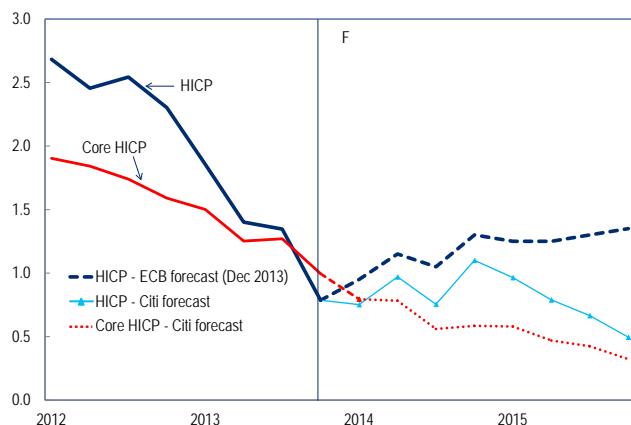
Citi's expectations for ECB policy rates¹: our economics team expect the ECB to cut the refi rate to zero by June 2014 and the deposit rate to move into negative territory to -0.1%, narrowing the rate corridor, in reaction to some undershooting of the newly published quarterly of HICP (Figure 2). The first rate hike is expected to be in 4Q16.

Other ECB measures: we also expect the ECB to eventually unveil a 1yr fixed rate LTRO after 1H14. Some discussion about additional provision of liquidity is likely to feature in the January (this week) and February ECB meetings, in reaction to recent moves in EONIA rates and excess liquidity levels.

Current levels are too high vs expectations: We believe the selloff seen in the 5yr point during the course of December has taken yields in this part of the curve to levels that do not reflect our expectations of Euro Area fundamentals and ECB policy that have been discussed above. As shown in Figure 3 below, EUR 3y2y are currently trading just over 2% (attractive entry level) and tend to rally in the lead up to ECB rate cuts (which we expect to occur by June 2014).

Our preferred way to fade the cheapening in this part of the curve is via curve trades rather than outright duration positions due to the volatility associated with these positions.

Figure 2. Euro Area – Inflation Forecasts, 2012-2015F



Source: Eurostat, ECB and Citi Economics

Figure 3. EUR 3y2y (and other forward points in the 5yr sectors) rallies into ECB rate cuts as market expectations of a cut increase



Source: Citi Research

¹ Euro Economics Weekly - 2014 Outlook, 6 January 2014

(B) Why we like fading the cheapness of 5s vs 30s

As mentioned previously, we are cautious about taking outright duration risk around the 5yr point based on current market conditions. Over the remainder of 1Q14, we expect there to be €11bn of 30yr bond supply from core EMU issuers; this represents 38% of total 30yr issuance in 2014, in our view (Figure 4).

All things being equal, with forthcoming supply being met by only €3.1bn coupon payments in the 30yr sector until end-1Q14, we would expect upward pressure on the long-end of the euro curve (Figure 5).

Furthermore, we expect a large portion of 30yr bond supply to be bought vs swaps given the tight levels of 30yr swap spreads. This paying interest in the 30yr sector of the euro curve should also be supportive EUR 5s30s steepeners (and associated forwards such as EUR 3y2y-5y25y).

Figure 4. Remaining supply from core issuers in 2014 (€bn)

2014	2yr/3yr	5yr	10yr	15yr	30yr+	Gross Supply
Q1	31	37	36	5	11	120
Q2	29	38	49	8	6	129
Q3	22	37	28	4	7	97
Q4	27	29	32	4	6	97
Total	108	141	145	20	29	444

Source: Citi Research, DMO, Bloomberg

Figure 5. Remaining coupons in 1Q14 from core issuers(€bn)

Coupons	2yr	5yr	10yr	15yr	30yr
Austria	0.4	1.1		0.4	0.6
Belgium	1.9	0.9	0.6	1.6	1.4
Finland					
France	2.0				
Germany	0.9	0.1	0.3		
Netherlands	1.0	0.3	0.7	1.0	1.1
Total	6.2	2.4	1.5	2.9	3.1

Source: Citi Research, DMO, Bloomberg

(A+B) Putting the two together

Aside from the fundamental and supply pressures discussed earlier, one of the most appealing features for 5s30s steepeners is the high level of carry (and vol adjusted carry on offer). As shown in Figure 6 and Figure 7 below, EUR 3y2y-5y25y steepeners offer around 53bps of 1yr carry (close to the highest level) and also an attractive level of vol-adjusted carry.

Taking into account the current yield spread and the 1yr carry on offer, the breakeven cushion on a one-year horizon is in the 9th percentile (Figure 8). Furthermore, in the last year the yield spread has not been below 64bps (current level of 117bp less 1yr carry of 53bp)².

Figure 6. The level of 1yr carry on receiving EUR 3y2y vs 5y25y is close to the highs (bp)



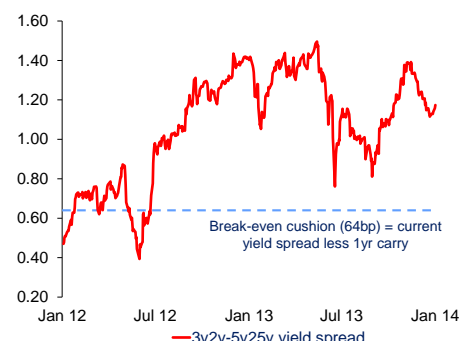
Source: Citi Research

Figure 7. The ratio of 1yr carry to 1yr realised volatility for 3y2y-5y25y is close to the highs



Source: Citi Research

Figure 8. Current yield spread of EUR 3y2y-5y25y and the 1yr carry on offer (bp)



Source: Citi Research

² We note that other trades offer better carry but taking into account (1) the spread between the break-even cushion on 3y2y-5y25y and the lowest yield spread over the last two years and (2) the volatility adjusted carry, we think this is one of the most attractive points to express EUR 5s30s steepeners

Appendix: Carry grids for EUR swaps

We screen for optimal carry points on both a pure carry and vol-adjusted carry metric

■ In Figure 9, we highlight 1yr carry for points on the euro curve (vs 6m Euribor).

Figure 10 divides the values in Figure 9 by the 1yr realised volatility of the underlying swap rate (to produce volatility adjusted carry).

■ Values in the 70-90th percentile are shown in bold and values in the 90-100th percentile are highlighted in bold with a yellow background.

1yr carry

Figure 9. 1yr carry for selected points on the euro grid (bp)

Rate Roll	Tenor														
	1y	2y	3y	4y	5y	6y	7y	8y	9y	10y	15y	20y	25y	30y	40y
Forward	1y	22	35	44	45	44	41	39	37	35	32	22	16	13	11
	18m	35	46	50	48	45	42	40	37	35	32	21	15	12	9
	2y	48	55	54	50	46	42	40	37	34	31	20	15	12	9
	3y	62	56	50	45	42	38	35	32	29	27	17	12	10	7
	4y	50	44	39	36	33	31	28	25	22	20	12	8	6	5
	5y	37	33	31	29	27	24	21	19	16	15	8	5	4	3
	7y	27	25	22	19	16	13	11	9	7	6	2	0	0	0
	10y	7	5	4	2	1	-1	-3	-4	-4	-4	-5	-5	-4	-3
	12y	0	-1	-3	-5	-6	-7	-7	-7	-7	-7	-7	-5	-4	-3
	15y	-11	-12	-11	-11	-10	-10	-9	-9	-8	-8	-7	-5	-4	-3
	20y	-6	-6	-5	-6	-6	-6	-5	-5	-5	-2	-2	-2	-1	-1
	25y	-6	-5	-5	-4	-3	-2	-2	-1	-1	0	0	0	0	0
	30y	2	2	2	3	3	3	2	2	2	2	1	1	1	1

Source: Citi Research

1yr vol-adjusted carry

Figure 10. 1yr vol-adjusted carry for selected points on the euro grid (Figure 9 divided by 1yr realized volatility of the underlying, %)

Rate Roll/ R.Vol	Tenor														
	1y	2y	3y	4y	5y	6y	7y	8y	9y	10y	15y	20y	25y	30y	40y
Forward	1y	42%	56%	65%	65%	64%	62%	60%	58%	56%	52%	38%	29%	24%	21%
	18m	54%	66%	68%	67%	64%	62%	60%	57%	54%	51%	37%	28%	23%	20%
	2y	65%	73%	70%	67%	64%	62%	59%	56%	53%	49%	35%	26%	22%	20%
	3y	78%	70%	66%	62%	59%	56%	53%	49%	46%	42%	28%	21%	17%	16%
	4y	62%	58%	55%	52%	49%	46%	42%	39%	36%	33%	20%	15%	11%	9%
	5y	53%	49%	47%	44%	40%	37%	33%	30%	27%	24%	13%	9%	7%	5%
	7y	40%	37%	33%	29%	25%	21%	18%	15%	12%	9%	3%	1%	0%	0%
	10y	12%	8%	6%	3%	1%	-2%	-5%	-6%	-7%	-8%	-9%	-8%	-6%	-5%
	12y	1%	-2%	-5%	-8%	-11%	-12%	-13%	-13%	-13%	-13%	-12%	-10%	-8%	-7%
	15y	-20%	-20%	-20%	-19%	-18%	-17%	-16%	-16%	-15%	-15%	-13%	-9%	-8%	-7%
	20y	-11%	-10%	-10%	-10%	-10%	-10%	-10%	-10%	-9%	-8%	-5%	-3%	-3%	-2%
	25y	-11%	-9%	-9%	-7%	-6%	-4%	-3%	-2%	-2%	-1%	0%	-1%	0%	0%
	30y	4%	4%	4%	5%	5%	5%	4%	4%	4%	3%	1%	1%	2%	2%

Source: Citi Research

Appendix A-1

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