

European Rates Weekly

2014 Outlook

- **The euro area's three pillar strategy:** For the euro area to sustain a viable, stable, self-financing scheme we believe three conditions must be met: economic stability, political stability and funding stability. We like strategies such as receiving EUR 5y5y vs EUR 20y5y and duration extensions in front-end EMU periphery.
- **EUR front-end outperforming USD:** Spreads between EUR and USD have already widened significantly at the long-end of the curve. We detail strategies for front-end de-coupling such as receiving EUR 2y1y vs USD 2y1y.
- **EUR Volatility Outlook:** Downward pressure on future realised volatility is likely to lead to lower implied volatility levels. We expect EUR skew to remain steep with the potential to steepen further. We present a selection of recommendations to capture this theme such as buying EUR 1y3y ATMF receiver spreads and to buy cheap bottom right vol towards the end of 1Q14.
- **UK Rates – Lower-for-shorter:** As 2014 progresses, there is likely to be increasing focus on the timing of the first rate hike (we expect Q2 2015) and the likely speed of policy normalization. This will be central to many strategies. For 2014 as a whole, we like being short 10yr gilts vs Bunds, long 30yr asset-swaps and playing the range in break-even inflation spreads. We will also look to enter 2s10s flatteners.
- **EMU trades:** We expect relatively low core EMU yields, OAT-Bund spreads to remain relatively range-bound and for more spread compression in the periphery. We like being long 10yr Ireland and believe 10yr Spain will outperform Italy.
- **Euro inflation trade for 2014:** The combination of downside inflation risks weighing on the front-end and sticky medium-term inflation expectations suggests a strategy of HICPxT steepeners in 2014. The curve has already steepened sharply, but we think it has further to go, and would certainly oppose any flattening.
- **Sovereign ratings now only to change on Fridays:** New regulatory requirements come into force in January which mean rating actions of EMU sovereigns will only be published on Fridays and be reviewed at least twice a year. We see this more as a change in communication strategy rather than having a direct market impact
- **SSA and covered bonds:** We expect elevated supply in euro supras next year but do not think this will mean significantly wider spreads. In covered bonds, we project net negative supply of €40bn. Hunt for value, not yield.

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Figure 1. Strategy Summary Table for 2014

Europe	View	Strategies
Direction	The EMU growth & inflation outlook remain consistent with Bund yields remaining relatively low. We expect 10yr yields to trade around 1.7% - 1.8% over 2013. In the UK, the policy outlook suggests trading gilts with a bearish bias in 2014. We expect 10yr gilts to reach 3.4% by year-end	Trade the range in core EMU markets
Money Market	Further cuts to the ECB refi rate, extended forward guidance and another LTRO are all likely to be supportive for money market rates in 2014. We expect EONIA to trend to 0 later in 2014.	Selective carry trades in the very front-end
Yield Curve	Our expectation of lower ECB policy rates and additional liquidity measures along with the high level of carry is supportive for long EUR 5yr vs 2s and 10s positions. Over the long-term, we expect positive carry long-end steepeners to perform as inflation remains low. For the 1H14, we recommend receiving GBP 2s5s10s for the carry. GBP 10s30s and 2s10s to have a flattening bias as front-end yields rise.	Receive EUR 5y5yF and pay EUR 20y5y Receive EUR 2s5s10s (spot or 1yF) Receive GBP 2s5s10s until 2H14 Look to enter 2s10s GBP flatteners at around 220-225bp (currently 200bp).
Cross-market	We expect EUR-USD spreads to widen further as the US economy outperforms the Eurozone. Markets are not pricing in our expectations of protracted divergence between the Fed and the ECB. We also expect further widening in 10yr gilt-bunds: economic divergence is likely to lead to policy rate divergence which is likely to lead to yield divergence. Gilts are likely to remain locked in a tight range to USTs.	Receive EUR 2y1y vs USD 2y1y Stay short 10yr gilts vs Bunds
EMU Spreads	Duration extension on peripheral curves is likely to be dominant in 2014 as investors extend well beyond the maturity of a theoretical new LTRO. In core markets, we expect OAT-Bund spreads to remain relatively low and range-bound. We expect Spain to outperform Italy and for Ireland to move towards the soft core ultimately following a rating upgrade.	Buy BTP May17 in ASW Long 10yr Ireland Long 10yr Spain vs Italy Trade the range in OAT-Bund spreads
Swap Spreads	We see good value in 10yr and 30yr bund spread wideners in 2014 for a number of reasons: lower issuance from Germany in 2014 vs 2013, the implications of Fed tapering on non-core European bonds, US debt ceiling concerns resurfacing and even the possibility of fresh Italian elections in Spring. In the UK, improving fiscal trends are likely to take 30yr gilt swap spreads back to flat	Buy 30yr Bunds in ASW (or consider buying 10yrs Bunds vs Eonia) Buy 30yr gilts in ASW
Inflation	The combination of downside inflation risks weighing on the front-end and sticky medium-term inflation expectations suggests HICPxT steepeners in 2014. The curve has already steepened sharply, but we think it has further to go, and would certainly oppose any flattening. We expect UK break-evens broadly track sideways in 2014. 4Q14 forecast for the 10yr break-even is 2.95% (vs 2.91% at the time of writing)	Enter 2s10s HICPxT steepeners at 60bp (we like 2s5s steepeners too) Look to sell Boblei18 break-evens at 95bp Buy UKT 10yr break-evens around 2.75% -2.80% and sell around 3.15% -3.20% .
Volatility	Downward pressure on future realised volatility is likely to lead to lower implied volatility levels. We expect EUR skew to remain steep with the potential to steepen further.	Buy EUR 1y3y ATMF receiver spreads Buy cheap bottom right vol towards the end of 1Q14. Long EUR 5y5y ATMF swaption straddle vs 2y2y ATMF swaption straddle
SSA	One clear characteristic of the SSA market remains its resilience amid an environment of elevated supply. We think this will be a prominent feature in 2014 too. We also expect new entrants in the agency market and perhaps even more green bonds.	Trade the range in core agencies vs their respective sovereigns Watch for RV in 3yr-5yr KfW-France and 7yr-9yr EIB-France Buy EU in primary (supply expected in Q1 and Q2)
For a list of outstanding trade strategies please see the Tradesheet section of this report		

Source: Citi Research

2014 European Yield Forecasts

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Core Europe

Bullish domestic factors will blend with a bearish US yield environment in 2014. We do not expect a substantial deviation of Bund yields from current levels in the coming three quarters (1.7-1.8%). However, the front-end of the EUR curve should de-couple further from the US given our forecast of another 25bp refi rate cut and 10bp deposit rate cut by the ECB. Together with somewhat enhanced forward guidance, this should anchor the 0-5y sector to flat monetary policy expectations, thus fuelling carry trades and further lowering Bobl's sensitivity to UST. Going into 2015, we see a slight improvement in the beta between Treasuries and Bunds and forecast yields to test 2%.

The uncertainty around our baseline comes mainly from further potential downward adjustment in HICP and the efficacy of ECB's response. The yield curve should reflect all these factors and we expect a steepening, especially in the 5-10y segment. The Eurozone's Three Pillar strategy should continue to provide ample support for core and non-core EGBs alike. Spreads to Bunds should remain at current tight levels with Austria and Belgium expected to outperform France and the Netherlands in 2014.

EMU Periphery

Steady demand from resident investors together with an increased risk appetite from foreign investors have been the main drivers of peripheral spreads in 2013. Apart from sporadic and short-lived bursts of risk aversion, macroeconomic, fiscal and political arguments have played a minor role. In this benign environment, we expect the ECB's measures to continue supporting the performance of peripheral EGBs also in 2014, albeit not at the pace seen this year. We expect 10y Bonos to outperform BTPs again, mainly due to Italy's persistent underachievement in terms of implementing a credible reform agenda. Special mention to Ireland, which will be outside of the official support programme in 2014 and is expected to validate the high level of expectations that have driven its performance in 2013.

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The forecasts for gilt yields in 2014 suggest a gradual shift towards higher yield levels. For the yield outlook, the speed of policy normalisation is more important than the timing of the first rate hike. Our base case is that policy rates begin to move higher in Q2 2015 and reach around 2% relatively quickly before a fresh assessment is made. The economic uncertainties remain great, but the recovery appears to be gathering pace and the risks to our forecasts are probably skewed towards higher yields. The core themes reflected in the forecasts are further underperformance of gilts vs Bunds and a relatively tight spread vs Treasuries. The 2s10s curve is likely to begin to bear flatten from mid-2014 as the first rate hike comes into view.

Figure 2. Interest Rate and Bond Market Forecasts as of 2 December 2013

	Quarterly Average						
	Current	1Q 14	2Q 14	3Q 14	4Q 14	1Q 15	2Q 15
US							
Policy Rate (Fed Funds) End Quarter	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-Month Libor	0.24	0.24	0.24	0.24	0.24	0.32	0.45
2 Year Treasury Yield	0.28	0.31	0.45	0.63	0.80	0.98	1.13
5 Year Treasury Yield	1.35	1.40	1.58	1.80	2.05	2.30	2.50
10 Year Treasury Yield	2.75	2.80	2.95	3.13	3.25	3.38	3.50
30 Year Treasury Yield	3.84	3.92	4.13	4.30	4.40	4.53	4.65
2-10 Year Treasury Curve	247	249	250	250	245	240	238
2 Year Swap Spread (Swap Less Govt), bp	10	15	20	20	20	20	20
10 Year Swap Spread (Swap Less Govt), bp	7	8	13	15	15	15	15
30 Year Swap Spread (Swap Less Govt), bp	-9	-7	-5	-5	-5	-5	-5
30 Year Mortgage Yield	4.35	4.43	4.60	4.78	4.95	5.15	5.33
10 Year Breakeven Inflation	220	230	240	238	235	238	238
Euro Area							
Policy Rate	0.25	0.25	0.00	0.00	0.00	0.00	0.00
Overnight Rate (EONIA)	0.13	0.10	0.00	0.00	0.00	0.00	0.00
3-Month (EURIBOR)	0.19	0.20	0.10	0.15	0.15	0.15	0.15
2 Year Schatz Yield	0.12	0.15	0.00	0.05	0.10	0.10	0.10
5 Year Bobl Yield	0.65	0.60	0.50	0.50	0.50	0.60	0.60
10 Year Bund Yield	1.70	1.70	1.70	1.70	1.80	1.90	1.90
30 Year Bund Yield	2.63	2.60	2.60	2.60	2.60	2.60	2.60
2-10 Year Bund Curve	158	155	170	165	170	180	180
10 Year BTP-Bund Spread	218	220	210	200	175	175	175
10 Year Bono-Bund Spread	246	230	220	180	150	150	150
2 Year BTP-Schatz Spread	100	100	75	75	50	50	50
2 Year Bono Schatz Spread	118	110	75	75	50	50	50
10 Year OAT-Bund Spread	47	50	45	45	45	45	45
10 Year Swap Spread (Swap Less Govt.), bp	27	35	25	25	25	25	25
10 Year Breakeven Inflation	144	140	145	145	150	150	150
Japan							
Policy Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3-Month Libor	0.14	0.15	0.15	0.15	0.15	0.15	0.15
2 Year Treasury Yield	0.09	0.10	0.10	0.10	0.10	0.15	0.15
5 Year Treasury Yield	0.20	0.20	0.15	0.20	0.25	0.35	0.40
10 Year Treasury Yield	0.60	0.55	0.50	0.60	0.70	0.90	1.00
30 Year Treasury Yield	1.65	1.65	1.60	1.65	1.70	1.85	1.95
2-10 Year Treasury Curve	51	45	40	50	60	75	85
2 Year Swap Spread (Swap Less Govt.), bp	12	12	10	12	14	17	19
10 Year Swap Spread (Swap Less Govt.), bp	17	15	11	14	16	19	20
10 Year Breakeven Inflation	96	95	90	85	85	95	100
UK							
Policy Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.75
3-Month Libor	0.52	0.52	0.55	0.60	0.65	0.70	0.90
2 Year Treasury Yield	0.44	0.50	0.70	0.85	1.00	1.25	1.50
5 Year Treasury Yield	1.54	1.60	1.85	2.00	2.15	2.40	2.60
10 Year Treasury Yield	2.78	2.85	3.05	3.20	3.30	3.40	3.50
30 Year Treasury Yield	3.58	3.65	3.75	3.85	3.90	3.95	4.00
2-10 Year Treasury Curve	234	235	235	235	230	215	200
10 Year Swap Spread (Swap Less Govt.), bp	-5	0	0	5	5	10	15
10 Year Breakeven Inflation	286	280	285	290	295	300	300
Australia							
Policy Rate	2.50	2.50	2.50	2.50	2.50	2.75	3.25
3-Month Libor	2.58	2.60	2.60	2.60	2.65	2.95	3.45
2 Year Treasury Yield	2.69	2.80	2.90	2.90	3.20	3.50	3.80
5 Year Treasury Yield	3.47	3.50	3.60	3.75	3.90	4.20	4.45
10 Year Treasury Yield	4.32	4.30	4.40	4.50	4.60	4.75	4.95
2-10 Year Treasury Curve	164	150	150	160	140	125	115
10 Year Swap Spread (Swap Less Govt.), bp	27	30	30	35	40	45	45

Source: Citi Research

EGB: Eurozone's Three Pillar Strategy

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Inflation and restructuring are not the only solution

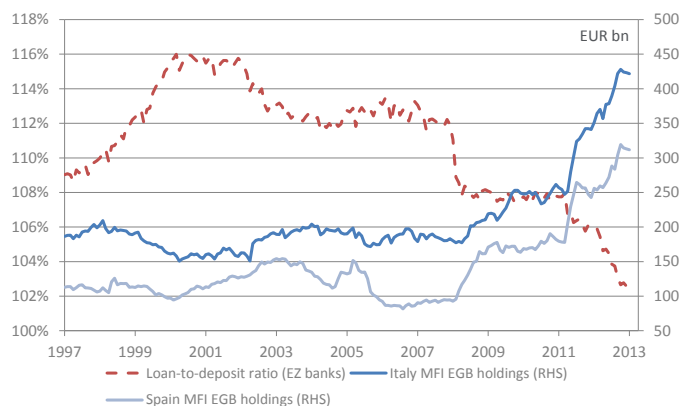
Vested interest in regulation: More lending to the public sector

Is there a grand strategy at official Eurozone level? What could be the long-term battle plan to prevent markets from rocking (again) the stability of the Union? What are the conditions that would allow such a strategy to work?

When a currency area experiences the kind of shocks that the Eurozone has and the need to deleverage becomes a pressing issue, most ready-made recipes would call for the obvious painful solution of a positive inflation shock and/or debt restructuring. There is also a third way, though. Why not "regulating" the location of wealth away from the private sphere and towards the public sector?

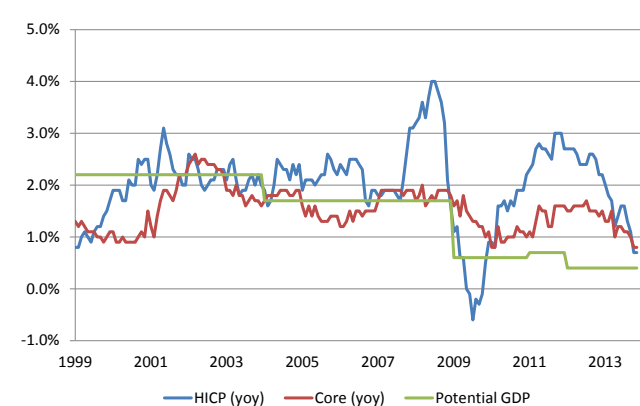
We already see tentative efforts to enable the transfer of privately owned funds from the realm of free decision making to the biased reality of regulated investments. Allowing pools of assets to efficiently warehouse government bond risk under Basel and Solvency regulation is a way to increase lending to the public sector. Unfortunately, this strategy has its drawback: In a world of limited resources, increasing the allocation to one sector also means draining resources from other sectors (Figure 3). This is particularly the case in the Eurozone, where the central bank has so far abstained from expanding monetary resources via QE.

Figure 3. Trade-off between private and public sector



Source: ECB, Citi Research

Figure 4. Low potential growth implying low/negative inflation risk



Source: European Commission, Citi Research

Self-financing schemes are an option not-to-default

This grand strategy resembles Japan and BOJ's efforts to passively manage the balance sheets of megabanks by allowing a huge long-term carry trade on the JGB curve. The consequences in terms of economic growth, inflation, debt dynamics and income redistribution are obvious. Nevertheless, such an expensive¹ trade-off between the private and the public sectors bears the benefits of minimizing the need for sovereign debt restructuring. In its strictest form, when all debt is held in domestic portfolios, the system may become circular and self-financing. In that sense, regulation has to be seen as an option not-to-default in the hands of Eurozone officials and the premium is the running cost of anemic growth and potentially negative inflation (Figure 4).

Long-run equilibrium conditions for the Eurozone

In order for this to become a viable, stable, self-financing scheme we believe three conditions must be met. Each of them is in itself a necessary condition:

Economic stability

- 1) **Economic stability:** The ability of households/firms to absorb another negative shock is reduced in comparison to the pre-crisis period. Another recession and the associated rise in unemployment rates would stress household savings and increase overall malaise. Similarly, a protracted

¹ Expensive in terms of economic and social losses.

period of negative inflation would (all else equal) threaten the sustainability of sovereign debt. At the moment, the consensus does not forecast another recession and very few analysts would assign a meaningful probability to deflation in the Eurozone². That is not to say that the probability of deflation has not increased.

Political stability

- 2) **Political stability:** The ability of radical, anti-European political parties to collect votes has improved during the crisis. This is not only the case for peripheral member countries (e.g. Syriza in Greece and M5S in Italy), but also for the hard core of the Eurozone (e.g. True Finns in Finland and FPÖ in Austria). The recent alliance between the French National Front of Marine Le Pen and Geert Wilders' Party for Freedom is yet another signal that there is a growing portion of the electorate that may dissent with Brussels' central administration and its grand strategy. Headline risk is particularly high during area-wide elections, the next European Parliament elections will be held between 22 and 25 May 2014.

Funding stability

- 3) **Funding stability:** The ECB plays a prominent role in this pillar by providing cheap funding to banks. In Otmar Issing's world, liquidity is supposed to be distributed outside the banking sector in order to control the economy. In Mario Draghi's world, liquidity is supposed to fund existing bank portfolios at very attractive levels in order to prevent asset price volatility and fears of a funding bottleneck having a negative impact on sovereign funding. It is not correct to say that ECB liquidity funds non-core EGBs³, but EGBs definitely profit from a stable funding environment. As was the case in Japan, the carry trade on banks' balance sheets is king.

Non-resident holdings? ECB has dealt with them in past

Each one of these conditions must be satisfied at all times in order to keep the Eurozone in a self-financing equilibrium – assuming we already are in one. The share of non-resident holdings of EGBs complicates matters as it increases the sensitivity of EGBs prices to external factors (e.g. credit ratings). However, the ECB has been able to absorb selling flows coming from outside the Eurozone in the past and we would expect them to be ready should such a market environment materialize again.

Trade Ideas for the Very Long Run

Here we want to focus on very long-term scenarios and we propose 2 trade ideas.

Rec EUR 5y5y, pay 20y5y

Trade #1: Receive EUR 5y5y, pay EUR 20y5y @ -24bp.

The strategy has a positive rolldown of 34bp in year 1 and another 43bp in year two. The terminal spread, i.e. spot 5y vs 15y5y is worth around 211bp. The strategy picks roughly the point of intersection of the 5y-fwd and the 20y-fwd swap curve (Figure 5). From a macro perspective it is yet another version of long-end, positive carry steepener, which is really the position we want in a scenario of long-term near stagnation with the risk of short episodes of deflation.

² Consensus Forecasts reports GDP growth of 1.3-1.5% between 2015 and 2023, while HICP is expected to drift towards 2% (from 1.4% in 2014) in the long run.

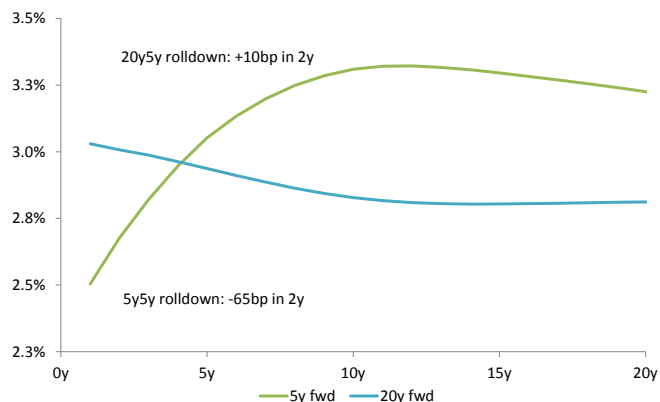
³ In fact government bonds constitute only 27% of collateral used by counterparties to the Bank of Italy (http://www.bancaditalia.it/pubblicazioni/stabilita-finanziaria/rapporto-stabilita-finanziaria/2013/rsf_2013_6/en_stabfin_6_2013/Financial-Stability-Report-6.pdf).

Buy BTP May-17 in ASW

Trade #2: Generalized duration extension on the peripheral curves.

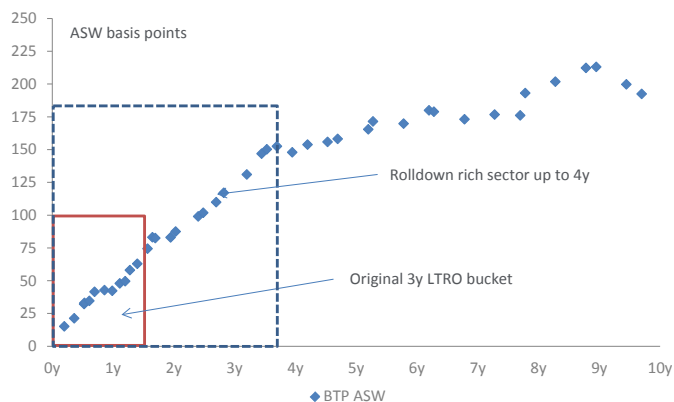
This is particularly the case in case of additional liquidity/funding measures. As we've noted in the past, investors are likely to extend well beyond the maturity of a theoretical new LTRO (Figure 6). This extension is even more likely if coupled with a stable macroeconomic and political environment. For example, buying BTP May-17 in ASW @156 generates an ASW-rolldown of 46bp over the course of 12 months.

Figure 5. Rollling down those forward curves...



Source: Citi Research

Figure 6. ...as well as on those peripheral curves



Source: Citi Research

EUR: Front-End Outperforming vs USD

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US economy to outperform the Eurozone

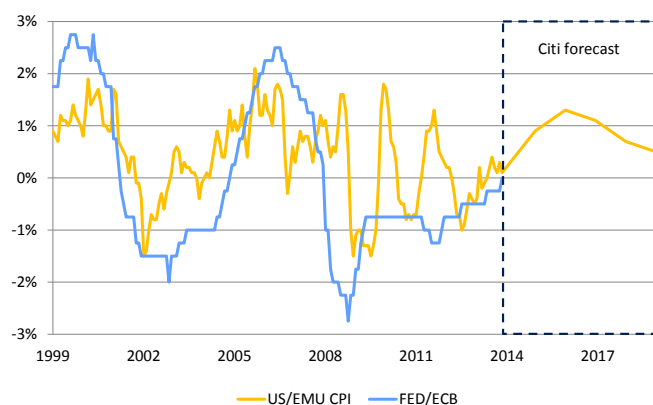
Markets are not pricing in our monetary policy scenarios

We've outlined our thinking on the "Low-for-Longer" theme in the Eurozone in a recent thematic publication⁴. Spreads between EUR and USD have already widened significantly at the long-end of the curve (e.g. 5y5y @145bp from 45bp on 1 January 2013). Here we look at ways to position for a front-end de-coupling between the US and the Euro area.

Citi's latest [global forecasts](#) suggest a continued outperformance of the US vs the Eurozone in macro terms: The real GDP differential is projected to widen from 1.8% in 2014 to 2.1% in 2015, while the inflation differential should peak at 1.3% in 2015 (from a current spread of 0.1%, Figure 7).

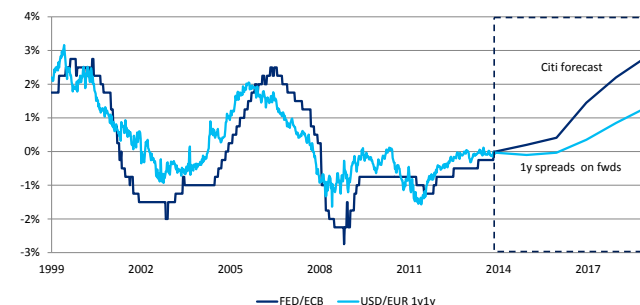
The long-end of the USD curve has well anticipated the diverging policy trajectory (incl. tapering) and USD/EUR 5y5y spreads have managed to widen by roughly 100bp during the course of 2013. At the same time, investors have taken on board FOMC's message that tapering does not necessarily imply the start of the rate hiking cycle and the expectations curve continues to trade at a lower implied rate than the "dot charts" (e.g. Dec-15 expectations are at 0.58% vs a median FOMC assessment of 1%). ECB expectations are essentially flat to the FED at the end of 2015, i.e. 1-month Dec-15 Eonia is approximately 0.56%.

Figure 7. Widening US/EMU inflation differential



Source: Citi Research

Figure 8. Policy trajectory and market spreads



	2013	2014	2015	2016	2017	2018
FED	0.25	0.25	0.41	1.50	2.70	3.80
ECB	0.25	0.05	0.00	0.05	0.50	1.00
Spread	0.00	0.20	0.41	1.45	2.20	2.80

Source: Citi Research

"Low-for-Longer" in the Eurozone is a main component of policy divergence

A closer look at Citi's policy trajectories suggests a protracted divergence between the FED and the ECB with the FF/refi spread widening to 280bp by 2018 (Figure 8), mainly reflecting the "low-for-longer" theme in the Eurozone. Looking at market spreads, we can see how such an aggressive policy divergence is not priced in the forwards: For example, the USD/EUR 2y1y spread is quoted at 30bp which contrasts with a forecast policy differential of 145bp by the end of 2016.

Trade Idea

Rec EUR 2y1y / pay USD 2y1y

We recommend receiving EUR 2y1y vs paying USD 2y1y @ up to 40/45bp. The choice of expiry is dictated by the gap between 2016 "dot charts" and the USD curve as well as the compromise between cost of carry (3bp/month) and sensitivity with respect to US domestic policy (e.g. tapering). First target on this spreads should be around 60/65bp with a final target in the 125/150bp area. Stops: 15/20bp area.

⁴ "Low(er)-for-Longer: Themes & Trades" (28 November)

EUR Volatility Outlook

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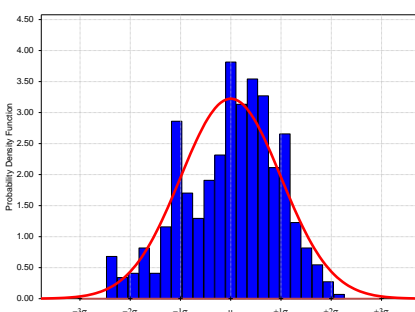
Downward pressure on realized volatility should lead implied volatility to yet lower levels, in our view.

With the rebound in EUR economic activity expected to be slow and uneven and monetary policy set to remain loose, rates in the Eurozone are likely to remain pinned or grind yet lower at the front-end.

Further out the curve, the belly in EUR should outperform USD in the scenario of a tapering lead sell-off, i.e. bullish domestic factors in Europe will blend with a bearish US yield environment in 2014; in turn we do not envisage substantial deviation of yields in the belly of the curve from current levels in the coming three quarters.

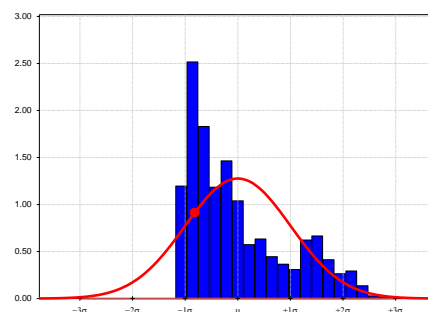
Given the views outlined above, downward pressure on realized volatility should lead implied volatility to yet lower levels. In particular, as rates at the front-end increasingly flirt with the zero nominal floor, yield distribution will tend to more pronouncedly exhibit log-normal properties as suggested by Figure 9 to Figure 12 below.

Figure 9. JPY 2y swap (1999 - 2001)



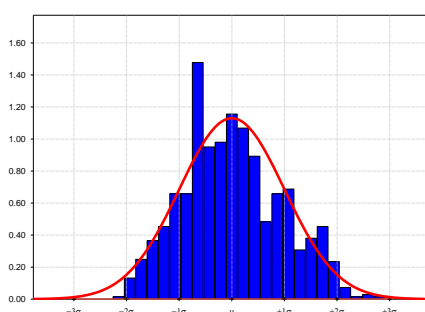
Source: Citi Research

Figure 10. JPY 2y swap (2000 – To Date)



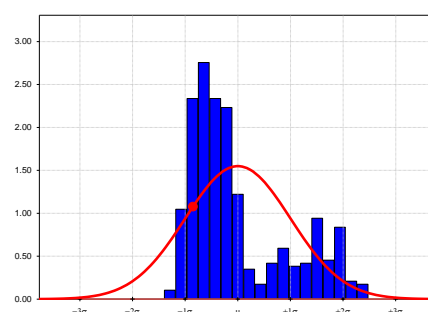
Source: Citi Research

Figure 11. EUR 2y swap (2009-2012)



Source: Citi Research

Figure 12. EUR 2y swap (2012 – To Date)



Source: Citi Research

At low level of rates a log-normal type distributions imply that rate changes tend to be proportional to the level of rates.

As a result, in a simple SABR option framework, the beta parameter should drift higher and rate changes will tend to be proportional to the level of rates. More in detail we analyse implied vol directionality in Figure 13 below where we estimate via simple regression the SABR beta parameters using year-to-date implied volatility and forward rates data. Observe the strong positive correlation for short expiry options on short and intermediate tails. Interestingly, long tails in gamma space look super normal for short expiries, which implies a tendency for normal volatility to increase as rates drift lower.

Figure 13. Estimated SABR beta coefficients

	1y	2y	3y	4y	5y	7y	10y	15y	20y	25y	30y
1m	0.49	0.92	1.03	1.01	0.97	0.93	0.87	0.58	0.19	-0.10	-0.31
3m	0.45	0.84	0.86	0.87	0.87	0.86	0.73	0.57	0.25	0.00	-0.17
6m	0.54	0.77	0.79	0.81	0.83	0.80	0.68	0.55	0.31	0.10	-0.04
1y	0.56	0.74	0.74	0.74	0.75	0.72	0.59	0.49	0.30	0.20	0.09
2y	0.60	0.68	0.68	0.68	0.67	0.64	0.54	0.47	0.36	0.27	0.20
3y	0.55	0.61	0.63	0.63	0.61	0.60	0.54	0.49	0.40	0.31	0.22
4y	0.57	0.63	0.61	0.60	0.60	0.61	0.56	0.51	0.43	0.33	0.23
5y	0.59	0.63	0.62	0.62	0.61	0.61	0.60	0.54	0.47	0.36	0.24
6y	0.64	0.65	0.65	0.65	0.63	0.63	0.59	0.56	0.50	0.38	0.22
7y	0.66	0.66	0.66	0.65	0.63	0.63	0.60	0.54	0.48	0.34	0.17
8y	0.70	0.65	0.65	0.65	0.63	0.62	0.58	0.48	0.40	0.28	0.11
9y	0.73	0.66	0.67	0.67	0.67	0.62	0.56	0.43	0.34	0.20	0.01
10y	0.78	0.70	0.67	0.69	0.67	0.63	0.56	0.40	0.30	0.11	-0.10
20y	0.39	0.28	0.26	0.26	0.25	0.14	-0.05	-0.30	-0.47	-0.59	-0.72

Source: Citi Research

Japan can give an indication of how much lower EUR implied volatility can go ...

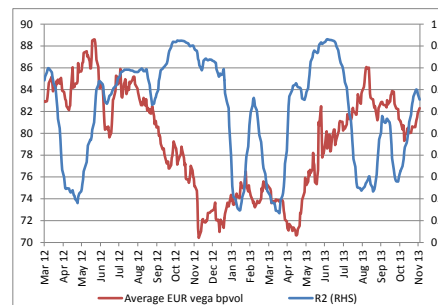
In terms of outright levels, implied volatility can significantly move lower from current levels as the EUR economy is nudging closer to resembling the Japanese economy during the liquidity trap in the 2000s: Figure 14 shows the potential outright EUR implied volatility downward moves if we crudely refer to the bottom of the 2010 JPY implied volatility sell-off. Note that whilst vega implied volatility is highly flow dependent (we discuss EUR MTN flows below), it also exhibits a (time varying) relationship with gamma implied volatility: Figure 15 shows the evolution of rolling R-squared from regressing a portfolio of vega implied vols against a portfolio of gamma implied vols; note how R2 picks up during episodes of strong trends, such as the vol rally following Bernake's congressional testimony in May.

Figure 14. EUR implied vol potential medium-term sell-off assuming JPY Oct-2010 market as terminal point.

	1y	2y	3y	4y	5y	7y	10y
1m	-8	-19	-27	-29	-28	-18	-8
3m	-14	-24	-32	-38	-38	-29	-21
6m	-17	-30	-37	-42	-43	-35	-27
1y	-27	-39	-46	-50	-48	-41	-31
2y	-47	-52	-53	-53	-51	-43	-35
3y	-58	-57	-55	-53	-50	-43	-34
4y	-60	-56	-52	-50	-47	-40	-33
5y	-55	-50	-47	-45	-42	-36	-32
7y	-38	-35	-33	-32	-31	-28	-25
10y	-20	-20	-19	-19	-19	-18	-17

Source: Citi Research

Figure 15. Evolution of R2 between EUR vega and gamma implied vol.



Source: Citi Research

EUR skew to stay steep or possibly steepen further over the next few quarters.

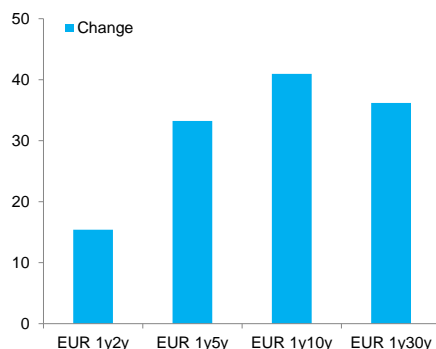
As for the EUR skew, over the last year, higher rates have coincided with steeper skews (Figure 16 to Figure 18). Going forward, we make the following observations:

■ **Front-end:** the prospect of lower policy rates (Citi expects the ECB to cut the refi rate to 0% in 2014 and for the deposit rate to move to -0.1%) is likely to result in demand for receiver spreads rather than selling payers, in our view. This is primarily due to a better risk-reward and a lower VaR for portfolio managers. Beyond this, as policy rates move towards what we would deem as the lower bound there is likely to be stronger demand for payers following the next rate cut – as accounts look to position for higher rates. With this in mind, we are very cautious about fading the current steepness of payer skew over the next few quarters.

■ **For 10yr+ tenors:** the effect of Fed tapering is likely to reduce appetite for receiver spreads in 10yr and 30yr tenors. Gamma flows in this segment of the vol surface are more likely to be via bearish structures using OTM payers rather than selling receiver spreads. This could result in further steepening of payer skew.

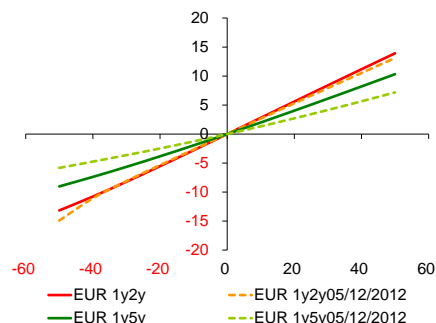
In brief, we would expect demand for ATM receivers to outstrip OTM bpvol in the front-end. This is likely to steepen *receiver skew*. For longer-dated tenors, demand for OTM payer bpvol is likely to be greater than ATM bpvol. As a result, we expect *payer skew* to remain steep and possibly steepen further.

Figure 16. 12m change in swap yields (bp)



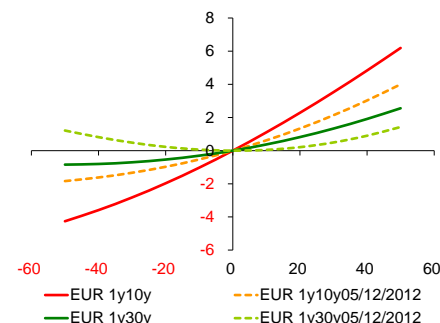
Source: Citi Research

Figure 17. EUR 1y2y & 1y5y skew vs 12m ago



Source: Citi Research

Figure 18. EUR 1y10y & 1y30y skew vs 12m ago

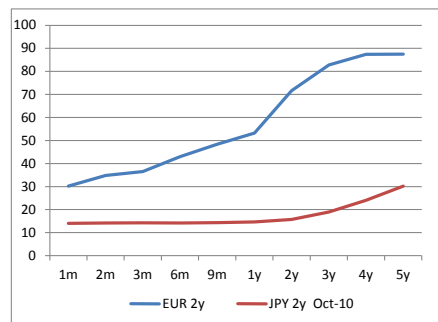


Source: Citi Research

Dynamics is key to understand future shape of implied volatility term structures.

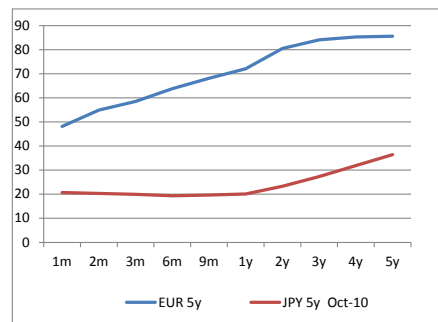
Turning our attention to the future shape of EUR *implied volatility term structures*, dynamics is key. Indeed, a static comparison between current EUR implied vol term structures and those which were prevalent in Japan towards the end of 2010 (Figure 19 and Figure 20) would lead initially to the conclusion that EUR implied vol term structure should flatten. However, the Japanese short expiry implied vol had already been stuck at significantly lower levels; by means of example, JPY vol calendar spreads such as 1y2y/5y2y have been showing strong directionality with 5y2y vol, still quite in contrast to EUR spreads (Figure 21 and Figure 22). In other words, *we expect EUR implied volatility term structures to bull steepen in the coming three quarters.*

Figure 19. EUR 2y swap implied volatility term structure vs. Oct-10 JPY 2y swap



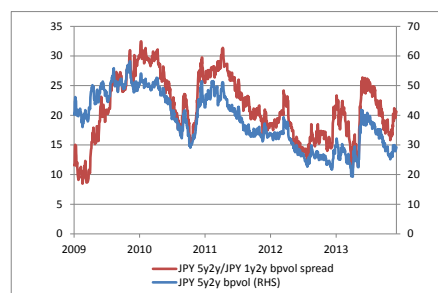
Source: Citi Research

Figure 20. EUR 5y swap implied volatility term structure vs. Oct-10 JPY 5y swap



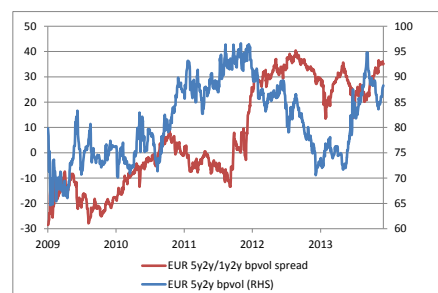
Source: Citi Research

Figure 21. Evolution of JPY 1y2y/5y2y vol calendar spread



Source: Citi Research

Figure 22. Evolution of EUR 1y2y/5y2y vol calendar spread



Source: Citi Research

MTN flows are key to understanding vega volatility.

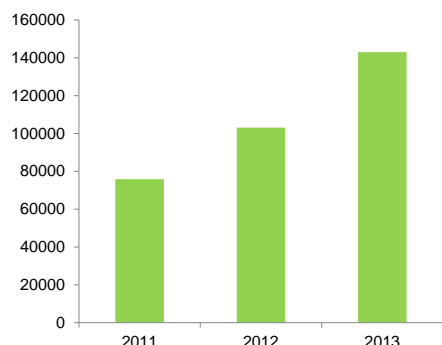
Finally we take a look at the outlook for vega from a flow standpoint. In the current market environment we believe it is reasonable to focus on 1) callables and 2) CMS linked notes.

1) Callables

The last three years have seen a consecutive rise in EUR callable issuance. Monthly callable issuance in 2013 has been higher than previous years for virtually all months. More recently, November 2013 saw the highest amount of callable supply in the last three years.

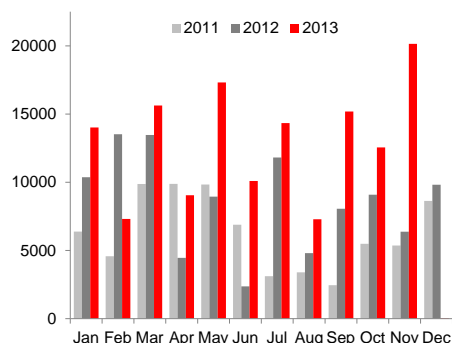
Based on the seasonal trend in the last three years, March and May tend to have the highest amount of callable issuance in each year. This is closely followed by November and December.

Figure 23. Callable issuance has increase in each of the last three years (€mn)



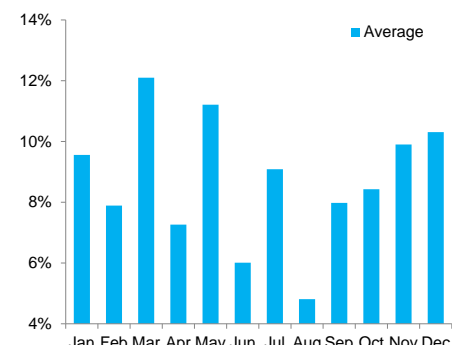
Source: Citi Research, Bloomberg

Figure 24. Monthly callable issuance (€mn): Nov 2013 saw the highest supply since 2011



Source: Citi Research, Bloomberg

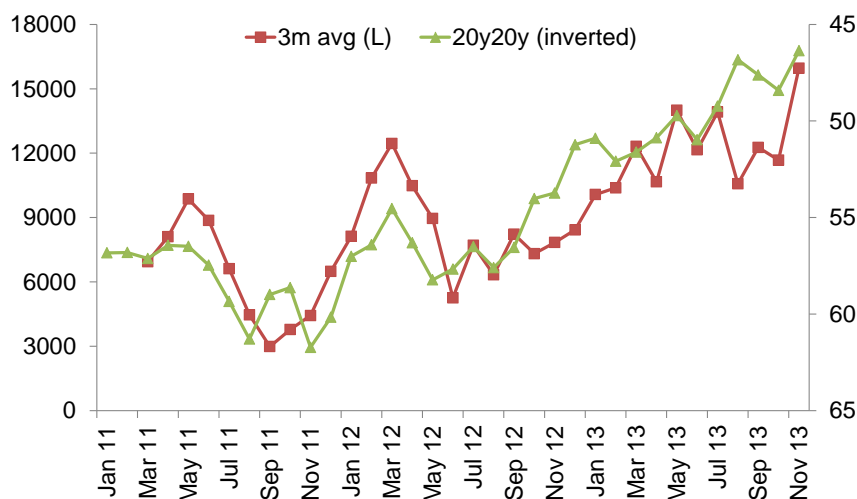
Figure 25. Average callable issuance by month since 2011



Source: Citi Research, Bloomberg

As shown in Figure 26, the increase in callable issuance that has taken place in the last few years has pushed EUR vega lower. The record amount of issuance in November 2013 has been one of the factors behind EUR 20y20y making three year lows. A continuation of the trend in callable issuance (the last three years have seen a continuous increase in callable issuance) is likely to result in downward pressure on 20y20y bpvol. Furthermore, lower levels of gamma (which we expect) is also likely to put downward pressure on 20y20y bpvol lower.

Figure 26. Callable supply (3month rolling average) vs EUR 20y20y bpvol

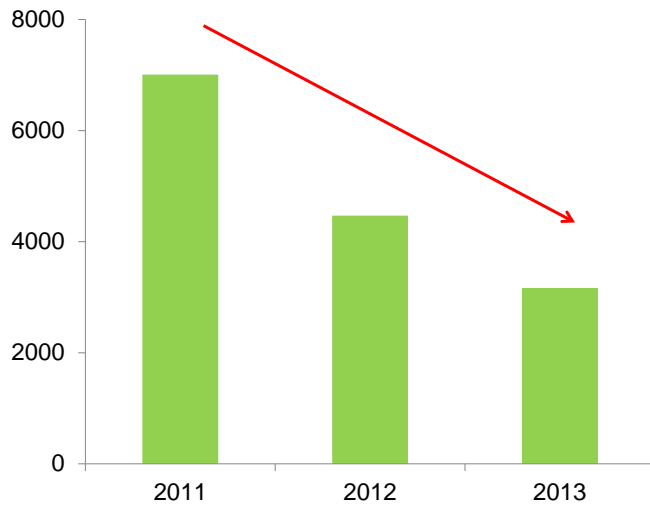


Source: Citi Research, Bloomberg

(2) CMS

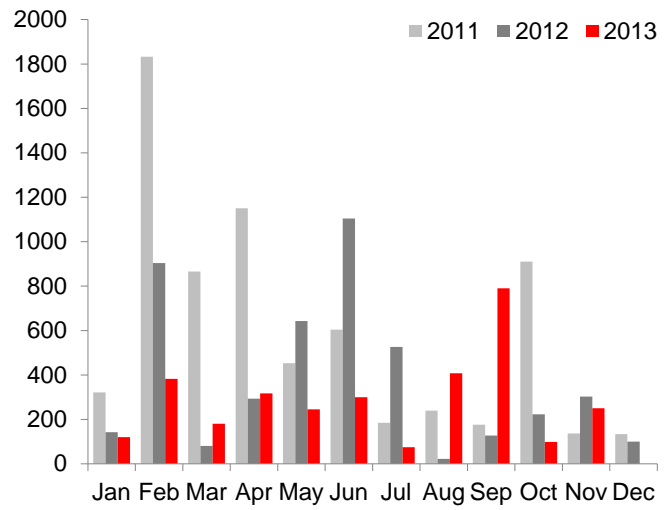
The last three years have seen a reduction in CMS issuance of around 30% per year. As shown in Figure 28 below, there does not appear to be any strong seasonal trends in issuance.

Figure 27. CMS issuance has declined in each of the last 3yrs (€mn)



Source: Citi Research

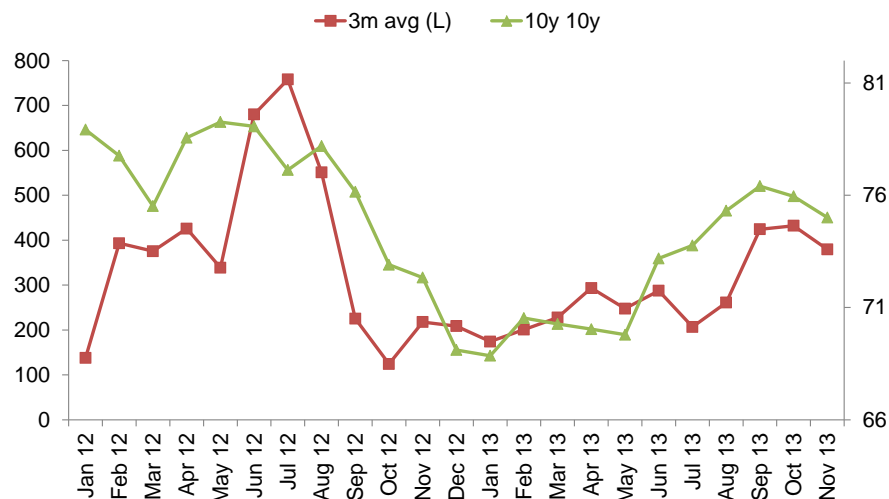
Figure 28. CMS issuance split by month (€mn)



Source: Citi Research

Over the last 18 months, the decline in CMS issuance has resulted in downward pressure on EUR 10y10y bpvol. Notably, the increase in CMS issuance between May 2013 and November 2013 pushed EUR10y10y vol 5bpv higher.

Figure 29. CMS supply (3month rolling average) vs EUR 10y10y bpvol



Source: Citi Research, Bloomberg

Conclusions

Given our volatility outlook as outlined above, we like the following EUR trades which are in line with our recent recommendations.

- Tactically, we recommend being long gamma only in a contingent format (see the volatility section in [European Rates Weekly](#), 21 November).
- Construed as terminal trade we still favour long EUR ATMF 1y3y swaption receivers and/or receiver spreads (see the volatility section in [European Rates Weekly](#), 28 November).
- Fundamentally and from a pure volatility standpoint, given our bearish expectation on future realized volatility over the next three quarters, we believe front-end volatility should be sold at current levels.
- We like long EUR 5y5y ATMF swaption straddle against 2y2y ATMF swaption straddle, given that 5y5y delivered volatility should outperform 2y2y as 2y2y realized volatility is likely to be pushed further down by accommodative monetary policy whilst 5y5y realized vol will reflect moves of the belly of the curve which is more exposed to the uncertainty stemming from the sovereign outlook in the Eurozone.
- We would wait until towards the end of the seasonal wave of callable flows (December 2013 and first quarter next year) to buy cheap and positively rolling implied volatility in the bottom right (15y15y, 10y30y, 20y20y).

UK Rates Outlook – Lower-for-shorter

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Higher growth vs lower inflation

The MPC are likely to raise raises from Q2 2015 to around 2% over 12-18 months

Yields are likely to rise beyond the forwards, but negative carry could hurt over shorter periods

The average earnings data is likely to become increasingly important

Setting the scene

Economic momentum: A wide number of indicators suggest that the economic recovery is gathering momentum. Citi forecast growth of around 3.2% next year, up from a likely 1.5% in 2013. At the same time, inflation is set to fall, with CPI likely to average 2.0% in 2014, down from 2.6% in 2013. For gilts, this sets the scene for opposing fundamental drivers in 2014: higher growth is likely to be the main bearish driver while lower inflation is likely to be the main bullish driver. Many of the other influential drivers from recent years – such as safe haven flows, fiscal risks and QE – are likely to take more a backseat. The most important factor for gilts will be the MPC's reaction function to this fundamental mix.

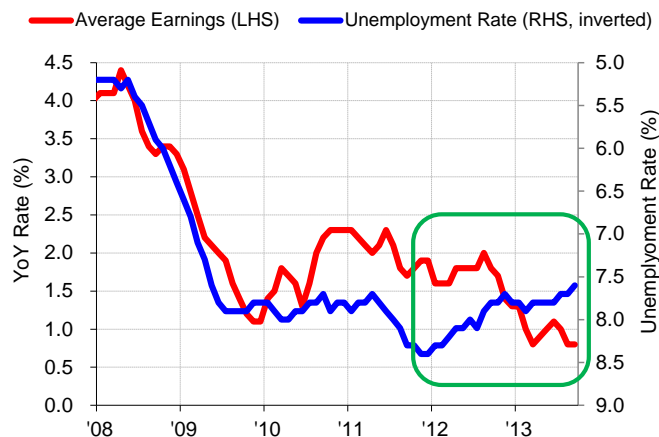
Policy outlook: Our economics team have brought forward the timing of the first rate hike from the MPC to Q2 2015, before even the Fed. This is likely to be followed by a relatively fast rise in the policy rate, over perhaps 12-18 months, to around 2% (implying 0% real rates) before pausing. This would still leave the policy rate well below neutral, which our economists tentatively estimate to be around 3%-4% (see [UK Economics Weekly](#), 29 November). This clearly contrasts with the 'lower-for-longer' outlook for the ECB. It's also worth mentioning that the Bank of England will conduct APF purchases to the tune of £21bn in 2014 as redeeming stock is re-invested (to maintain QE at £375bn, as stipulated under guidance).

Duration – short bias

Bearish, but watch the carry: The policy outlook above suggests trading gilts with a bearish bias in 2014. We are still a long way from the first rate hike, but gilt yields are likely to drift slowly higher as policy normalization comes into view. For the 10yr sector, we envisage gilt yields reaching 3.4% by year-end (compared with a forward of around 3.20%), 65bp higher than current levels. Negative carry suggests a nimble strategy over shorter time periods as the sell-off won't be a straight-line.

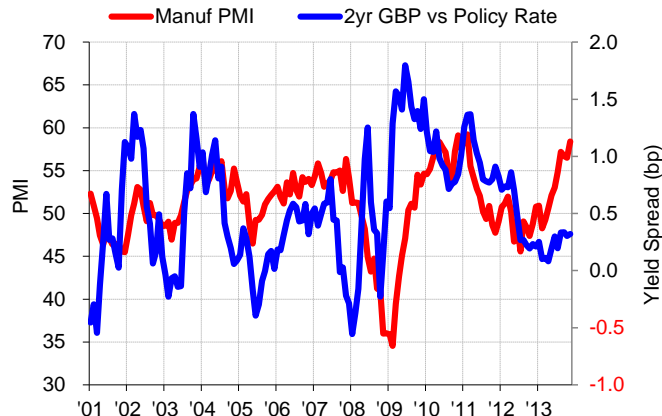
Speed of any sell-off will be data dependent: The path to higher policy rates discussed above is our base case, but of course there is great uncertainty. As Carney put it, what happens after guidance will depend on economic conditions when we get there and what we learn along the way. The data focus has already shifted from growth to the output gap (and the jobless rate). The next major focus is likely to be the average earnings data as that could have an important influence over the speed of eventual policy rate normalization. For now, the average earnings growth is still falling even though the jobless rate is falling (Figure 30).

Figure 30. Avg earnings are falling, even with a lower jobless rate



Source: Citi Research, ONS.

Figure 31. The front-end remains anchored, despite improving activity



Source: Citi Research, PMI, Bloomberg.

Risk of lower-for-longer: The greatest risk to our view is that the recovery takes a stumble or that the MPC find it hard to wean the economy off near-zero interest rates. The lack of growth in the rest of Europe may also act as a drag.

Curve – 2s10s unlikely to steepen much further

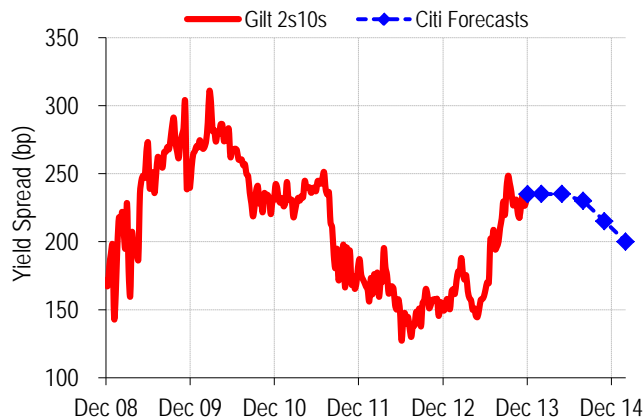
The 2yr rate will move higher as the first rate hike comes into view

The front-end may lose its anchor: The outlook for the gilt curve will depend largely on the fortunes of the front-end. The front-end end has, so far, largely ignored the pick-up in growth prospects (Figure 31). This probably reflects forward guidance, the focus on the output gap and the understanding that rate rises are still a considerable way off. However, this is likely to change as 2014 progresses and the first rate hikes come into view. The 2yr gilt yield is currently at the top of the 0.05%-0.50% range that has held for the last two years. We expect this range to be broken in 2014 with the 2yr rate likely to double by the end of the year to around 1%. The risks are probably skewed towards an even larger sell-off as the market is likely to build in a healthy risk premium given the uncertainty over the speed of policy normalization post guidance.

Look to enter 2s10s GBP flatteners at around 220-225bp

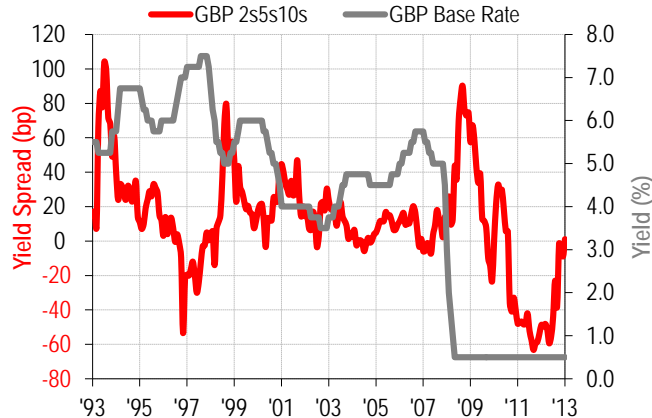
2s10s bear flattener with flat carry: As the front-end becomes unhinged, we expect 2s10s to eventually flatten. Positioning for such also has the advantage of being carry-neutral. However, the long-established bear-steepening, bull-flattening dynamic may not be strongly challenged until later in 2014. We are not expecting 2s10s to steepen by much further (Figure 32), but any sudden bearish impetus is likely to steepen the curve. As such, we would keep 2s10s flatteners on the radar in the early stages of 2014, perhaps executing if 2s10s GBP reaches 220bp (currently 195bp). For gilts, we would fade any steepening to around 265bp.

Figure 32. GBP 2s10s is likely to flatten, eventually



Source: Citi Research, Bloomberg.

Figure 33. The GBP 2s5s10s fly is back to more 'normal' levels



Source: Citi Research, Bloomberg.

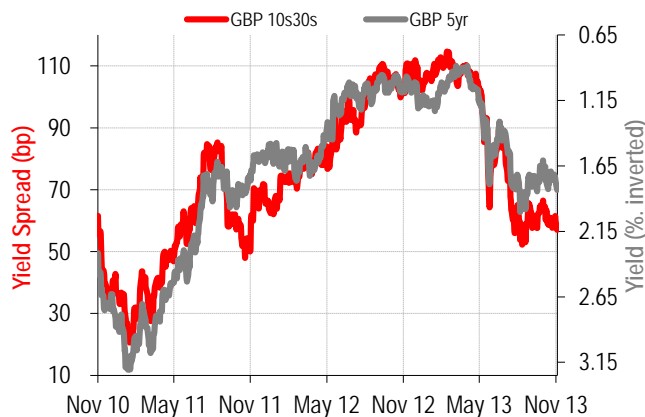
2s5s10s is back to flat and benefits from positive carry

Receive 2s5s10s for the carry, but don't hold for long: For 2014 as a whole, we think 5s will underperform on the curve. However, it is likely that rate hikes need to be closer in view before 2s5s10s really starts to cheapen. Paying 5s on the curve is also strongly carry negative and we would avoid this in the early stages of 2014, especially given 2s5s10s has already reverted to more 'normal' levels (Figure 33). Rather, we would prefer to look for tactical opportunities to receive 2s5s10s in early-2014 to pick-up the carry, worth +19bp over six months.

10s30s is directional with 5s

10s30s directional with a flattening bias: The 10s30s curve remains highly directional and our bearish forecast suggests a flattening trend will prevail in 2014. The 10s30s curve has become more sensitive to the belly of the curve having previously been driven more by the front-end. Again, this highlights the importance to the outlook of the speed of policy normalization. Moreover, the sharp pick-up in LDI-related demand for the long-end, which has been evident in 2013, is unlikely to fade. Many of the newer schemes are probably under-hedged. This is likely to offset long-end supply (as it did in 2013), which again may be skewed towards ultras.

Figure 34. GBP 10s30s is driven by 5s



Source: Citi Research, Bloomberg.

Figure 35. The 10yr gilt-Bund spread is likely to widen further



Source: Citi Research, Bloomberg.

Cross-market – stay short gilts vs Bunds

Further widening likely in 10yr gilt-Bunds, target 150bp

Further divergence ahead for gilt-Bunds: The 10yr gilt-Bund spread has widened by around 60bp in the second half of 2013. We expect further widening in 2014: economic divergence is likely to lead to policy rate divergence which is likely to lead to yield divergence. This theme could last for years given our economists' view that the MPC will hike in Q2 2015 whereas we don't expect the ECB to hike until 2018 (and indeed the ECB may cut rates in H1 2014). For the 10yr gilt-Bund spread, we are targeting 150bp by year-end compared with 110bp currently (Figure 35).

Gilts likely to remain locked in a tight range to Treasuries

Gilts to trade close to Treasuries: Judging by our economists' forecasts for growth, inflation and policy rates for the coming years, there is little to choose between gilts and Treasuries. Furthermore, long-dated gilts are likely to continue to act as a close substitute for Treasuries and track them within a tight range. We prefer to trade this spread on a more tactical basis.

Swap spreads – 30yr gilt swap spreads may richen

Improving fiscal trends are likely to take 30yr gilt swap spreads back towards flat

Lacking drivers: With policy rates on hold and markets recovering from the crisis period, swap spreads may lack direction. Moreover, even though fiscal trends are improving rapidly in the UK, gross issuance may be slow to fall thanks to high redemptions (and the absence of one-off factors that have reduced the CGNCR in recent years). There is unlikely to be a structural re-pricing of long-dated swap spreads until issuance starts to fall markedly. That said, 30yr swap spreads currently look cheap and some richening seems warranted (Figure 36).

Inflation – range-bound break-evens, higher real yields

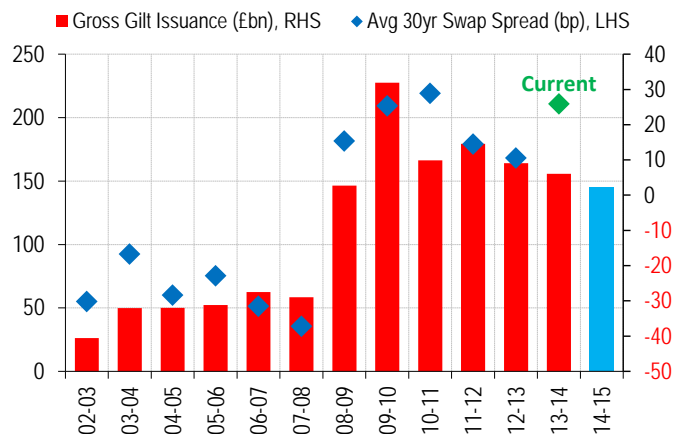
Downside risks to break-evens, but the impact of higher mortgage interest payments on RPI provides an anchor over the longer-term

Break-evens anchored by the wedge: Our base case is that UK break-even inflation spreads broadly track sideways in 2014. Our Q4 2014 forecast for the 10yr break-even is 2.95% compared with 2.91% at the time of writing. The risk to this forecast is probably skewed to the downside. Developed markets continue to face disinflationary pressures and the bearish trend in commodity prices is likely to continue over the next couple of years as the super cycle of the last decade continues to unravel. However, UK break-evens are likely to be anchored, to an extent, by the RPI-CPI wedge (Figure 37). Once again, the speed of policy normalization is likely to be pivotal to the outlook. Higher policy rates will feed through to higher mortgage interest payments which are directly included in the RPI index. Other policy measures, such as the recent revision to the FLS to exclude its use for mortgage loans will also have an impact. For 10yr break-evens, we would be buyers around 2.75%-2.80% and sellers around 3.15%-3.20%.

Real yields are likely to lead any sell-off

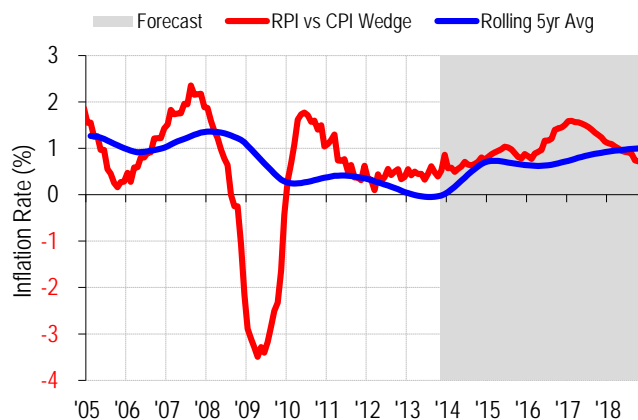
Real yields likely to move higher: The scenarios presented above, of nominal yields moving higher, but break-even inflation rates remaining range-bound, suggests that the anticipated sell-off will be real yield led. This fits with the economic backdrop of improving growth, but falling inflation. A gradual rise in real yields makes sense as recovery takes hold. In the 10yr sector, real yields are over 100bp higher than the lows, but are still deep in negative territory at -0.40%.

Figure 36. Gross gilt issuance vs average 30yr swap spread



Source: Citi Research, Bloomberg, DMO.

Figure 37. The RPI-CPI wedge is likely to widen in coming years



Source: Citi Research, ONS, Citi Economics Forecasts.

Summary – our favourite trades for 2014

UK yields are likely to drift higher in 2014, across all maturities, but many bearish strategies face the hurdle of negative carry. This is likely to make curve and cross-market trades that navigate the carry more attractive. The timing of the first rate hike is likely to remain uncertain and the anticipated speed of policy normalization is likely to be central to many strategies in 2014.

- Look to enter 2s10s GBP flatteners at around 220-225bp (currently 200bp).
- Receive 2s5s10s GBP for the carry (19bp over six months), but only in the first half of the year.
- Stay short 10yr gilts vs Bunds, targeting +150bp vs a 1yr forward of around +110bp (currently 110bp)
- Long 30yr gilt swap spreads, target 0bp (currently +25bp)
- For 10yr break-evens, we would be buyers around 2.75%-2.80% and sellers around 3.15%-3.20%.

EGB Outlook and Trade Ideas for 2014

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After the remarkable returns delivered in 2013 by the periphery and much reduced realized EMU volatility, the market is left wondering what to do for an encore. Given our outlook for a return of economic growth (albeit modest), various rating and outlook upgrades and further ECB policy loosening, we believe periphery spreads will rally further in 2014. We expect Spain to outperform Italy and for Irish spreads to move towards the soft-core. Within the core market, we expect Germany 2s5s10s to richen and for OAT-Bund spreads to remain largely range-bound. We detail the key themes and trades where we have high conviction for 2014.

Total return analysis – Italy & Spain deliver: 2014 encore?

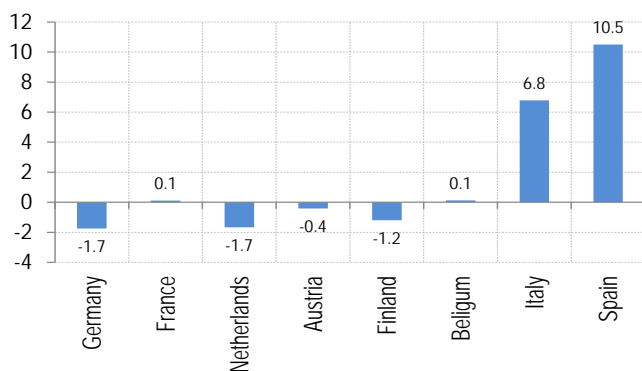
Spain and Italy significantly outperform

The distinction between core and non-core total returns could scarcely be clearer. In 2013, Spain and Italy delivered 6.8% and 10.5% respectively compared with low single digit or slightly negative returns in core EMU (Figure 38). The rally in Bono and BTP yields is considerable, inspired by the reliable domestic bid and wider ECB policy as part of Europe's "Three Pillar Strategy" – see our lead article on page 7

BTP and Bonos remain attractive on a volatility adjusted yield basis

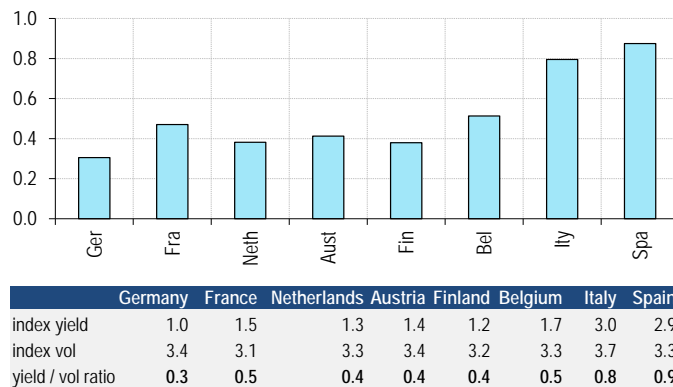
For non-periphery markets, France and Belgium have outperformed. Furthermore, both sovereigns offer the highest level of volatility adjusted yields among the core sovereigns in EGBI. We detail risk adjusted yields for the Citi EMU indices in Figure 39. We believe this characteristic will continue to be a beneficial consideration when making allocation decisions among core EMU sovereigns in 2014, further promoting relatively low French and Belgian spreads to Germany. For non-core markets, the greatly reduced volatility in periphery yields means that on a risk-adjusted basis, Spain and Italy continue to stand out as attractive markets on this measure.

Figure 38. 2013 Total Returns of Citi EGBI Sub-Indices (%)



Source: Citi Research

Figure 39. Volatility adjusted yields of Citi EGBI Indices



Source: Citi Research

Core market outlook and trades for 2014

Bunds to trade around 1.7%-1.8% in coming quarters, drifting higher slightly into Q4 2014

The setting of sluggish EMU growth and low inflation all points to relatively low core EMU yields and outperformance vs the US (detailed on page 10). We believe 10yr Bunds are likely to trade around 1.7%-1.8% in the quarters ahead and that the reach-for-yield – both in terms of duration and credit quality - will have various consequences for European fixed income.

Germany 2s5s10s – richening in the belly of Germany's curve

Flatter 2s5s in core markets

Extend in duration: To be clear, although Draghi clearly disappointed the market at the latest ECB press conference ([ECB - Ready to Act, But Likely Conditional on Lower Inflation Path](#)), this was in the context of a November rate cut and positive PMI performance for example (especially in Spain). Stepping back from such near-term volatility and assessing the economic outlook more broadly, we continue to

believe that further easing by the ECB should not be ruled out in 2014. Our economists also enhanced forward guidance and another LTRO later next year.

Duration extensions

The market implication in core EMU is clear in our view: with front-end yields anchored, the strategy of extending on the curve is likely to remain popular for investors hungry for yield. This is especially true in a scenario of negative rates as such an environment may preclude certain entities which are focused on capital preservation (central banks) from investing in certain sectors. Ultimately, we therefore expect 2s5s flattening in core EMU and a richening in 2s5s10s over the medium term. We have published a forecast for Germany 2s5s10s of -70bp for Q2 (returning to levels seen in early 2013) in the latest [Global Economic Outlook and Strategy](#). In addition, this theme also works in EUR 2s5s10s swaps, both in spot and forward space, as detailed in our recent [European Rates Weekly](#).

France – OAT-Bund spreads to remain relatively low in 2014

OAT-Bunds locked in a range

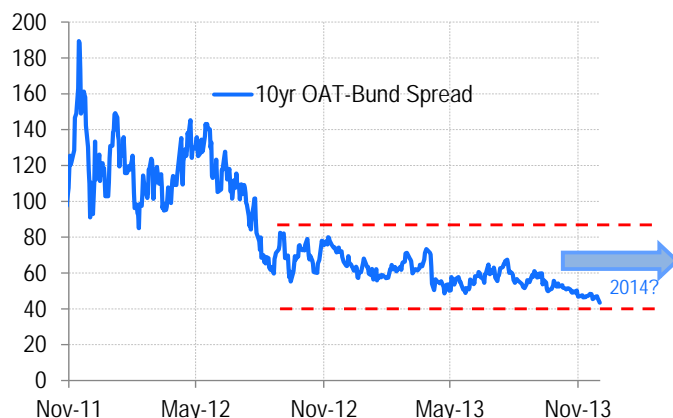
Extend on the credit curve: France is likely to remain the most effective means to diversify among core EMU sovereigns, largely due to its market depth and liquidity. We do not believe that fundamental weaknesses will necessarily mean wider OAT-Bund spreads which we expect to trade around 50bp in the 10yr sector in 2014.

Figure 40. We expect the belly of Germany to rally to previous lows



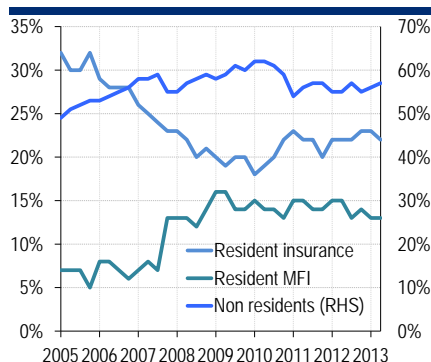
Source: Citi Research

Figure 41. We do not necessarily expect wider OAT-Bund spreads (bp)



Source: Citi Research

Figure 42. Holders of French govt debt (%)



Source: Citi Research, AFT

Fundamentals might not point to tight spreads.... French government bonds have defied a wave of negative news in 2013, proving their resilience and attractiveness as a liquid alternative to Bunds. Despite two downgrades over recent years by S&P, record low opinion polls for the President and weakening fundamentals (such as competitiveness and relative unit labour costs), the simple fact is that OAT-Bund spreads have remained low. Clearly, such factors are not the dominant drivers of this spread (Figure 41).

...but flows and French market depth do: Instead, we continue to place weight on the flows, especially the contribution made by the Asian investor community. Analysing the demand structure of the French debt market reveals how non-resident investors have held around 57% in a stable fashion over recent years (Figure 42). Within the domestic space, insurance companies (22%) and banks (13%) are the main players. Put simply, Asian accounts, although long OATs, are still buyers and such accounts are likely to continue to add on weakness because France continues to be a liquid alternative to Germany with sometimes interesting spread pick-ups in an otherwise low yield environment. Our perception is while this dynamic might not be as fierce as it has been in previous quarters, it should help contain OAT-Bund spreads over the course of 2014. This argument also extends to other (albeit less liquid) soft core sovereigns such as Belgium, which we also think will continue to benefit from the generalized theme of spread compression.

Periphery outlook and trading strategies for 2014

Our assessment of non-core EMU fixed income in 2014 can be characterized in terms of stabilizing sovereign credit quality, but where key risks remain. On the one hand, macroeconomic adjusts are occurring and ECB policies (especially OMT and the LTROs) have effectively diminished various tail and contagion risks (Figure 43). However, debt levels in Spain, Italy, Ireland and Portugal remain historically very elevated and the monetary policy transmission mechanism is still impaired. Fiscal tightening is likely to be less severe which in part helps explain the improvements in domestic demand. To trade this economic context, we detail our key themes below.

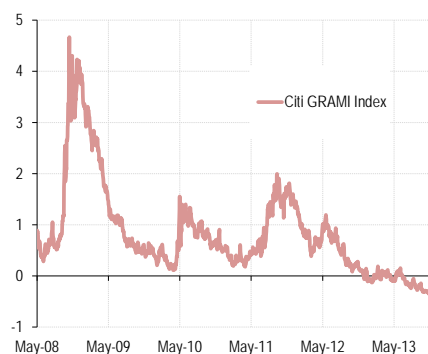
Spain – the downgrade that didn't happen

Spain's rating is stable – literally: Moody's revised its outlook on its Baa3 rating of Spain to "stable" on 4th December. Moody's placed Spain on negative outlook back in October 2012 following a 5-month review period. This was at a time when Spain's market access was under debate. The tension in that debate has substantially diminished and Spain's market access is reasonably secure.

Spain to remain Investment Grade: Spain is now rated stable by Fitch (BBB), S&P (BBB-) and Moody's (Baa3). We therefore do not expect any change in Spain's rating over the near or medium term, meaning that Spain will now remain Investment Grade and hence eligible for various benchmark indices.

10yr Bonos to rally to 150bp: The prospect of Spain losing its IG status has plagued the Bono market for over a year. Together with accommodative ECB policies, the reliable domestic bid and improved fundamentals (Spain left recession in Q3 2013), we believe the 10yr spread to Germany is likely to continue to rally in 2014 as it has done in 2013, and have an indicative target of 150bp for later next year. A key factor underpinning this view is further loosening of the ECB, especially in the guise of rate cuts and a new LTRO (*Global Economic Outlook and Strategy*).

Figure 43. Low levels of risk aversion



Source: Citi Research

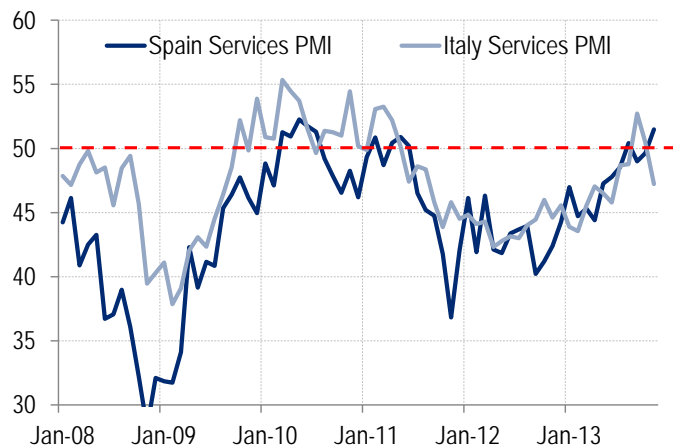
Spain's rating is Stable by Moody's, S&P and Fitch

Peripheral spread compression

Long Spain vs Italy – we expect Bonos to trade inside BTPs in 2014

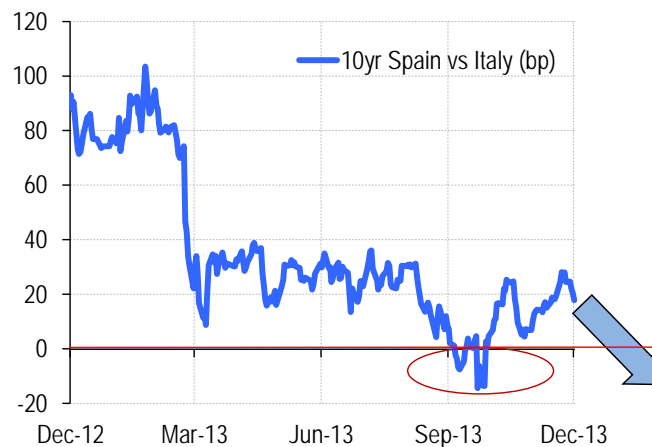
Although we are constructive on periphery spreads overall, on a cross market basis, we believe there is a compelling case for Spain to outperform Italy over the medium term. The factors behind this view include the following.

Figure 44. Spain and Italy Service PMIs



Source: Citi Research, Haver

Figure 45. We expect Spain to outperform Italy over the course of 2014



Source: Citi Research

Spain left recession this year and is leaving its assistance programme without further support

Relative economic performance: Citi continues to revise up Spanish growth forecasts and now expects 0.2% for 2014 as a whole (revised from a -2% expectation back in January 2013). The engine behind Spanish growth is and will likely remain strong export performance. In addition, less fiscal drag should also help private consumption and competitiveness. Recent PMI data has also been positive, especially in the service sector where the last print was the highest since mid-2010, in contrast to Italy whose figure was sub-50 (Figure 44). The European Commission has warned that both Italy and Spain run a risk of “non-compliance” in terms of their budgetary plans and obligations laid out in the Stability and Growth Pact. For Italy, the EC continues to comment that the government might require additional tightening in order not to breach debt reduction rules in 2014.

Rajoy has a solid Parliamentary majority

Relative government parliamentary strength: Spain's PM Rajoy has demonstrated that his government can weather various bouts of political event risk relatively well. Looking at the relatively parliamentary configurations in more detail, note that Rajoy has a solid majority following the landslide win against the Socialists in the general election of November 2011 (the PP has 186 of the 350 seats in Congress and 166 seats of the 266 seats in the Senate). In Italy – where the government needs a majority in both the Chamber and the Senate – the array of political event risk needs little introduction. Although Letta is likely to maintain his political authority in the wake of Berlusconi's Senate departure, risks of fresh elections sometime next year remain. Furthermore, headline risk continues surrounding the implementation of reforms and more recently, pertaining to passing in Parliament of a new election law whose constitutionality may be debated.

Spain's rating is unlikely to change, downgrade pressure remains for Italy

Rating trajectory: As detailed above, Spain is now rated with a stable outlook by Moody's (Baa3), Fitch (BBB) and S&P (BBB-). Italy is rated just one notch higher by these three rating agencies, but is on negative outlook (again by all three agencies). As detailed in our [Global Economic Outlook and Strategy](#), given this simple fact, downgrade pressure is higher for Italy than for Spain over the medium term.

Spanish supply is being absorbed well – 5yr paper was sold at the lowest yields since 2005 today

We expect Bonos to trade inside BTPs next year

We believe Ireland will be upgraded in 2014

Figure 46. Ireland's Unemployment Rate is Falling (%)



Source: Citi Research, Bloomberg

Relative supply pipeline: Italy's stock of debt (133% of GDP) compared with Spain (94% of GDP) means regular issuance of BTPs is a customary characteristic of the EMU fixed income landscape. In a sense, Italy can therefore be more vulnerable to changes in market sentiment. We expect €228bn in gross Italian supply and around €120bn in gross Spanish bond supply next year.

Spain and Italy trades for 2014: We therefore believe that over the medium term, there is scope for Spain to outperform Italy. We have published an indicative forecast for 10yr BTP spreads to Bunds to rally to around 175bp by Q4 2014, but for Bono spreads to Bunds to be nearer 150bp. Hence, we expect Spain to trade inside Italy by as much as 25bp, and hence outperform around 50bp from current levels. We also continue to favour 2s10s steepeners on the Italian domestic curve for reasons detailed in our [European Rates Weekly](#).

Long Ireland – the road back to investment grade?

We continue to be constructive on Ireland and expect an upgrade in its sovereign rating in 2014. Full details can be found in our [European Rates Weekly](#) 31st October. Ireland is the only EMU sovereign to have a positive outlook (S&P). Our argument for being long Ireland is based on the following drivers.

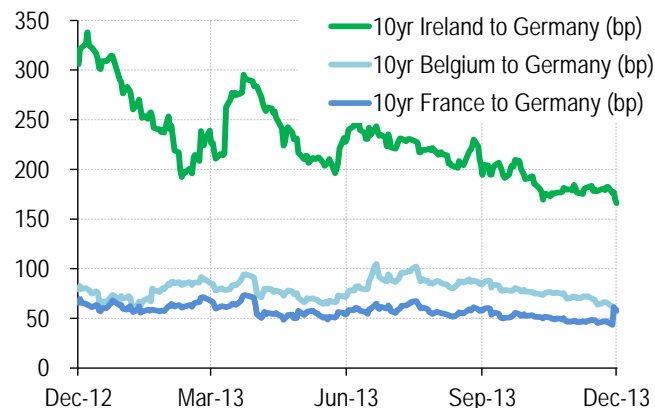
Economic factors: On various metrics, Ireland has shown improvement in its economic fundamentals. Recent data show its unemployment rate falling to 12.9% last month from a high of 15% in Q1 2012. Citi expects growth of 1.4% next year. We also view 2013 issuance and the fact that it is successfully leaving its Troika programme without further support as credit positives.

Rating upgrade: In a scenario where Moody's upgrades Ireland later in 2014 (it is likely Moody's will put Ireland on review for upgrade initially), we believe this will arguably be the most significant EMU rating event for some time. This is because Ireland's investment grade status will be restored, opening up opportunities for accounts whose mandates do not allow for off IG benchmark index investments. We expect spreads to rally towards the soft core in this event.

Lack of supply: Ireland is fully funded for 2014. The NTMA had initially indicated a provisional 2014 supply pipeline of €6bn- €10bn which would be pre-funding for 2015. Most recently, Ireland has recouped €4.8bn from the redemption of preference shares in Bank of Ireland Plc.

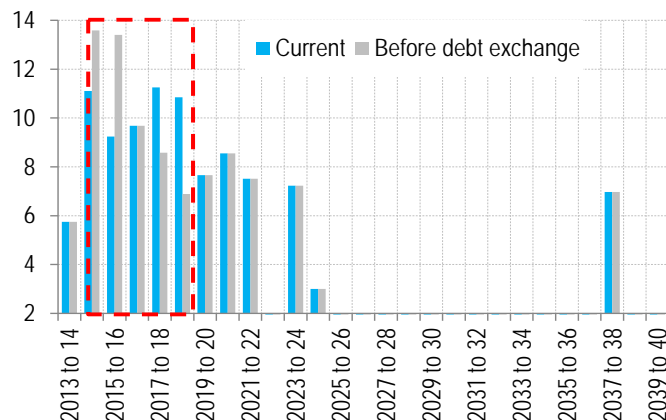
Trade – spread compression: We believe Ireland will continue to perform well in 2014 and we have published in [Global Economic Outlook and Strategy](#) that 10yr spreads to Germany could reach 135bp later next year (trading around 170bp presently). This is a conservative indicative projection and we believe risks are that this spread will be even lower over the course of 2014. We would also recommend watching out for opportunities in the primary market next year as Ireland is likely syndicate supply early in H1 in our view (Figure 47).

Figure 47. Ireland – the road back to soft core?



Source: Citi Research

Figure 48. Portugal Maturity Profile (€bn)



Source: Citi Research

Portugal – a return to market access?

New 5yr early next year is our base case

Following Spain and Ireland, Portugal is set to be the third EMU sovereign to exit a financial assistance package in 2014. Although fundamental concerns remain, which include whether further support might be required, we see the recent €6.6bn debt swap as an encouraging development. This effectively lowered the redemption profile to €11bn in 2014 and €9bn in 2015 (Figure 48). The extent to which Portugal can regain market access next year will be a key determinant in its spread outlook in our view. Going forward we expect a new 5yr early in 2014 (*The Morning Call*).

Conclusion – low core yields, tighter periphery spreads

Our EMU views for next year can be summarized as thus: low core yields, Europe to outperform the US, OAT-Bund spreads to remain relatively low and for generalized spread compression amid periphery markets. Risks to the scenario include the Fed tapering decision, the ECB's AQR and stress tests and European parliamentary elections in May. However, if 2013/2012 are anything to go by, the ECB stands ready to "do what ever it takes" even if the December meeting disappointed the market. Underpinning all our views is the economic outlook for Draghi to enact further loosening in ECB policy over the course of next year.

Trades for 2014

Trade the range in OAT-Bund spreads

Long Spain vs Italy

Long Ireland

Euro inflation – HICPxT steepeners for 2014

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Inflation curve steepeners make sense over the next year

The market is underestimating how long inflation will stay depressed, in our view

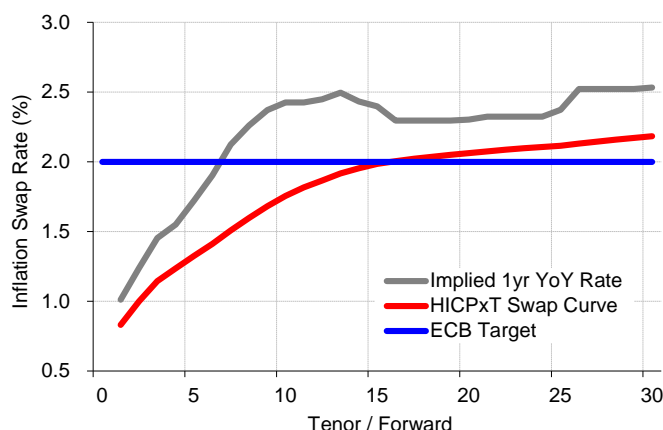
Euro break-even inflation spreads have bounced strongly in the last week having repriced significantly lower in early November. A near-term correction was justified, in our view. Cash break-evens had reached cheap levels vs inflation swaps. Indeed, we entered a tactical long in BTPei18 break-even vs 5yr HICPxT on [21 November](#) at -60bp. It has since corrected and at -47bp is closing in on our target of -43bp.

However, our focus this week is on a much longer trading horizon of one-year. The near-term correction in break-evens may have been justified, but a sustained rally in break-evens is highly unlikely in our view. As we have highlighted in recent publications (for example in [Low\(er\)-for-Long: Themes & Trades](#), 28 November 2013), the risks to euro area inflation look firmly skewed to the downside.

Inflation set to stay low, with risks to the downside

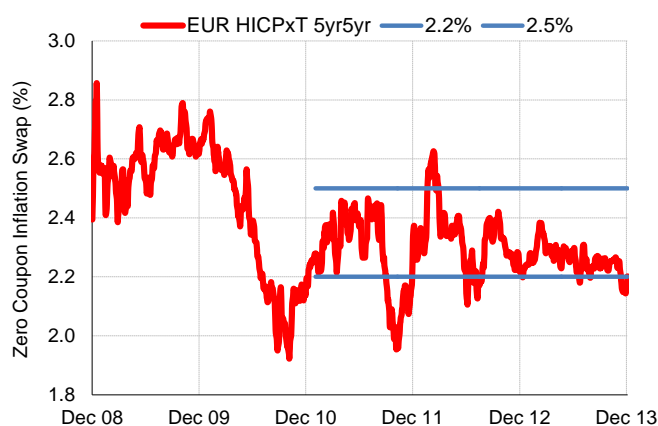
Our economics team forecast headline inflation of 0.9% in 2014 on average, falling to 0.7% in 2015 before rising to 1.1% in 2016. This compares with the current 1y HICPxT inflation swap rate of 0.83%, a 1y,1y forward rate of 1.2% and a 1yr, 2yr forward of 1.4%. The market is pricing low inflation over the next year and a sustained period - of six years currently – with inflation well below the ECB's target of below, but close to, 2% over the medium-term (Figure 49). However, the market is underestimating how long inflation will stay close to historic lows, in our view. We also think the ECB's new mid-point forecast for inflation in 2015 at 1.3% is too high, although low enough to justify further eventual policy action.

Figure 49. The near 1yr forwards are too rich, in our view



Source: Citi Research

Figure 50. The 5y5y forward inflation swap is quite sticky



Source: Citi Research, Bloomberg.

Core inflation could be close to 0% by end-2015

The risks to our inflation forecasts are probably skewed to the downside. There are strong headwinds acting against inflation, not least falling wage pressure in the periphery (Italy and Spain make up 30% of the index). Our economists' output-gap based model for core inflation (see [One Shock Away from Deflation](#), 8 November) suggests that it will trend down towards 0% by end-2015. Against this backdrop, headline inflation will be vulnerable to further downside from global disinflationary forces and any falls in food and energy prices.

The ECB will likely add further stimulus in response to disinflationary pressures

The ECB are likely to react and have various policy options on the table including enhanced forward guidance, additional liquidity provision, a rate cut and direct asset purchases (see [ECB: Seen on Hold in December, but More Easing Likely in 2014](#), 28 November). The inflation market will need to decide over the course of 2014 whether or not the ECB are credible inflation generators (as opposed to its well established inflation fighting credentials).

Inflation curve likely to steepen further

Long-end inflation expectations are relatively sticky

We expect that ECB action may help to anchor inflation expectations further out. It is also worth noting that the 5yr, 5yr forward inflation swap rate has been relatively stable in recent years. Over the last three years, it has traded between 2.2%-2.5% on 82% of occasions. It is currently just below this range at 2.18% (Figure 50). Furthermore, it has rarely traded below 2%, despite previous deflation scares.

Front-end of the inflation curve likely to remain under pressure as realized inflation falls

In contrast, the front-end is likely to remain highly dependent on the path of realized inflation, no matter how the ECB react. As discussed above, the front-end of the HICPxT curve looks rich relative to our inflation forecasts and is likely to remain under pressure over the course of 2014, in our view, especially as we expect the headline rate to dip to 0.6% in the coming months.

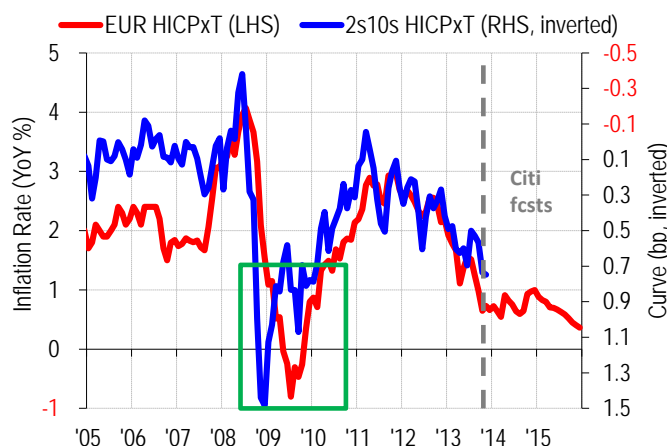
Any flattening is an opportunity to put on steepeners, in our view

The combination of downside inflation risks weighing on the front-end and sticky medium-term inflation expectations suggests a strategy of inflation curve steepeners for 2014. The curve has already steepened sharply. We think it has further to go, and would certainly oppose any flattening.

The 2s10s (and 2s5s) inflation curves are very sensitive to realized inflation

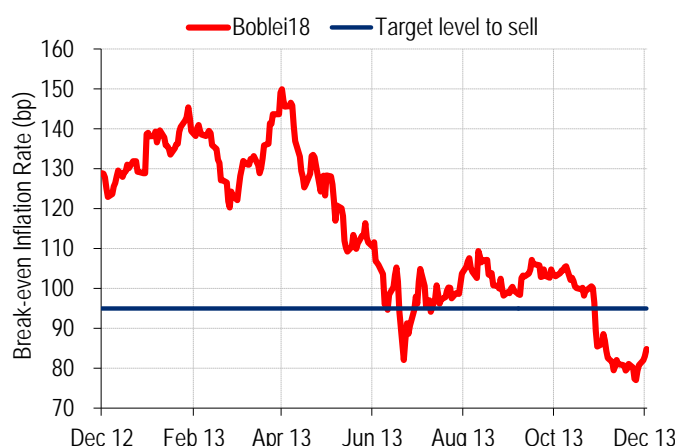
For example, the 2s10s HICPxT swap curve is currently around 76bp compared with 45bp in mid-2013. However, it traded at a steeper level than this for most of the period between October 2008 and February 2010. This was the last major deflation scare when headline inflation printed below 1%. Our economists' latest inflation profile suggests headline inflation will remain at or below 1% for the next 13 months and at or below 1.1% for the next 31 months. Based on this profile, further steepening in 2s10s (and 2s5s) is likely, in our view, as illustrated by Figure 51.

Figure 51. Further HICPxT steepening likely



Source: Citi Research, Bloomberg, Citi Economics forecasts.

Figure 52. 5yr cash break-evens likely to form a new, lower range



Source: Citi Research, Bloomberg.

Euro inflation trade ideas for 2014

- 2s10s (or 2s5s) HICPxT steepeners. For 2s10s, our target entry level is 60bp (currently 76bp). We expect the curve to steepen to around 100bp.
- An alternative in forward space would be to sell the 1y, 1y forward HICPxT, which looks particularly rich to our inflation forecasts, and buy the 5y, 5y forward HICPxT, which is often sticky around current levels.
- For cash break-evens, we would be sellers of, for example, Boblei18 break-evens at 95bp (currently 85bp, Figure 52). We doubt a rally can be sustained and a new, lower-range is justified.

New rules for EMU sovereign ratings in 2014

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There has been much discussion (and some confusion) regarding the evolving process of EMU sovereign ratings in 2014. We outline the key points below. In short, new regulations come into force from January which change the way rating agencies assign their European credit assessments. This is not a methodological change, but rather one relating to transparency and accountability – which we generally see as welcome.

Rating changes only to be published on Fridays...

Evolving regulation with a focus on enhancing transparency

Rating regulation: Rating agencies have been regulated since the Washington G20 summit in 2008. Since then, regulations have been modified and there are important changes for EMU investors that come into force next year. Without laboring too much detail, rating agencies are governed by regulation referred to as “CRA”. The latest round of such regulation came in the guise of #462/2013 amending the previous #1060/2009. This is referred to as “CRA3” which made various changes to the existing framework – mostly with a focus on enhancing transparency and aiming to reduce over reliance on ratings. This includes items such as only publishing rating reports on Fridays.

EMU sovereign ratings impacted

Scope – who is affected: Specifically, the new requirements listed below are for ratings of sovereigns the primary rating analyst is located in European office (usually London). This will therefore affect the various EMU sovereigns whose debt markets we regularly analysed.

...and that's not all

The points to note...

The key items for investors to note include the following:

- **Friday rule:** Paragraph 42 of CRA3 states that publication of rating actions “should be set on a Friday” outside market hours.
- **Reviewed twice a year within a clear time table:** Ratings are to be reviewed at least every 6 months. This means that there will effectively be a “timetable” with at least 2 dates per year on which a sovereign rating is reviewed. S&P has indicated it will release its calendar for 2014 in December 2013.
- **Notification:** Rating agencies must now notify sovereigns before the publication of credit ratings and rating outlooks a full working day (currently, it is 12 hours).

Conclusion – little direct impact, but a change in communication

A change in communication strategy

We do not expect any direct impact on the market or indeed sovereign ratings themselves as a consequence of this regulatory development. This can be seen more as a change in the communication strategy by the rating agencies which we broadly welcome. However, it may induce periods of specific focus on the now known dates a rating action may happen for a given sovereign. Going forward, the regulation also calls for the European Commission to prepare a report by July 2016 to assess the efficacy of the new regime.

Euro SSA 2014 Outlook

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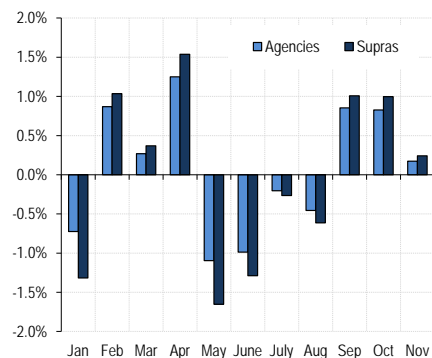
Full details can be found in our [Euro SSA and Covered Bonds Monthly - 2014 Outlook – Navigating a Low Spread Environment](#)

The outlook in brief: Both agency and supranational bonds yielded positive returns so far in 2013 (1.94% and 0.54% respectively based on € iBoxx total return indices, YTD Figure 53). One clear characteristic of the market remains its resilience amid an environment of elevated supply. This dynamic should not be underestimated and underlines a strong technical backdrop which we think will also be prominent in 2014. We expect a similar (and historically) elevated level of supply next year: for example euro supra supply was around €103bn in 2013 and we expect €95bn in 2014 from the main issuers. We also expect new entrants in 2014, this time from the agency sector rather than the supra sector. In terms of performance Spreads have generally tightened vs swaps (year-to-date performance is shown in Figure 54). In short, we expect a range bound spread market in 2014 highlighting the importance of relative value considerations and the strong (regulatory) demand for high quality assets. Our core trading strategies would be to add on weakness and to move up in quality when yields compress.

We expect new entrants in the UK, French and Dutch agency market and perhaps maturation of the green bond market

New entrants: Another prominent theme of the SSA market is the continued evolution of new entrants. 2013 saw the emergence of Deutschland bonds, euro green bonds and the ESM. In 2014, we expect further development of such markets as well as new issuance from the French and UK agency market (municipal finance) and from the Dutch agency sector (in the housing market).

Figure 53. Monthly Total Returns of € iBoxx Agency and Supra indices (%)



Source: Citi Research

The downgrades of France and the Netherlands by S&P means there is now a rating differential between some EMU sovereigns and some core SSAs

We expect a range bound market in spreads, so buy on weakness when liquidity permits

Figure 54. SSA yield and ASW changes year-to-date

Issuer	SSA bond	Maturity	Level (%)	Change (bp)	Level (bp)	Change (bp)
				since 02 Jan 13		since 02 Jan 13
			Yield	Spreads to Swaps		
EIB	EIB 4.125 Apr 24s	15-Apr-24	2.24	14	19	-11
EFSF	EFSF 2.25 Sep 22s	05-Sep-22	1.98	8	16	-13
EU	EU 2.75 Apr 22s	04-Apr-22	1.79	14	4	-6
KFW	KFW 4.625 Jan 23s	04-Jan-23	1.81	14	-7	-8
RENTEN	RENTEN 2.875 Aug 21s	30-Aug-21	1.55	10	-9	-8
CADES	CADES 4.125 Apr 23s	25-Apr-23	2.20	-1	28	-24
BNG	BNG 3.875 May 23s	26-May-23	2.14	10	20	-13
iBoxx Index	€ iBoxx Agencies		1.54	2	36	-21
iBoxx Index	€ iBoxx Supranationals		1.90	19	23	-8

Source: Citi Research *10yr sector or near enough to ensure bonds with a complete history since January 2013.

Two themes for next year – what to do

Move up in quality: If there are two overriding strategic themes for 2014, one is the idea of “moving up in quality”. This has become all the more apparent given the recent downgrades of various sovereigns such as France and the Netherlands. Liquidity, supply and broader technicals will continue to play their part in driving spreads and must be respected in terms of the ability to execute trades when moving out of EMU sovereigns and into SSAs. However, we would prioritise the monitoring and analysis of such yield differentials when there are positive spread pick-ups out of lower rated sovereigns into higher rated SSAs throughout 2014.

Buy on weakness: Given our base case for a largely range bound spread market, with supply influencing many market moves and relative performance among issuers, another core strategy we recommend is to buy on weakness. We see little reason for a fundamentally re-pricing of core SSAs and should spreads widen on

supply or further sovereign downgrades, then this is likely to represent a buying opportunity in related SSAs in our view.

Covered Bond Strategy

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Another year of net negative issuance is laying ahead for covered bond investors. Net negative supply of €40bn is on the cards. While supportive for compression to be continuing, chasing for value than for yield becomes increasingly important. For a more detailed view on covered bond markets in 2014 in the primary and secondary market can be found here: <LINK>

Covered Bond Outlook 2014

Primary market: We expect EUR benchmark covered bond issuance in 2014 of around €113bn. Main factors will be the recovery of the European economy and the development of mortgage lending activity. Moreover, the senior market can continue to provide an attractive funding channel. Repayments under the established long-term refinancing operations and the option of another LTRO will be additional supply drivers. At the same time, the total amount of maturing EUR benchmark covered bonds will be €155bn. Hence, shrinkage of €42bn is on the cards – a consecutive year of net negative supply for covered bonds.

Figure 55. Supply forecasts and redemptions overview, EURbn

	Issuance 2013	Issuance 2014	Redemptions 2014	Net supply 2014
Australia	3.8	4.0	-	4.0
Austria	3.8	4.0	4.0	0.0
Belgium	3.5	4.0	-	4.0
Canada	4.5	10.0	-	10.0
Denmark	1.0	1.0	0.5	0.5
Finland	3.3	5.0	4.0	1.0
France	17.8	20.0	29.0	-9.0
Germany	16.6	18.0	31.0	-13.0
Ireland	3.0	3.0	3.0	0.0
Italy	8.3	8.0	2.0	6.0
Netherlands	3.3	4.0	6.0	-2.0
New Zealand	1.0	1.0	-	1.0
Norway	6.5	5.5	-	5.5
Portugal	0.8	0.5	3.0	-2.5
Spain	11.8	15.0	49.0	-34.0
Sweden	5.5	5.0	8.5	-3.5
Switzerland	0.0	1.0	2.0	-1.0
UK	1.0	4.0	11.0	-7.0
USA	0.0	0.0	2.0	-2.0
Total	95.2	113.0	155.0	-42.0

Source: Citi Research; Issuance 2013 up until 30/11/2013;

Secondary market: Spreads versus swaps reached a 5y-low in October of this year. The availability of covered bonds will decrease given our issuance forecast. This will be supportive for spreads vs swaps. High beta segments should profit most of it. Hence, we think that the compression trade will continue in 2014 although tightening potential has decreased substantially. Spreads versus sovereign bonds will mainly be a function of the economic recovery of European countries, rating actions and demand overhang in covered bond markets. In core covered bond segments, we continue to find most value in the “fallen angels”. Apart from that, investors should increasingly try to chase value, not yields given the extremely low yield environment where investors are not properly compensated for taking risk.

Further details can be found in our [*Euro SSA and Covered Bonds Monthly - 2014 Outlook – Navigating a Low Spread Environment*](#)

Tradesheet

New Trades

See EGB trades for 2014, page 23

1. Buy 10yr Spain vs Italy

Buy Bono 4.4% Oct23 at 4.26%

Sell BTP 4.5% May23 at 4.06%

Open 20bp. Current 20bp. Target -25bp. Stop 45bp.

See EGB trades for 2014, page 23

2. Buy 10yr Ireland vs Germany

Buy Ireland 3.9% Mar23 at 3.53%

Sell Germany 1.5% Feb23 at 1.77%

Open 176bp. Current 176bp. Target 135bp. Stop 196bp.

Please see UK Rates Strategy for details

3. Buy 10yr gilt vs Treasuries

Buy gilt 2.25% Sep23 at 2.84%

Sell Treasury 2.5% Aug23 at 2.77%

Open 7bp. Current 7.5bp. Target -5bp. Stop 13bp.

Record of Our Closed Trades

Figure 56. Record of our Closed Trades

Region	Trade	Levels	Rationale
UK	Sell UKT Sep23 vs Jan16	Open 203bp Current 225bp P&L 22bp Target 225bp Stop 192bp	Hit Target 5 December 2013 European Rates Weekly, 24 October 2013.
Curve	Sell UKT 2.25% Sep23 at 2.60% Buy UKT 2% Jan16 at 0.57%		

Source: Citi Research

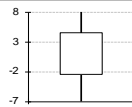
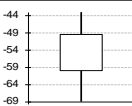
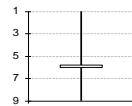
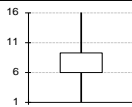
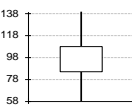
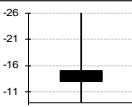
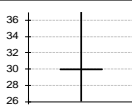
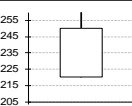
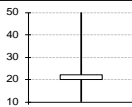
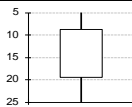

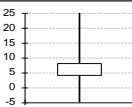
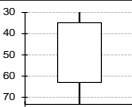
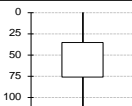
Record of Our Open Trades

Figure 57. Record of our Open Trades

Region	Trade	Levels	Rationale + Publication Date
EUR	Long 10yr Spain vs Italy	Open 20bp Current 20bp P&L 0bp Target -25bp Stop 45bp	Spain has a stable rating and lower political risks compared with Italy European Rates Weekly 5 Dec 2013
Cross Market	Buy Bono 4.4% Oct23s at 4.26% Sell BTP 4.5% May23s at 4.06%		
EUR	Long 10yr Ireland vs Germany	Open 176bp Current 176bp P&L 0bp Target 135bp Stop 196bp	Ireland is fully funded next year and we expect a rating upgrade in 2014 European Rates Weekly 5 Dec 2013
Cross Market	Buy Ireland 3.9% Mar23s at 3.53% Sell Bund 1.5% Feb23s at 1.77%		
UK / US	Buy 10yr gilt vs Treasuries	Open 7bp Current 8bp P&L -1bp Target -5bp Stop 13bp Time Stop 31 December	10yr gilt-Treasury spread exhibits a strong seasonal pattern in December UK Rates Strategy, 2 December 2013
Cross Market	Buy gilt 2.25% Sep23 at 2.84% Sell Treasury 2.5% Aug23 at 2.77%		

Source: Citi Research

Figure 58. Record of our Open Trades (continued)

EUR	Buy OATi17 break-even vs BTANi16	Open: -2.4bp Current: 5bp P&L: 7bp Target: 8bp Stop: -7bp	Relative value looks attractive	
Inflation	Buy OATi17 break-even at 115bp Sell BTANi16 break-even at 117.4bp		European Rates Weekly, 21 November 2013	
EUR	Buy BTPei18 break-even vs 5yr HICPXT	Open: -60bp Current: -49bp P&L: 11bp Target: -43bp Stop: -69bp	Attractive valuation vs inflation swap and lack of supply into year-end	
Inflation	Buy BTPei18 break-even at 73bp Sell 5yr HICPXT swap at 133bp		European Rates Weekly, 21 November 2013	
UK	Buy gilt Jul19 vs Jul18 on asset-swap	Open: 6bp Current: 6bp P&L: 0bp Target: 1bp Stop: 9bp	Relative value and behaviour of the last benchmark roll suggest new 5yr should richen vs old	
Swap Spread	Buy gilt Jul19 YYS at -3bp Sell gilt Jul18 YYS at -9bp		UK Rates Strategy, 19 November 2013	
EUR	Sell France vs Belgium and Germany	Open: 6bp Current: 9bp P&L: 3bp Target: 16bp Stop: 1bp	Attractive entry level, possible auction concession and non-supportive cash flow profile for OATs into year-end	
Cross Market	Sell BTAN 1.75% Feb17 at 0.51% Buy OLO 4% Mar17 at 0.66% Buy Bobl 0.5% Apr17 at 0.30%		Euro Rates Strategy, 8 November 2013.	
EUR / UK	Sell UKT Sep23 vs DBR Aug23	Open: 85bp Current: 108bp P&L: 23bp Target: 140bp Stop: 58bp Revised Stop: 85bp	Entry levels are attractive for medium-term gilt-Bund wideners	
Cross Market	Sell UKT 2.25% Sep23 at 2.60% Buy DBR 2% Aug23 at 1.75%		European Rates Weekly, 24 October 2013. Revised Stop: UK Rates Strategy, 11 November 2013	
UK	Buy UKT Sep19 vs Sep17 and Sep22	Open: -15bp Current: -13bp P&L: -2bp Target: -26bp Stop: -9bp Total carry (3mths): +1.7bp	Attractive RV with positive carry	
Curve	Buy UKT 3.75% Sep19 at 1.72% Sell UKT 1% Sep17 at 1.15% Sell UKT 1.75% Sep22 at 2.44%		European Rates Weekly, 24 October 2013.	
UK	Sell UKT Sep23 vs Sep21 and Mar25	Open: 30bp Current: 30bp P&L: 0bp Target: 37bp Stop: 26bp Total carry (3mths): +1.3bp	Attractive RV with positive carry	
Curve	Sell UKT 2.25% Sep23 at 2.60% Buy UKT 3.75% Sep21 at 2.18% Buy 5% Mar25 at 2.72%		European Rates Weekly, 24 October 2013.	
EUR	BTP 2510s steepener	Open: 220bp Current: 250bp P&L: 30bp Revised Target: 260bp Revised Stop: 240bp	Redemptions to support 2s in 2014. Political uncertainty & long-end issuance to weigh on 10s.	
Curve	Buy BTP 3.75% Apr16 at 1.98% Sell BTP 4.5% May23 at 4.18%		European Rates Weekly, 10 October 2013. Revised Levels: The Morning Call, 14 November 2013	
UK	Sell 30yr gilt swap spreads vs 10yr	Open: 20bp Current: 22bp P&L: 2bp Target: 50bp Stop: 10bp	Fiscal risks, supply pressures and the absence of QE to put steepening pressure on the gilt curve.	
Swap spread	Sell gilt 3.25% Jan44 ASW at 20bp Buy gilt 1.75% Sep22 ASW at 0bp		UK Rates Strategy, 30 July 2013	
Europe	Buy 5yr Belgium vs France	Open: 19.5bp Current: 9bp P&L: 11bp Revised Target: 5bp Revised Stop: 14bp	Tactical long supported by upcoming cash flows.	
Cross Market	Buy OLO 4% Mar18 at 1.15% Sell OAT 4% Apr18 at 0.95%		Euro Rates Strategy, 24 July 2013 Revised: European Rates Weekly, 21 November 2013	
Europe	Buy ERZ3 1x2 call spread	Open: 1c Current: 0.5c P&L: -0.5c Target: 12.5c Stop: -3c	Dec Euribor has cheapened 30/35c since May ECB rate cut. However, a cut to the deposit rate would be required for a significant rally.	
Money Market	Buy ERZ3 99.750/875 1x2 call spread at 1c		Euribor, 24 June 2013	
Europe	Receive EUR 10y2y vs 12y3y	Open: 4bp Current: 8bp P&L: 4bp Target: 25bp Stop: -5bp	Cheapness of the sector due to legacy ASW positions. The trade offers a positive roll-down for relatively low volatility	
Curve	Receive EUR 10y2y at 3.1% Pay EUR 12y3y at 3.14%		The Morning Call, 23 January 2013	
Europe	Sell EUR 1y3yF ATMf straddle and buy ATMf-25 receiver	Open: 63bp Current: 35bp P&L: 28bp Target: 30bp Stop: 73bp	Fwd levels in front-end EUR swaps are too high when additional policy measures by the ECB are likely to be undertaken	
Volatility	Sell EUR 1y3yF ATMf (-1.36%) straddle for 98bp Buy EUR 1y3yF ATMf-25 receiver for 35bp		IIRS 9 August 2012	
UK	Sell GBP 2y2y ATMf straddle	Open: 76bp Current: 35bp P&L: 41bp Target: 0bp Stop: 114bp	The fundamental backdrop in the UK supports selling GBP 2y2y vol	
Volatility	Sell GBP 2y2y ATMf (1.04%) straddle at 76bps		IIRS 12 July 2012	

Source: Citi Research Futures trading involves a substantial risk of loss

Summary of Recent Publications

Date	Publication	Topic	Page	Region
5-Dec-13	NOTE	Euro Rates Strategy: Moody's Revises Its Baa3 Rating of Spain to "Stable"	-	EUR
3-Dec-13	NOTE	Euro SSA and Covered Bonds Monthly: 2014 Outlook	-	EUR
2-Dec-13	NOTE	European Flow Monitor: Net demand is now positive for both core and non-core	-	EUR
2-Dec-13	NOTE	UK Rates Strategy: 'Tis the season to be long gilts (vs Treasuries)	-	UK
28-Nov-13	European Weekly	"Low-for-Longer": Where Do We Stand?	4	EUR
		Euro inflation in a lower-for-longer scenario	8	EUR
		EUR Swaps: curvature & swap spreads	10	EUR
		EUR Vol: Anatomy of Carry Trades	13	EUR
		EMU spread markets	15	EUR
		Low-for-Longer and the Demand for Bonds	18	EUR
28-Nov-13	NOTE	Weekly Supply Monitor: Euro, UK and US Supply Outlook	-	Global
28-Nov-13	NOTE	European Rates Strategy: The Month-end RV pack	-	EUR
27-Nov-13	NOTE	Euro Rates Strategy: EUREX Calendar Rolls (Z3/H4)	-	EUR
26-Nov-13	NOTE	EMU Supply: supportive cash flow profile for Italy in December	-	EUR
25-Nov-13	NOTE	European Flow Monitor: Net demand is now flat for both core and non-core	-	EUR
21-Nov-13	European Weekly	EGB: Eurozone's Three Pillar Strategy	8	EUR
		Gilts, linkers & the Autumn Statement	11	UK
		Euro Volatility Strategy: Contingent Long Gamma via Bund Futures Options	15	EUR
		EGB: Belgian bonds – where do we stand?	17	EUR
		Euro inflation: cautious long in break-evens	18	EUR
		SSA: Green Shoots in € Green Bonds	20	EUR
		Covered Bond Strategy	22	EUR
		End-November EGBI Projection	28	EUR
21-Nov-13	NOTE	Weekly Supply Monitor: Euro, UK and US Supply Outlook	-	Global
21-Nov-13	NOTE	EMU Inflation-linked Index Projection	-	Global
20-Nov-13	NOTE	Euro SSA Strategy: Green shoots in € green bonds	-	EUR
19-Nov-13	NOTE	European Month-end Index Projections: supportive for France, Italy and Germany	-	EUR
19-Nov-13	NOTE	EUR Vol: Contingent Long Gamma via Bund Futures Options	-	EUR
18-Nov-13	NOTE	European Flow Monitor: Buying of non-core	-	EUR

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Notes

Notes

Appendix A-1

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