6 December 2012 | 60 pages

Europe

European Rates Weekly

2013 Outlook

- **Outlook:** We expect an ECB cut in 13Q1 and a second cut in Q2 or Q3, OMT activation in 13H1, with Italy following Spain, and a likely Grexit in early 2014. We expect Bund yields to drift higher until anticipation of Grexit drives another flight to quality. We recommend less aggressive allocation of risk towards France in 2013.
- **US/Europe:** Citi forecasts further decoupling between the US and the Eurozone in 2013. Markets are not pricing that in. Receive 5y5y EUR vs 5y5y USD.
- **EMU spreads:** The negatives are well documented, but positive surprises have the most potential to move markets. With self-interests currently aligned to preserve the status quo, the rally could easily continue into Q1. When Spain requests aid, trade the policy response, not the fundamentals: wait to buy spikes in front end yields.
- **UK gilts:** Direction will be driven by a weak economy and the EMU crisis in our view. With yields volatile, but largely rangebound, carry will be king. For cross-market, curve and swap spreads, QE decisions and issuance are likely to be highly influential.
- **UK inflation:** The combination of underlying disinflationary trends and CPAC make us wary about the prospects for UK break-evens in 2013. We recommend selling 5yr break-evens as a medium-term trade.
- **Euro inflation:** Returns are likely to underwhelm in 2013 versus 2012 with credit dominating inflation concerns. Sell 10yr break-evens above 2%, overweight Germany vs France and Italy, and sell 5yr, 5yr forward FRF CPIxT vs EUR HICPxT.
- **Euro money markets:** We expect roll-down strategies to remain very popular trades and consistently to beat forwards-based expectations. Receive EUR 1y3yF.
- **Euro volatility:** We recommend expressing bullish positions in front-end EUR forwards, conditional bull-steepeners and calendar spreads.
- **SSA:** In 2013, we expect core SSA spreads to remain low and largely range-bound. The sector should continue to benefit from its high credit quality, relatively low volatility, secondary market liquidity and safe haven status.
- **EMU supply:** We provide a monthly breakdown of our provisional expectations for 2013 EMU supply by country, along with coupons and redemptions.

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

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Figure 1. Strategy Summary Table

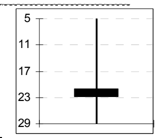
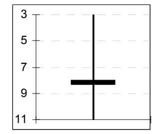
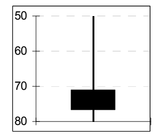
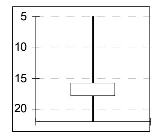
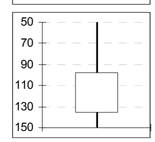
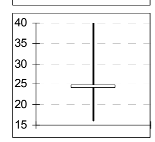
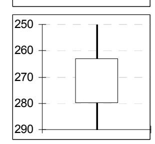
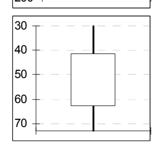
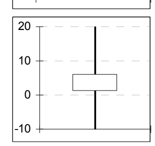
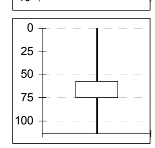
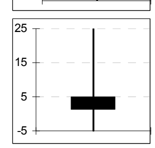
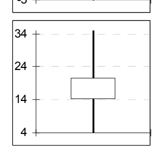
Europe	View	Strategies
Direction	We expect an ECB cut in 13Q1 and asecond cut in Q2 or Q3, OMT activation in 13H1, with Italy following Spain, and Grexit early 2014. We expect Bund yields to drift higher until anticipation of Grexit drives another flight to quality and the authorities to contain Bono yields.	We prefer cross-market risk to outright directional risk
Money Market	We expect roll-down strategies to remain very popular trades and to consistently beat forwards-based expectations. We do not expect the exercise of the January 2013 early repayment option to alter the structure of carry trades.	Receive EUR 1y3yF
Yield Curve	With the front-end well anchored, the Bund curve is likely to continue to behave directionally. We expect peripheral curves to flatten before the policy response drives front-end led steepening. In gilts, significant flattening in 10s30s is only likely if yields move higher although issuance patterns and changes to pension discount rates will also be key drivers.	Core curves to remain largely directional in 2013
Cross-market	We maintain a preference for Bunds over Treasuries over the longer-term. Seasonals into year-end support gilts over Treasuries.	Receive EUR 5yr5yr, pay USD 5yr5yr Risk reward favours gilts over Bunds
EMU Spreads	With self-interests temporarily aligned to preserve the status quo, and demand strong, the current spread rally could easily continue into Q1. We expect this to end with OMT activation in 1H 2013. When the current ebullient mood evaporates next year, and Spain finally requests aid, trade the policy response, not the fundamentals.	Wait to buy spikes in front end Spanish yields (or to box Bono steepeners with BTP flatteners). Sell OATs vs Bunds should the spread break the 60bp-85bp range
Swap Spreads	We expect further narrowing of 5 and 10yr German swap spreads as the current mutually beneficial stand-off between the Troika and Spain continues. We suggest selling Schatz vs EONIA as a way to express a deposit rate cut into negative territory.	Sell Schatz vs EONIA 30yr gilts to outperform vs swaps
Inflation	Returns in euro inflation markets are likely to underwhelm in 2013 compared with the double digits of 2012. Break-evens are likely to lack clear direction owing to the benign inflation outlook, although there are downside risks if market liquidity deteriorates. In the UK market, the combination of underlying disinflationary trends and CPAC make us wary about the prospects for UK break-evens in 2013, especially in Q1	Sell 10yr euro break-evens above 2% Overweight Germany vs France and Italy Sell 5yr, 5yr forward French CPIxT vs euro HICPxT. Sell 5yr UK break-evens or 5s10s break-even steepeners.
Volatility	EUR front-end fwds are considerably elevated vs spot and do not reflect further ECB action. EUR calendar spreads in the 10yr tenor are too high. The EUR curve has scope to bull-steepen further. GBP 2y2y vol is too rich vs fundamentals, we continue to suggest selling straddles on a rolling basis.	Buy EUR 2y10y bpv vs 5y10y bpv Buy EUR 3y2y ATMF receiver (the 1yr roll on the underlying offsets the option cost) EUR 5s20s conditional bull-steepener with 18m expiry Sell GBP 2y2y ATMF straddles
SSA	Given the various fundamental concerns in the euro area and likely volatility in EMU spreads, we expect demand for AAA/AA SSA paper will remain healthy. Although performance might not be as strong as in 2012, we expect positive returns in 2013. However, we are likely to see better levels to add and would trade the range and buy on dips.	Long front-endr KfW vs France Long front-end EU vs EIB

Source: Citi Research

Tradesheet

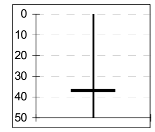
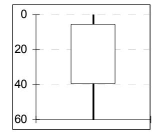
Record of Our Open Trades

Figure 2. Record of our Open Trades

Region	Trade	Levels	Rationale + Publication Date	
UK / US *Cross Market*	**Buy Gilt 1.75% Sep22s vs UST 1.625% Aug22s** Buy Gilt 1.75% Sep22s at 1.86% Sell UST 1.625% Aug22s at 1.65%	Open 21bp Current 23bp **P&L -2bp** Target 5bp Stop 29bp	Gilts should be supported by strong seasonalsinto year-end (Time stop: 31 December 2012) *European Rates Weekly 22 November 2012*	
Europe *Curve*	**Buy NWB 3.5% Jan21s vs BNG 2.625% Sep20s** Buy NWB 3.5% Jan21 at 1.71% Sell BNG 2.625% Sep20 at 1.63%	Open 8bp Current 8bp **P&L 0bp** Target 3bp Stop 11bp	Yield compression trade for fundamentally similar Dutch agencies *European Rates Weekly 15 November 2012*	
Europe / US *Inflation*	**Sell 10yr US CPI ZC swap vs EUR HICPxT ZC swap** Sell 10yr US CPI ZC swap at 2.79% Buy 10yr EUR HICPxT ZC swap at 2.08%	Open 71bp Current 77bp **P&L -6bp** Target 50bp Stop 80bp	The Fed's inflationary stance looks well priced and some reversal of recent trends is likely in the near-term. The US-euro inflation swap differential is at appealing historical levels *Global Inflation Strategy 9 October 2012*	
Europe *Curve*	**Receive EUR 30s50s** Receive EUR 30s50s at 18bp	Open 18bp Current 16bp **P&L 2bp** Target 5bp Stop 22bp	Long-end of EUR swap curve is pricing in more than required de-hedging by Dutch pension funds. CVA activity should support the trade. *European Rates Weekly 11 October 2012*	
Europe *Duration*	**Receive EUR 1y3yF** Receive EUR 1y3yF at 1.36%	Open 136bp Current 98bp **P&L 38bp** Target 50bp Stop 150bp	ECB rate cut and very high carry should be supportive for this trade *IIRS 13 September 2012*	
Europe *EMU Spreads*	**Sell 5yr Austria vs 5yr Germany** Sell RAGB 4% Sep16 at 0.59% Buy Bobl 1.25% Oct16 at 0.35%	Open 24bp Current 25bp **P&L 1bp** Target 40bp Stop 16bp	Risk of delay to the ECB's OMT programme and attractive entry levels *IIRS 13 September 2012*	
Europe *Curve*	**Italy 2s10s flattener** Sell BTP 4.25% Jul14 at 2.20% Buy BTP 5.5% Sep22 at 5.00%	Open 280bp Current 263bp **P&L 17bp** Target 250bp Stop 290bp	We expect this strategy to work in both a risk-on environment (duration extension across front-end BTPs) & risk-off environment (increase in credit risk would bear-flatten the curve) *Assessing the Impact of a Theoretical OMT… 12 September 2012*	
Europe *Volatility*	**Sell EUR 1y3yF ATMF straddle and buy ATMF-25 receiver** Sell EUR 1y3yF ATMF (=1.36%) straddle for 98bp Buy EUR 1y3yF ATMF-25 receiver for 35bp	Open 63bp Current 41bp **P&L 22bp** Target 30bp Stop 73bp	Fwd levels in front-end EUR swaps are too high in an environment where additional policy measures by the ECB are likely to be undertaken *IIRS 9 August 2012*	
Europe *Cross Market*	**Long KfW 1.375% Feb17s vs OAT 5% Oct16s** Buy KfW 1.375% Feb17 at 0.62% Sell OAT 5% Oct16s at 0.63%	Open 1bp Current 6bp **P&L 5bp** Target 20bp Stop -10bp	Spread compression looking overdone and we look for KfW to outperform should the EMU crisis intensify *IIRS 2 August 2012*	
UK *Volatility*	**Sell GBP 2y2y ATMF straddle** Sell GBP 2y2y ATMF (1.04%) straddle at 76bps	Open 76bp Current 57bp **P&L 19bp** Target 0bp Stop 114bp	The fundamental backdrop in the UK supports selling GBP 2y2y vol *IIRS 12 July 2012*	
Europe / US *Duration*	**Buy USD Payer Spread vs EUR (delta-weighted and fx-adjusted)** Buy 108 units USD 2yr5yr ATMF payer at 2.1% Sell 108 units USD 2yr5yr ATMF+100 payer at 0.8% Sell 100 units EUR 2yr5yr ATMF payer at 1.9% Buy 100 units EUR 2yr5yr ATMF+100 payer at 0.64%	Open 5bp Current 1bp **P&L -4bp** Target 25bp Stop -5bp	Range-bound short rates with short term cash-flow support for Europe *IIRS 12 July 2012*	
US / Europe *Cross Market*	**Long 10yr Bund vs UST** Sell UST 1.75% May22 at 1.62% Buy Bund 1.75% Jul22 at 1.48%	Open 14bp Current 21bp **P&L 7bp** Target 35bp Stop 4bp	The recent weakness in equities, the upcoming NCR profile & our ARTS weekly trading signal suggests buying 10yr Bunds vs USTs *Interest Rate Strategy Update 25 June 2012*	

Source: Citi Research

Figure 3. Record of our Open Trades (continued)

US / UK	**Long 30yr Gilt vs UST**	Open	36bp	With Operation Twist extension largely priced in, QE resumption should help gilts outperform treasuries	
		Current	38bp		
Cross Market	Buy UKT 4.5% Dec42 at 3.09%	**P&L**	**-2bp**		
	Sell UST 3% May42 at 2.74%	Target	0bp		
		Stop	50bp	*UK Rates Strategy 20 June 2012*	
US / Europe	**Pay USD 2y 2y fwd vs EUR**	Open	40bp	We expect divergence between UST and core EMU yields	
		Current	6bp		
Cross Market	Pay USD 2y 2y fwd at 1.27%	**P&L**	**34bp**		
	Receive EUR 2y 2y fwd at 1.67%	Target	0bp		
		Stop	60bp	*IIRS 23 February 2012*	

Source: Citi Research

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Global Economic Outlook and Strategy

Following the latest Global Economic Outlook and Strategy – Prospects for Economies and Financial Markets in 2013 and Beyond and Global Asset Allocation - November 2012 publications from our global economists and market strategists, we highlight Citi's key views.

Global

GDP (YoY) 2013F 2.6%
CPI 2013F 2.8%

Citi's global growth forecasts are little changed from last month, at 2.6% for 2013 and 3.1% for 2014, with Asia outperforming, the US picking up after near-term weakness, and Europe staying weak through 2013-14.

US

GDP (YoY) 2013F 1.6%
CPI 2013F 1.9%
Rates on hold at 0.25% in 2013

Modest growth is expected to continue in the US amid a continuing focus on fiscal drag and an emerging housing rebound. Our economists expect a short-term agreement to avoid most of the fiscal cliff while the Fed is likely to extend QE through at least the better part of 2013 and possibly beyond.

Euro Area

GDP (YoY) 2013F -0.7%
CPI 2013F 1.4%
Policy rate 4Q 2013F: 0.25%

Citi expects the euro area to remain in recession in 2013 (-0.7%) and 2014 (-0.4%). While the ECB's OMT programme is likely to reduce risks of a broad based EMU break up, our economists expect Greece to leave the euro area probably in early 2014 and sovereign debt restructuring in several periphery countries over the longer-term. The ECB is likely to cut the refi rate to +0.25% and the deposit rate to -0.25% in the course of 2013.

UK

GDP (YoY) 2013F 0.8%
CPI 2013F 2.5%
Rates on hold at 0.5% in 2013

The UK economy may well fall back into slightly negative growth in Q4 as the boost from the Olympics unwinds, and the underlying momentum of the economy is likely to remain weak in 2013.

Japan

GDP (YoY) 2013F 0.7%
CPI 2013F -0.3%
Rates on hold at 0.1% in 2013

Following a prospective change in the government in the upcoming general elections on December 16th, the Bank of Japan leadership will also change next spring. How the basic thrust of economic policies — both monetary and fiscal — will change will probably be an important key for financial markets in 2013.

China

GDP (YoY) 2013F 7.8%
CPI 2013F 2.8%
Deposit rate Q4 2013F 3.25%

Citi economists have revised up 2013 growth forecast slightly from 7.6% to 7.8%. The current growth rebound may last into 1H next year, due to lagged effect of policy easing and supported by the investment impulse of the local governments. As policy stance returns to neutral and more aggressive reforms are introduced in late 2013, growth may decelerate again in 2H, and YoY growth may briefly fall below 7% in early 2014.

Australia

GDP (YoY) 2013F 3.1%
CPI 2013F 2.9%
Policy rate 4Q 2013F: 3.00%

The challenge of rebalancing the economy against a backdrop of deleveraging and global uncertainty likely will require some further easing of monetary policy, probably early in the new year.

Figure 4. Interest Rate and Bond Market Forecasts as detailed in the latest Asset Allocation publication

		Quarterly Average					
	Current	1Q 13	2Q 13	3Q 13	4Q 13	1Q 14	2Q 14
US							
Policy Rate (Fed Funds) End Quarter	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-Month Libor	0.31	0.30	0.35	0.45	0.50	0.60	0.65
2 Year Treasury Yield	0.27	0.30	0.40	0.50	0.65	0.80	0.90
5 Year Treasury Yield	0.67	0.75	0.95	1.05	1.35	1.55	1.65
10 Year Treasury Yield	1.67	1.75	2.00	2.25	2.55	2.75	2.85
30 Year Treasury Yield	2.81	2.95	3.20	3.45	3.80	3.95	4.05
2-10 Year Treasury Curve	167	145	160	175	190	195	195
2 Year Swap Spread (Swap Less Govt.), bp	13	15	20	20	25	25	25
10 Year Swap Spread (Swap Less Govt.), bp	3	10	15	15	15	15	15
30 Year Mortgage Yield	3.54	3.50	3.70	3.85	4.15	4.35	4.40
10 Year Breakeven Inflation	240	250	250	245	240	240	240
Euro Area							
Policy Rate	0.75	0.50	0.25	0.25	0.25	0.25	0.25
Overnight Rate (EONIA)	0.07	0.07	0.00	-0.05	-0.05	-0.05	-0.05
3-Month Libor	0.13	0.15	0.05	0.05	0.00	0.00	0.00
2 Year Treasury Yield	0.00	0.05	-0.05	0.00	-0.05	0.05	0.05
5 Year Treasury Yield	0.43	0.70	0.50	0.75	0.50	0.55	0.60
10 Year Treasury Yield	1.42	1.50	1.75	1.75	1.50	1.25	1.50
30 Year Treasury Yield	2.34	2.35	2.30	2.40	2.20	2.20	2.30
2-10 Year Treasury Curve	142	145	180	175	155	120	145
10 Year OAT-Bund Spread	73	80	90	100	120	120	130
10 Year BTP-Bund Spread	338	350	350	325	400	400	400
10 Year Bono-Bund Spread	427	450	350	325	425	425	425
2 Year BTP-Schatz Spread	206	200	250	250	250	250	250
2 Year Bono Schatz Spread	310	250	250	250	250	250	250
10 Year Swap Spread (Swap Less Govt.), bp	31	25	20	15	40	30	40
10 Year Breakeven Inflation	175	180	185	195	180	180	180
Japan							
Policy Rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3-Month Libor	0.19	0.20	0.20	0.20	0.20	0.20	0.20
2 Year Treasury Yield	0.10	0.10	0.10	0.15	0.15	0.15	0.15
5 Year Treasury Yield	0.19	0.20	0.25	0.25	0.30	0.30	0.30
10 Year Treasury Yield	0.74	0.85	1.00	1.05	1.10	1.10	1.10
30 Year Treasury Yield	1.95	2.10	2.20	2.25	2.25	2.25	2.25
2-10 Year Treasury Curve	64	75	90	90	95	95	95
2 Year Swap Spread (Swap Less Govt.), bp	15	18	18	18	20	20	18
10 Year Swap Spread (Swap Less Govt.), bp	3	3	5	4	7	7	5
UK							
Policy Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3-Month Libor	0.52	0.55	0.55	0.55	0.55	0.55	0.55
2 Year Treasury Yield	0.30	0.35	0.40	0.45	0.35	0.15	0.35
5 Year Treasury Yield	0.84	0.80	0.85	0.90	0.75	0.50	0.75
10 Year Treasury Yield	1.83	1.85	1.95	2.00	1.80	1.65	1.80
30 Year Treasury Yield	3.09	3.10	3.15	3.15	3.05	2.90	3.05
2-10 Year Treasury Curve	154	150	155	155	145	150	145
10 Year Swap Spread (Swap Less Govt.), bp	9	20	25	20	25	35	25
10 Year Breakeven Inflation	261	215	225	230	230	235	235
Australia							
Policy Rate	3.25	3.00	3.00	3.00	3.00	3.00	3.00
3-Month Libor	3.45	2.95	3.00	3.05	3.05	3.10	3.20
2 Year Treasury Yield	2.78	2.25	2.25	2.35	2.45	2.50	2.70
5 Year Treasury Yield	2.82	2.40	2.40	2.55	2.70	2.90	3.10
10 Year Treasury Yield	3.30	3.00	3.10	3.30	3.50	3.75	4.00
2-10 Year Treasury Curve	52	0.75	0.85	0.95	1.05	1.25	1.30
10 Year Swap Spread (Swap Less Govt.), bp	59	60	60	65	65	70	75

Source: Citi Research and Bloomberg

Forecasts, Self-Interest and the Status Quo

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"Whatever it takes…"

Going into year end there is an eerie calm in Europe, with spreads tightening while Bund yields remain low. But just beneath the surface the icebergs that threatened to rip a gash in the hull of Europe earlier in the year still lurk. While it is possible that somehow the committee of captains - who wrestle and fight over temporarily steering the ship in different directions - actually manage to avoid the sea full of obstacles, it seems far-fetched. But the change in the market mood that started off with Draghi's commitment to do "whatever it takes" contains the key to keeping the ship afloat. We don't deny the considerable potential for bad news, but it doesn't automatically translate into lower Bund yields/higher peripheral yields in the way that it did in earlier phases of the crisis in our view.

It's not just austerity fatigue and donor fatigue that are important. Bad news fatigue opens the door to the possibility of positive surprises.

The risks which have the potential to move prices further or for longer than currently anticipated are the positive ones. These are extremely unlikely to come from economics. But it is very possible that they come from improvements in the institutional framework - even if this only means doing what should have been done already. A positive surprise could also be as simple as negative ones not being allowed to materialize. We argue that, in the short term, it is in everybody's interest for the status quo to be prolonged, and the probability of the current hiatus in the crisis persisting is being underestimated. However, the economic reality can only be staved off for so long, and we anticipate OMT activation in the first half of next year. We suggest trading strategies to capitalize on this.

Yield forecasts for Bunds and peripherals

Forecasting Bund yields is inextricably bound up with your view on the trajectory of the EMU crisis, and by extension, risk appetite. Below we look at our forecasts for the year ahead, before going on to focus on what could potentially move markets the most, viz, nothing going wrong, and how that could come about.

Key points behind our forecasts…

Figure 6 shows our quarterly Bund, BTP, and Bono forecasts out to 1Q14 – please see our Global Economic Outlook and Strategy: Prospects for Economies and Financial Markets in 2013 and Beyond for the full set of forecasts and underlying economics. The three key points are: (i) ECB cut in 13Q1 and second cut in Q2 or Q3; (ii) OMT activation in 13H1, with Italy following Spain, and (iii) a likely Grexit early 2014. Basically, we have Bund yields drifting higher until anticipation of Grexit drives another flight to quality and the authorities containing Bono yields. Looking at the forecast quarterly averages another way, we have Bund yields peaking at 1.75 in 2013 and average Bono yields at their highs in 1Q13.

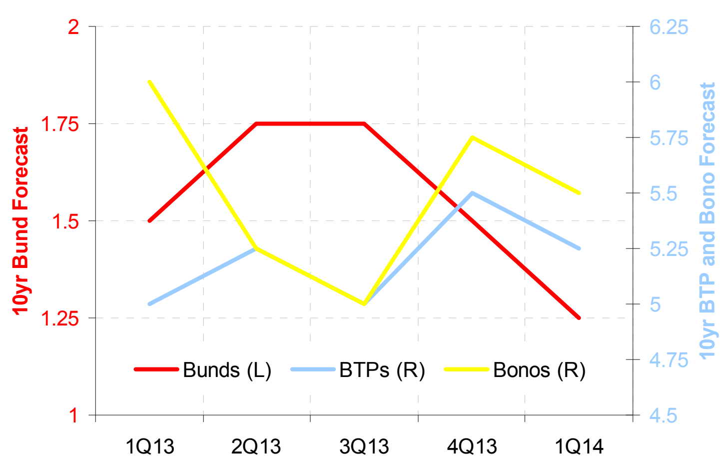
Figure 5. Bloomberg forward rates (%, bps)

Yields	Spot	3m fwd	1yr fwd	2yr fwd
Germany	1.03	1.47	1.64	1.90
Italy	3.96	4.56	4.89	5.26
Spain	4.99	5.64	5.96	6.28

Changes from spot	3m fwd	1yr fwd	2yr fwd
Germany	44	62	87
Italy	60	93	129
Spain	66	97	129

Source: Bloomberg

Figure 6. Citi 10yr Bund, BTP and Bono forecasts (period averages)



Source: Citi Research, 26 November Global Economic Outlook and Strategy

But from a market perspective, more interesting than the quarterly forecasts are the risks which have the potential to move prices further or longer than currently anticipated. And with so much EMU bad news fatigue, these risks are positive. But first, let's step back from EMU for a moment. Here, both comparisons with Japan and technicals point to Bund yields having found a floor.

Convergence with Japan gives no pointers

There is little support for lower Bund yields from comparison with the Japanese experience

Much has been written in recent times about how Japan in 2002-2007 could serve as a guide to the current situation. There are well-documented and important differences of course but to the extent that Japan is a template, the remaining scope for convergence is limited at best[1]. Figure 7 compares the JGB curve over that period with the Bund curve now. Positive differences represent where the Bund curve has already gone beyond the JGB curve, and negative differences highlight where there is arithmetical scope for further convergence.

Figure 7. Comparing Japanese yields in 2002-2007 with the current Bund curve (%)

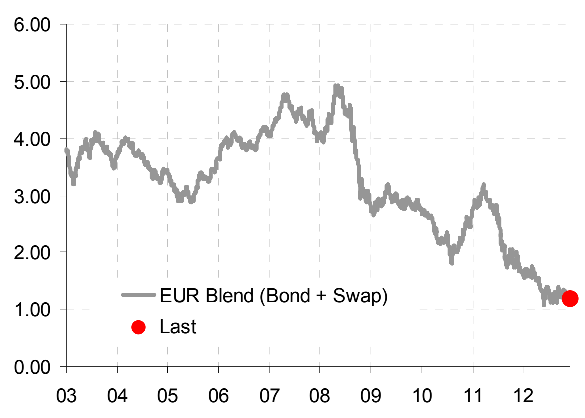
	2yr	5yr	10yr	30yr	2s10s	10s30s	Curvature	2s5s10s	5s10s30s
Japan 2002-07 Average	0.23	0.66	1.38	2.21	1.15	0.83	-0.40	-0.29	-0.11
Bunds	0.02	0.44	1.42	2.33	1.40	0.91	-0.49	-0.56	0.07
Difference	0.21	0.22	-0.04	-0.12	-0.25	-0.08	0.09	0.27	-0.18

Source: Citi Research

Technicals suggest yields have found a floor too

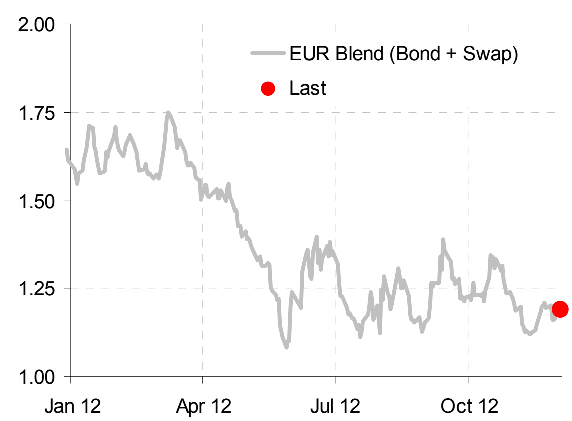
European yields – which have fallen nearly 400bps from their peak (Figure 8) - have settled into a range (Figure 9) since Draghi's catalytic statement to do "whatever it takes" in July.

Figure 8. Average European yields are basing (bonds + swaps)



Source: Citi Research

Figure 9. European yields unable to break lower

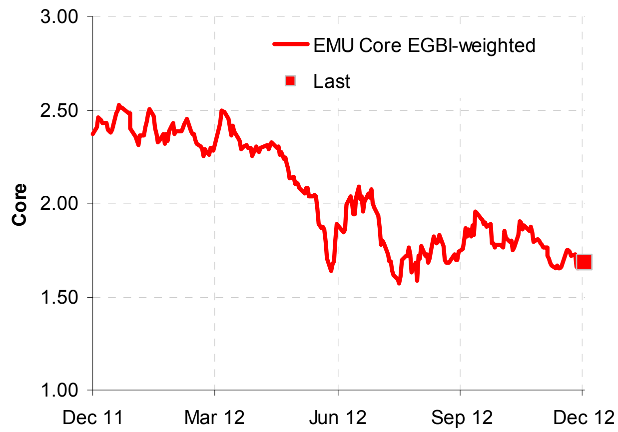


Source: Citi Research

However, when you decompose the bond component into core (Figure 10) and non-core (Figure 11) it is clear that peripheral yields are still firmly on a downward trend. We think this could easily continue going into next year. This brings us neatly back to the unusual alignment and balance of self-interests in preserving the status quo in Europe, at least for the time being. Despite all the negatives

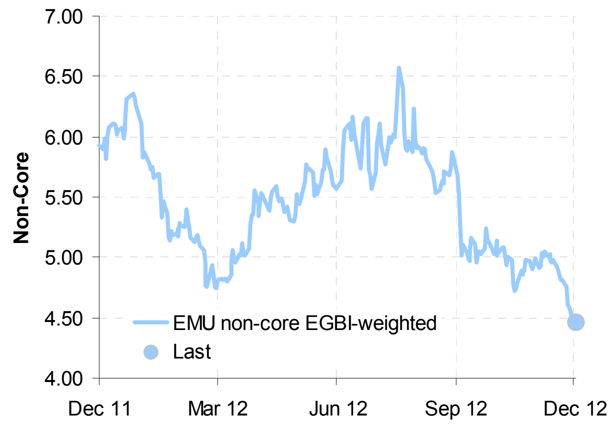
[1] Repeating the exercise for Treasuries highlights only the long end and the curve's steepness.

Figure 10. Core yields have lost momentum



Source: Citi Research

Figure 11. Peripheral yields are still trending lower



Source: Citi Research

The main risks in Europe are ultimately still political

Politics can only trump economics for so long

The runaway train may have been stopped, for now, but the troika can only do so much in terms of keeping the brakes on and buying time. Ultimately national politicians are the only ones who can deliver what is necessary. But left to their own devices politicians are not renowned for taking difficult decisions if there is an option to postpone them or drag their feet. That is where markets come in. Markets' stock in trade is present valuing the future, and they make it clear to politicians that there is a price to be paid for inaction and postponement (even if that payment is deferred). Markets provide an even more immediate (and less manageable) motivation for national politicians than their electorates.

Implementation will become increasingly difficult

On the one hand, politicians have the markets, and on the other, increasingly unhappy electorates. And because unemployment is the lagging indicator, social unrest has the potential to get considerably worse before it gets better. Even in countries which have been very stoical about the necessity of reform and austerity, e.g. Portugal, recent problems clearly show that there are limits to the pace and extent of pain that can be imposed. In countries with especially high youth unemployment this danger is even more pronounced. What this means in practical terms is that even with deadlines being stretched by political necessity, implementation will become increasingly difficult for politicians. Expectations will need to be kept in line with reality and what may become progressively more difficult.

many shades of black

This problem is exacerbated by the probability that the fiscal multiplier is higher than was implicitly assumed by governments when austerity programmes were agreed. When interest rates are stuck close to their lower bound, central banks don't have the option of reducing policy rates to offset any tightening of fiscal policy. The consequent increase in the fiscal multiplier translates into a stiff headwind for fiscal retrenchment. Of course, nobody knows what that multiplier is, but academic studies[2] suggest its range is higher than governments would like, or assumed. If normal growth rates are further away than expected, then yields in Europe will continue to be driven by the EMU crisis, rather than returning to more familiar territory of anticipation of the economic and policy rate cycle.

[2] E.g., Blanchard/Leigh, Summers/DeLong, and Auerbach/Gorodnichenko.

But if the EMU crisis continues to drive yields in Europe, and given the myriad ways in which things can go wrong, how can we be forecasting higher Bund yields and lower peripheral yields?

But we see scope for tighter spreads in the near term

But the dominant market mood has switched

The dominant mood has switched from fear of EMU disintegration, to a presumption that, whatever it takes, the wheels will be kept on. That has allowed the market to shrug off news that would have rattled it in a less ebullient mood. But that is not just irrational exuberance. Significant changes have taken place under the surface.

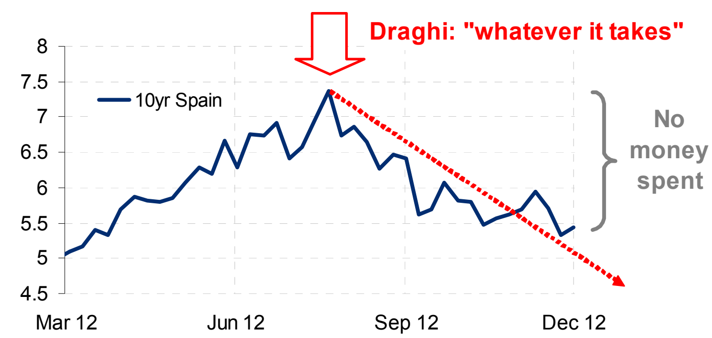
What has changed

For example, it may offend national notions of fairness, but Germany now appears to believe that keeping the enterprise afloat - even if that means begrudgingly subsidizing the passage of certain other passengers who currently lack the ability to pay - is preferable to the whole thing sinking[3]. At least for the time being.

The majority of self-interests are aligned in favour of maintaining the status quo, in the short term.

There has always been a fine, and constantly changing, balance between the rate (and duration) of austerity that electorates are willing to bear, and the markets' confidence that the planned economic trajectory is credible. But with the markets in the mood to believe, this balance becomes much less perilous to strike. What is unusual about the current situation is that everybody is benefitting in the short term. Self-interest has consistently been the most useful lens for viewing the EMU crisis, and now is no different. And that argues for the status quo continuing.

Figure 12. Everyone is benefitting from the reduction in yields



Source: Citi Research

Markets, the ECB, Spain, national governments, investors, politicians… all are enjoying the current sweet spot

Markets have taken comfort from Draghi's pronouncements and the positive direction of travel of the institutional framework. All parties are enjoying the sweet spot where the OMT has not been activated, but is standing by reassuringly. Investors have a vested interest in believing in the OMT, and while it has not been activated, it can't be tested. So we are in the happy situation where Spain wants to avoid OMT activation and yields are allowing it to do so. Investors are happy because yields continue to grind in, because of the existence of the OMT, ESM etc. Governments are happy because yields are at such attractive levels to fund and they don't have to stump up hard cash to bolster the firewall. Politicians are happy because with yields so low they feel the pressure to act (and lose votes) is off. And the ECB is happy because the threat of intervention is far cleaner, cheaper and safer than its actuality.

[3] Belated recognition (or perhaps just acceptance) of that has turned the focus to reducing and containing the overall cost. If paying for another is the least costly option then it is rational to fight to reduce that bill to the minimum and to specify what you are, and are not, paying for. (Precisely the opposite motivation applies to the prospective beneficiaries of course). You want every guarantee that the writedown will be a one-off, and not merely the thin end of the wedge.

Conclusion: wait to catch the policy response wave

In the short term, the vast majority of incentives are aligned in favour of maintaining the status quo. It is nobody's interest to change it in the short term, and the longer it continues the closer we get to having a necessary and sufficient institutional framework in place to limit the fallout from any adverse events. In this environment we can see the yield on offer from alternatives to Bunds as appearing increasingly attractive, whether in core or non-core markets. Either way, Bunds lose some of their shine. And at the same time, the trend to lower peripheral yields is also happily feeding on itself as the risk/reward gets continually reassessed in the face of continued gains.

The crux is the market maintaining its good mood

If politicians can perform the balancing act of playing well to the troika[4] on the one hand, and mollify their electorates on the other, we could see the markets confound the peddlars of doom into next year. The crux is the market maintaining its good mood. When that changes – and we are confident it will - we are back to the old dynamic of any rallies being curtailed by profit-taking, knee jerk risk-off rallies in Bunds, and markets probing and testing the cracks.

See the following section for trading strategies

But for the time being, while all the self-interests remain aligned, we could be in for a longer wait, and a longer spread rally, than many expect. For that reason we are wary of selling Spain to position for the seemingly inevitable rewidening of spreads. As ever, the view is the relatively easy bit, but the timing is both more difficult and more important. Catalysts are impossible to predict – in one set of circumstances an event will spark a conflagration, in another it will burn out harmlessly by the wayside[5]. But there are still ways to approach investing in this environment. In the following section we address ways to trade the scenarios outlined above. We focus first on Spain, and then Italy and the impact of the OMT.

[4] Samaras clearly understood this when he started his European tour to charm and mollify.

[5] Ongoing sources of potential danger are supply pressures in the new year and German and Italian politics/elections.

Spain: Trade with the Policy Response

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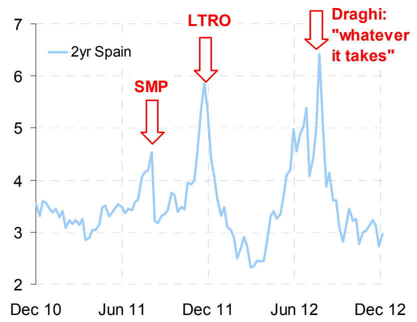
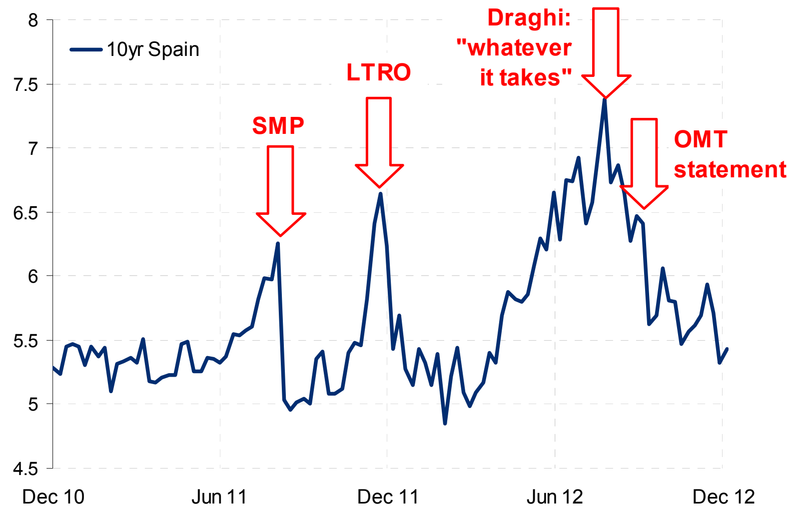
Although we see the risk-on move continuing in the near term, when the current mood evaporates next year, the key – as it has been all along - is not to focus on the fundamentals, but to trade the policy response[6].

Figure 13. Front-end rallies driven by policy responses not fundamentals



Source: Citi Research

Figure 14. The power of the policy response



Source: Citi Research

Buy spikes in front end Bono yields: In practical terms, this means waiting to buy a spike in the front end of Spain instead of selling it now. (Our flow analysis – see below - also shows demand for Spain concentrated at the front end). As Figure 14 above clearly illustrates, the policy response drives the move, and you don't fight the policy makers when they have been roused.

2s10s BTP/Bono box is an alternative way to express the view: An alternative expression would be boxing a steepener in Spain with a flattener in Italy, as we get front-end led flattening in Spain as the market tests for weakness and puts pressure on Spain to request aid.

Figure 15. The effect on the 2s10s BTP/Bono box of Spain steepening harder than Italy.

Source: Citi Research

[6] It is noteworthy that bringing yields down from their summer peaks has not cost a cent.

Italy and the Possible OMT

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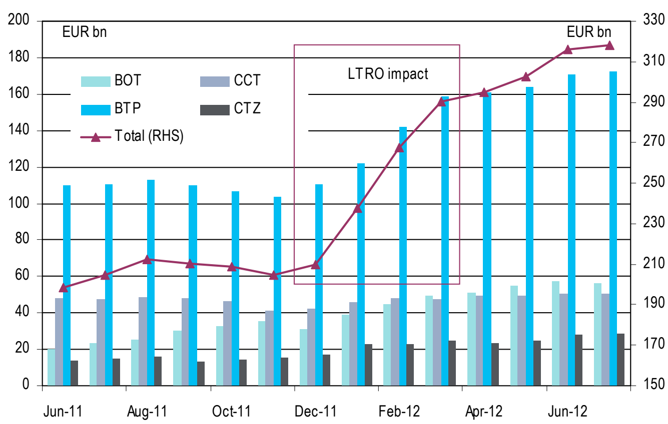
Assessing the Impact of a Theoretical OMT on the Market for Italian Government Debt[7]

We expect a similar dynamic in Italy as Spain, though we expect Spain to request aid first and acknowledge the higher political risks in Italy. Below we outline our views on the Italian government bond market, including our thoughts on trends in international diversification, the dynamics of yield curve segmentation as well as the impact of a hypothetical OMT. The ECB announcement of the OMT led to a broad flattening dynamic across peripheral markets which, as anticipated, continued in both risk-on and risk-off environments. However, we believe the immediate reaction to a hypothetical OMT for Italy would be steepening of 2s10s and an outperformance of 0-3yr BTPs vs comparable instruments (BOT, CTZ, CCT and BTPei).

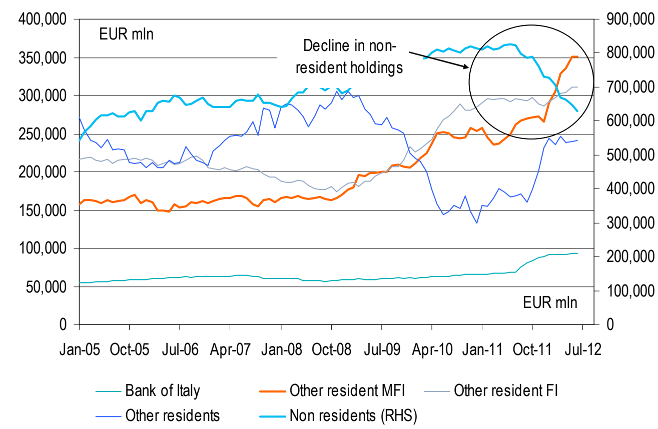
The market for Italian government bonds is segmented not only in terms of geographical distribution, but also in terms of product trends (Figure 19).

Figure 16. Resident MFI Holdings of Italian Government Debt by Instrument



Sources: Bank of Italy

Figure 17. Holdings of Italian Government Debt by Investor Category



Source: Bank of Italy

Figure 17 shows the evolution of non-resident holdings of Italian public debt. Note the shift in investor preference taking place during the second half of 2011 as a consequence of the rapid deterioration in macroeconomic fundamentals as well as the deterioration in expected risk-adjusted returns. The percentage of non-resident holdings declined from 52% to an estimate of 39% during the 12-month period ending in June 2012.

In our view, this process of endogenisation of public debt is not a cyclical, short-term process, but rather a structural shift towards a more stable and regulated domestic investor base. The same process has been observed in other countries as well, mainly reflecting non-standard monetary policy strategies. Examples are QE in countries like Japan and the UK and the LTRO/SMP in the Euro area.

In a recently published paper[8], the IMF expresses the view that the marked increase in non-resident holdings seen during most of the Euro period is linked to integration and regulation: "*The period leading to the global financial crisis was marked by a broad-based trend toward international financial integration, which in turn encouraged the international diversification of portfolios...in addition, supporting*

[7] This article was first published on 12 September 2012

[8] Andritzky, June 2012, WP/12/58

regulatory changes catalysed larger non-resident holdings. For example, government bonds of all euro area issuers received a zero risk weighting for the calculation of capital adequacy ratios". In the long-term, a significant share of domestic holdings is expected to help reduce both the volatility of bond returns and the sensitivity of bond returns to changes in a country's credit rating.

Moreover, increasing the share of resident holdings provides the policymaker with an efficient financing mechanism that sources funds from households. Again, the liquidity loop between commercial banks, the postal savings system and the JGB market engineered by the BoJ over the years is a paramount example of how household wealth can be used for the purpose of public debt financing.

The SMP Precedent

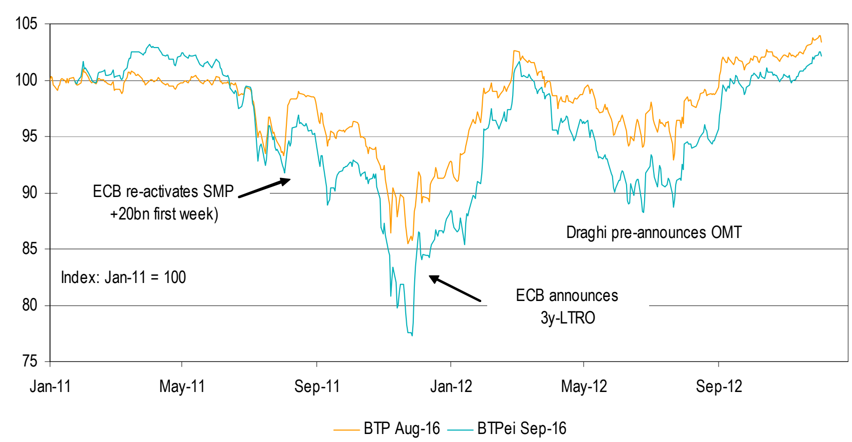
Should the ECB ever activate the OMT for the Republic of Italy, we estimate the impact on the share on non-resident holdings would be quite comparable to activation of the SMP and the 3y LTRO programme last year.

From the standpoint of investor preference, the BTP curve is fragmented into three main EGBI buckets (market value):

- **1yr - 3yr** (€241bn, 25% of the index): Predominantly domestic institutions and central banks
- **3yr -10yr** (€443bn, 46% of the index): Domestic and internation investors, both fast and real money including reserve managers, wealth funds, HF, banks
- **+10yr** (€284bn, 29% of the index): Relatively limited domestic participation, we estimate that not more than EUR 100-125bn (35-45% of Italy +10y EGBI) are in invested by resident accounts.

Furthermore, we have to take into account other debt products issued by the Italian Treasury. The relative and indirect impact of SMP's re-activation on important funding instruments such as the CCT (8.2% of outstanding debt) and the BTPei (7.9%) can be severe at times and should not be underestimated (see Chart 3).

Figure 18. 5yr Italian Debt Price Performance, Indexed at 100 in January 2011



Source: Citi Research

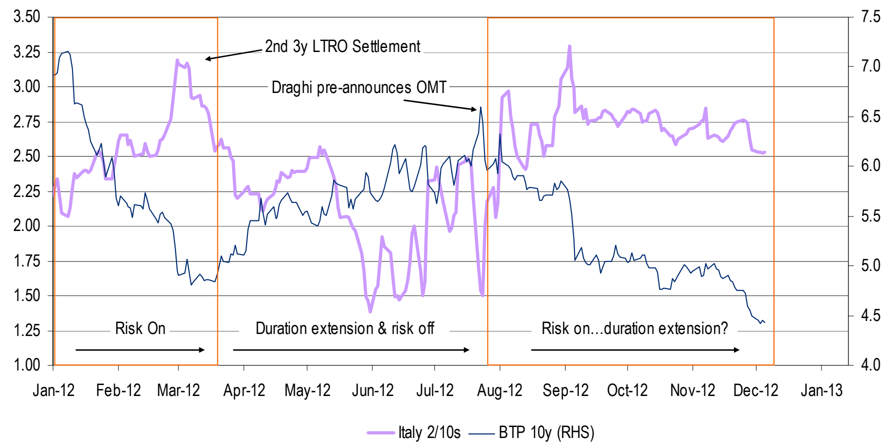
According to ECB's documents, the OMT is yet another highly sector-specific policy tool and we see the risk of financial anomalies appearing on the Italian government bond market in the event of its activation.

Risk-Reward Continues to Favour Flatteners in Italy

In the current environment, where the OMT is nothing more than an option in ECB's palette of non-standard monetary policy strategies (we believe Mr Weidmann would vehemently disagree that it can be accounted for as a monetary policy tool), we are witnessing a flattening of the BTP curve.

This re-shaping of the term structure reflects not only OMT's disclosure, but also investor preference arguments discussed above. The current flattening theme seems to work in both risk-on and risk-off modes, a situation similar to the first half of 2012 when a combination of domestic duration-extension strategies and short-covering by fast money and international investors produced a 180bp flattening on BTP 2s10s (Figure 22).

Figure 19. Italy 2s10s (Left, %) and 10yr Yield (Right, %)



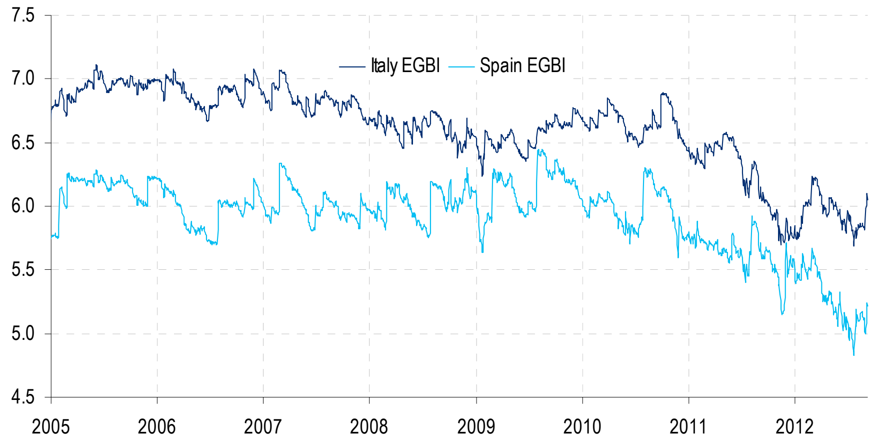
Source: Citi Research

Long-Term Impact on Issuance and Sovereign Rating

From a long-term perspective, we need also to consider the impact of OMT on the overall duration of a government bond market. As we can see in Figure 23, debt duration of the Italian and Spanish EGBI has dropped during the EMU sovereign crisis.

Non-conventional monetary policy, not only QE but also in the form of LTROs, intensify the investor segmentation across the curve. Given the prospect for stable demand from resident accounts in the front-end of the curve, the trend towards reducing debt duration is understandable from an issuers' point of view although it could increase roll-over risk over time.

Figure 20. Modified Duration of Italy and Spain EGBI Sub-Indices



Source: Citi Research

In terms of credit implications as detailed by the rating agencies, both Moody's and S&P point to the potential positives of OMTs but that ultimately, the policy is mostly a buying-time exercise. S&P noted[9] that "*The announcements that the ECB made largely conform with Standard & Poor's Rating Services' expectations and therefore do not affect our current euro area sovereign ratings and outlook*" They conclude, "*the ECB's position has been constructive….it's up to the governments to use this respite effective*". Similarly, Moody's have a similar view in their document which is entitled "*ECB Debt Purchases Can Buy Time for Struggling Sovereigns, but Crisis Resolution Requires Government Action*".

Conclusion & Investment Recommendations

Putting the pieces together, we think the immediate reaction to a hypothetical OMT for Italy is going to be:

- Steepening on BTP 2s10s (similar to as in Spain)
- 0-3y BTPs to outperform comparable instruments (BOT, CTZ, CCT, BTPei).
- Further reduction in the duration of debt issue by the Republic of Italy.

At the same time, this scenario's embedded uncertainty is compounded by investor risk aversion, which is unlikely to be low in the event of OMT's activation. In reality, the probability of activating the OMT for Italy is a function of the level of – let's say – 2yr BTP yields. As we've seen in the past, episodes of low risk appetite tend to be coupled with pronounced yield curve flattening. This is a direct result of notional-based risk management, through which flattening positions are a synthetic way to buy CDS on a single name.

From a quantitative point of view, the impact of central bank buying on the developed government bond markets is estimated in the region of 25-40bp on average across the curve for every 10% of outstanding bonds purchased[10]. In the hypothetical case of an OMT applied to Italian government bonds, we need to limit the analysis to approximately EUR 375bn of 0-3yr nominal BTPs.

[9] S&P Ratings Direct: "*The European Central Bank's Policy Initiatives Could Benefit Some Sovereigns, But Implementation Risks Remain*". 7th September 2012

[10] See Andritzky, June 2012 and Neely, April 2012, as an example.

In our qualitative assessment, the bulk of the response to a 10% OMT purchase of BTPs (€38bn) would impact the 0-3y sector more significantly than the estimates discussed above. Not only have the studies been conducted on the average expected return of the government bond market, but also they consider an average G7 market and do not take into account the specific segmentation of the BTP curve.

As a benchmark case, we can use the BTP market's response to the SMP. In its Financial Statement relating to the week ending on 12 August 2011, the ECB reports an increase in Item 7.1 ("*Securities Held for Monetary Policy Purposes*") of EUR 22bn. During that period, BTP 2yr yield declined by approximately 120bp. Given the differences between SMP and OMT, this response should be enjoyed with a grain of salt.

Investment Recommendation: Flatteners

The likelihood of near-term activation of the OMT for Italy, as implied by the current level of BTP yields is very low: BTP 2yr @2.10% vs 4.70% in Aug-11 prior SMP and 7.70% in Nov-11 prior to the first 3yr LTRO.

We recommended keeping BTP flatteners in the 06 September *International Interest Rate Strategist* when they were around 280bps. As discussed at length above, we expect this strategy to work both in a risk-on as well as in a risk-off market environment. Our first target of 250bp has been passed, while the medium-term potential for this strategy remains in the 150-200bp area.

France: Flow to Dominate Again in 2013

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In an environment of near-zero interest rates, risk-loving investor have the choice of shifting location on the capital structure or extending duration of their investments. French government bonds have benefited in 2012 from their AAA rating, their phenomenal liquidity, their superior risk-adjusted returns as well as favorable market positioning and flow. We expect the flow to dominate valuations again in 2013, but market positioning is now radically different in comparison to Q4 2011. Against the background of large net supply, this trims the probability of French government bonds outperforming within EMU indices in 2013.[11]

French sovereign debt has outperformed the Euro GBI in the post-Lehman world. The French sub-index of the WGBI has returned 21.7% since Jan-09, i.e. +3% excess return vs EMU, +4.8% vs Italy and +10.1% vs Spain. Top performer in this period has been Austria with a total return above 26%.

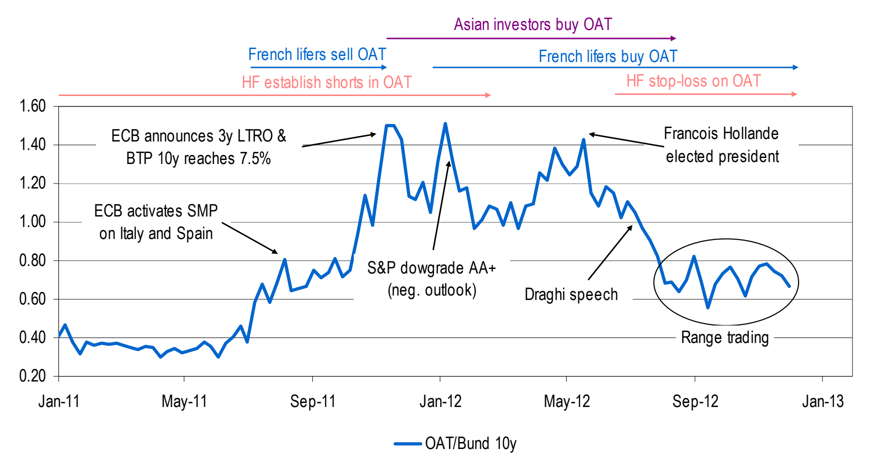
Year-to-date, France is up by 7.7%, in line with the Euro GBI return. Nevertheless, the performance has been stunning especially against the background of the tremendous volatility experienced in Q4 2011.

Notwithstanding the macroeconomic environment, we don't think a similar performance is on the cards for 2013. The reason has to do with the significant demand/supply imbalance that we currently observe in the market. Let's start looking into the demand side of the price equation.

Demand Analysis

At the start of 2012, hedge funds were carrying successful shorts from Q4 2011, Asian accounts were just about to start their rotation into Euro AAA-benchmarks while domestic lifers where just about to start rebuilding their core OAT position after the shakeup in peripheral markets in Q4 2011. The market was not long OAT.

Figure 21. Events and demand dynamics over the past 18 months



Source: Citi Research

During the course of the year, market positioning changed drastically as a result of the following flows (Figure 21):

- **Asian investors:** Portfolio rotation from Italy into Bunds and OATs as well as from Treasuries and MBS into OATs.
- **Hedge funds:** Painful shorts stopped somewhere between Q2 and Q3.

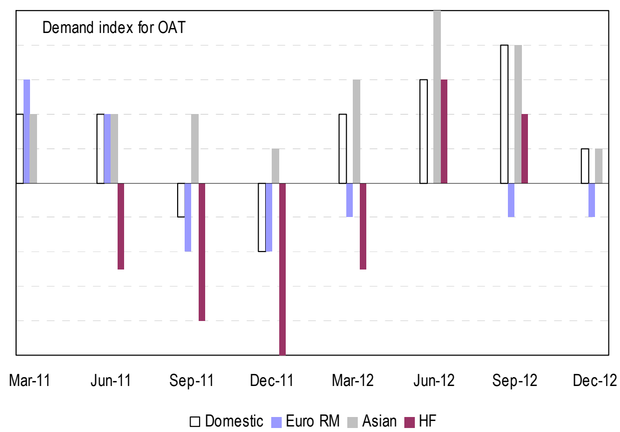
[11] This article was first published on 15 November 2012.

- **Lifers:** Continuous investment into OATs financed by large cash balance, resulting from de-risking of peripheral portfolios during the second half of 2011.

To better visualize market positioning on France through time, we aggregate investor intelligence on a quarterly basis (Figure 22). This is a subjective assessment of the strength of underlying buying/selling flows in the OAT market from four representative investor categories. We find it nonetheless useful in comparing and tracking the flow over time.

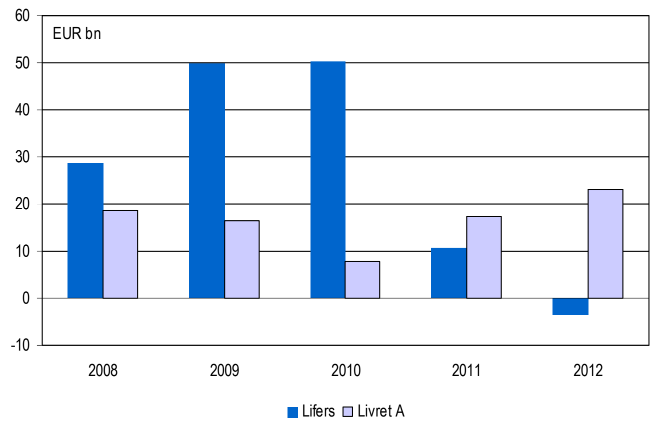
In Q4 on aggregate, we think that domestic and Asian investors are still buyers of OATs albeit at a significantly slower pace compared to previous quarters. On the other hand, our perception is that European real money and global fast money are slightly underweight/short. Overall the level of conviction in shorts is still low and we expect investor to be rather reactive than proactive at this point (i.e. significant short would materialize on weakness as opposed to sellers at tight OAT/Bund spreads).

Figure 22. Estimate of market positioning in French govies



Source: Citi Research

Figure 23. French lifers' net collection not supportive of OATs



Source: Citi Research

We conclude the demand section with a final point on domestic investors:

- **Banks:** Compared to banks in other regions, French banks warehouse a low amount of EGB risk on their balance sheet. Moreover, our impression is that the risk is not concentrated in domestic securities to the same extent as it is in Spain or Italy. Gauged by previous experience in peripheral markets, French banks are likely to act as a "backstop" in case of violent market moves. It is not clear to us whether French banks would proactively seek a larger EGB allocation on their banking books, given negative diversification effects.

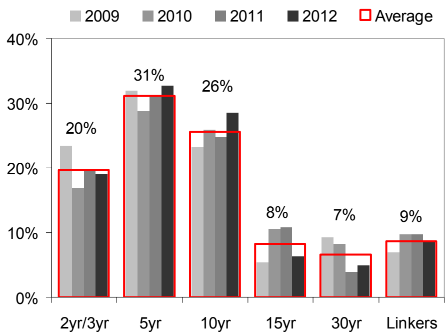
- **Life insurers:** Gone are the years of large net collection (e.g. 2009-2010 with roughly EUR 50bn each). Net collection for French lifers has turned negative in 2012 (Figure 23), reflecting very low OAT yields as well as improved conditions for competitor retail products (e.g. Livret A). Moreover, the prospect for further significant investments on the back of cash balances is not rosy given the pace at which lifers have been buying OATs throughout 2012.

Overall, we cannot expect demand for OATs to be as supportive a factor as it has been in 2012.

Supply Analysis

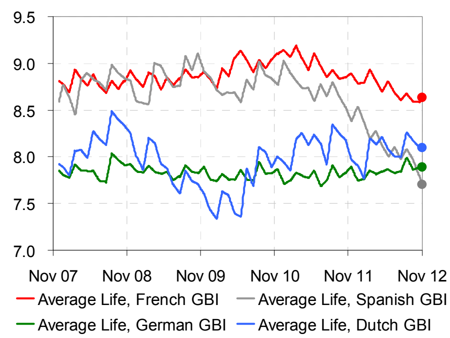
- **Gross issuance:** We forecast €188bn of issuance (BTAN/OAT) in 2013. Net of buybacks (of approximately €18bn) we estimate €170bn of issuance.
- **Issuance by maturity:** Analysing the breakdown of gross issuance in previous years and our estimate for the remainder of 2012 suggests that gross issuance in 2013 is likely to be split across the following maturities: 2/3yr (€37bn), 5yr (€59bn), 10yr (€48bn), 15yr (€16bn), 30yr (€12bn) and linkers (€16bn).
- **Average maturity:** As shown in Figure 25 below, the average maturity of French government debt has declined in recent years. However, it continues to be much higher than comparative issuers.

Figure 24. % of yearly issuance split by tenor (2009 to 2012)



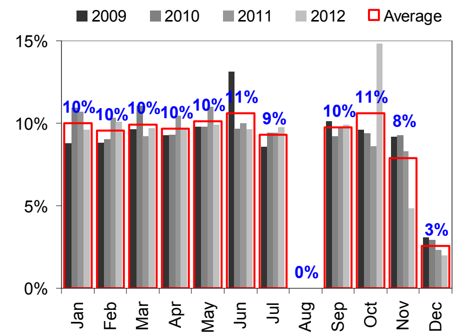
Source: Citi Research, AFT

Figure 25. Average life (yrs) of French debt falling but still higher than Germany



Source: Citi Research

Figure 26. % of yearly issuance split by month tenor (2009 to 2012)



Source: Citi Research, AFT

- **New issues** - we expect the following new securities to be issued in 2013: 1 x new 2yr BTAN in April/May, 2 x new 5yr BTANs in January/February and June/July, 1 x new 10yr OAT in June/July and 1 new 30yr OAT in 2Q13

Figure 27. Monthly net cash requirement profile for 2013

2013	Gross Supply	Coupons	Net Supply	Redemptions	NCR
Jan	19	2	17	18	-1
Feb	19	1	18		18
Mar	18		18		18
Apr	18	17	2	22	-20
May	19		19		19
Jun	18		18		18
Jul	18	6	12	33	-22
Aug					
Sep	18		18	11	7
Oct	25	15	10	22	-12
Nov	11		11		11
Dec	5		5		5
Total	188	41	147	106	42

Source: Citi Research, Bloomberg

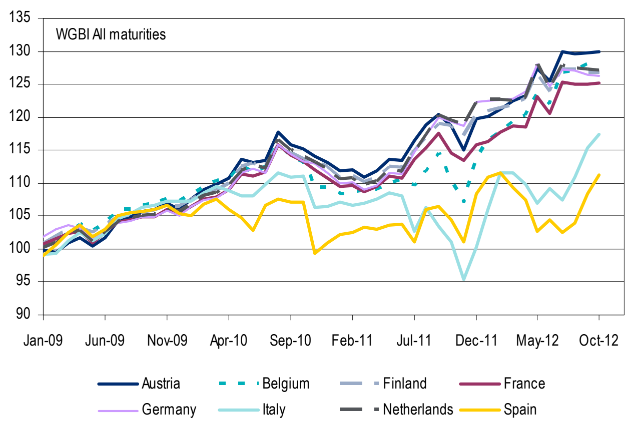
- **Monthly issuance profile:** the monthly issuance profile of French government debt is fairly consistent with most months accounting for 10% of total issuance (Figure 26). There is typically no issuance in August and supply in December is fairly muted at around 3% of total annual issuance.
- **Monthly cash flow profile:** Our estimates for monthly issuance in 2013 along with coupons and redemptions can be found in Figure 27. The net cash requirement (NCR) is -€1bn in January as €18bn of redemptions and €2bn coupons outweigh €19bn of gross supply. All things being equal this should be supportive for short-end French yields during the course of January.
- The NCR moves sharply from being supportive for bonds in January to being non-supportive for bonds in February and March due to minimal coupons and zero redemptions in these months (Figure 27).
- **Cross-market comparison:** The 2013 net cash requirement (+€42bn) for France is the second highest amongst non-programme issuers in EMU-11[12]. All things being equal this maybe interpreted by investors as being relatively negative for French bonds – which could result in France underperforming other core issuers.

[12] The NCR for the Netherlands will be €1bn higher than France, in our view.

Total Return Analysis

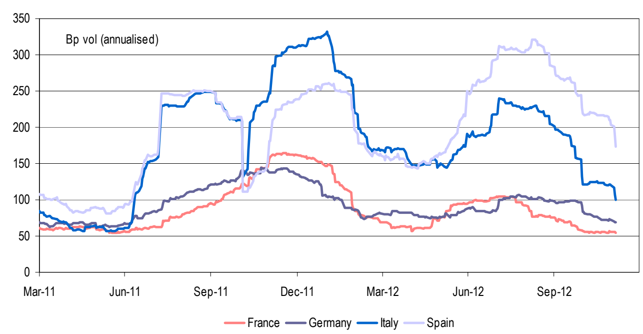
Within the Euro GBI universe, France keeps performing in line with its AAA-peers (Figure 28). Looking back, the underperformance experienced in Q4 2011 looks more like an incident, rather than a structural shift in investors' risk assessment. Looking forward and looking at market-implied risk metrics only, investments in the French government bond market still look relatively attractive in terms of volatility-adjusted returns. One possible measure is the promised yield adjusted by delivered yield volatility. We show a vector of such risk-adjusted 10y yields in Figure 29: France and Italy are outperformed only by Belgium. Still, France has the highest risk adjusted-yield amongst its AAA peers!

Figure 28. AAA performance…



Source: Citi Research

Figure 29. …even better in risk adjusted terms



Issuer	BP vol 10y	Yield 10y	Risk adj yield
Austria	47	1.77	0.04
Belgium	45	2.17	0.05
Finland	81	1.60	0.02
France	55	2.02	0.04
Germany	69	1.34	0.02
Italy	100	4.58	0.05
Netherlands	60	1.57	0.03
Spain	173	5.51	0.03

Source: Citi Research

However, we are cautious of looking at risk-adjusted yield as a measure of future return, because by construction it is a very backward looking indicator of performance. One example is Italy: Risk adjusted yields on BTPs were in line with AAA risk-adjusted yields up to Q2 2011 and this was often cited as a reason for investing in BTPs…

Summary & Strategy

We expect flow components to provide less support for the OAT market in 2013 than they have done in 2012. All else equal, we see a pressure towards a wider OAT/Bund equilibrium level materializing in the 2nd half of 2013 (see Global Economic Outlook and Strategy: Prospects for Economies and Finacial Markets in 2013 and Beyond, published 26 November 2012). The risk scenario is clearly skewed towards a break of the 60-80bp trading range in Q1 as a result of an evident supply/demand imbalance. On the positive side, we need to consider the (still) attractive, above benchmark risk adjusted yield as well as potential support for the front-end of the OAT curve coming from the ESM investing its paid-in capital. Within this environment, we recommend less aggressive allocations of risk towards France with a bias towards a steeper yield curve.

Demand patterns reflect the mood change[13]

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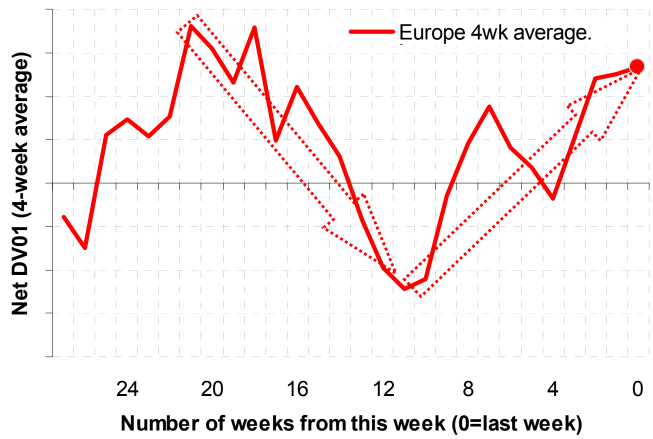
Flow analysis reveals hidden aspects of the sea change in the market caused by Draghi's "whatever it takes".

The dominant mood has shifted from a very real fear of disintegration of the European project, to a presumption that, whatever it takes, the wheels will be kept on. What is interesting is how this has translated into changes in patterns of demand for bonds, whether in terms of duration, core vs periphery, or maturity buckets.

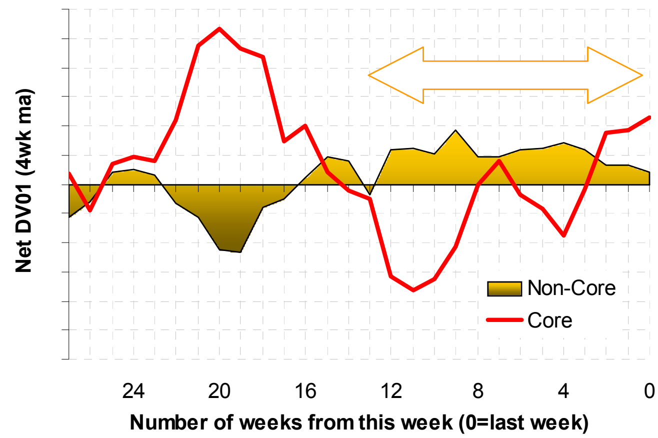
Demand for European government bonds has rebounded in the last quarter (Figure 30). This period has been characterised by increasing demand for the core, and, for the first time since the crisis began, sustained buying of the periphery (Figure 31).

Figure 30. Rebound in demand for European government bonds



Source: Citi Research

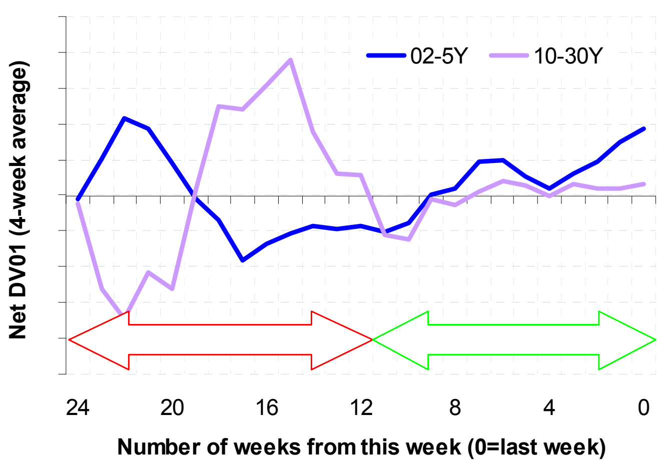
Figure 31. Rebound in core demand accompanied by sustained demand for periphery for the first time since the beginning of the crisis



Source: Citi Research

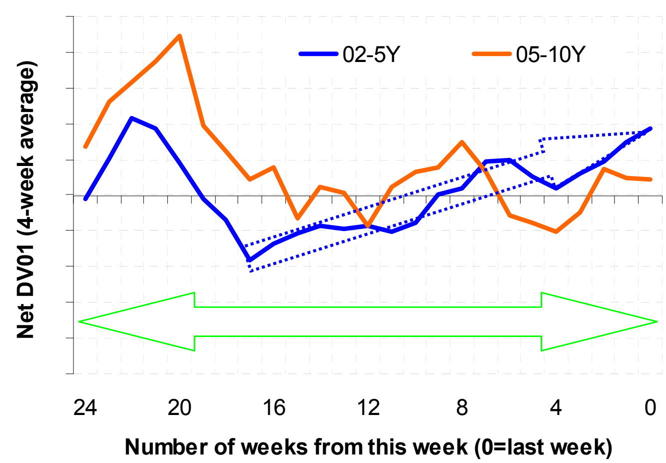
Whereas demand for the front end and the long end tended to move in opposite directions (Figure 32), since the upswing in overall demand and the sustained buying of the periphery, they have moved together.

Figure 32. Inverse relationship between demand for either end of the curve prior in the last 3 months, and a positive relationship since



Source: Citi Research

Figure 33. Demand out to 10yrs tends to move in tandem, but clear upward trend to appetite for front end



Source: Citi Research

[13] The flows in this section are based on executed Citi electronic customer trades.

Clear upward trend in demand for the front end

By contrast, demand for the 2-5yr and 5-10yr buckets have had a positive relationship over the whole period (Figure 33). It is noteworthy however, that demand for the front end has been on a sustained upswing for some time now, influenced no doubt by the prospect of ESM paid-in capital flows.

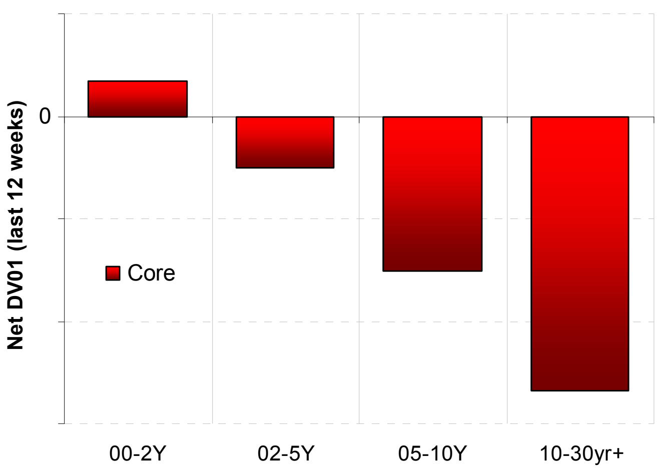
The above uses 4-week averages to reduce the noise and reveal medium term trends. Below we use aggregate net DV01 over the last 12 weeks since the demand patterns highlighted above have changed.

Clear inverse relationship between demand for the core and duration.

Demand for Spain much more concentrated on the curve than for Italy.

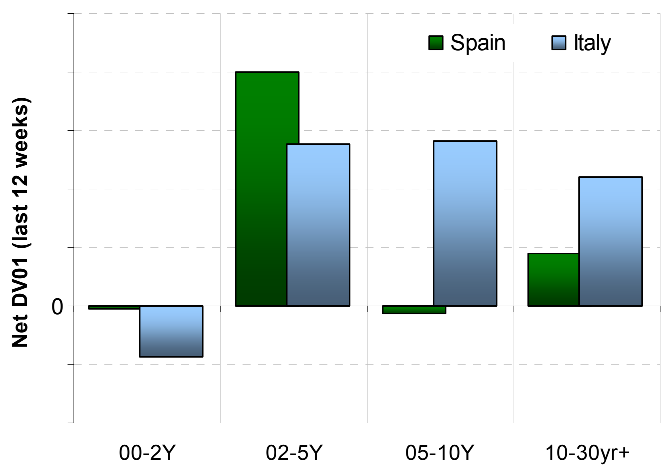
Within the net selling of the core that we have seen in that period, there has been a clear inverse relationship between demand and duration (Figure 34). In the periphery we have seen a clear distinction between the pattern of net demand for Italy and Spain over the last 3 months as a whole. Figure 35 shows appetite for Spain concentrated almost exclusively in the 2-5yr bucket, while demand for Italy has been spread relatively smoothly, in DV01 terms, across the curve. Demand for both countries coincides in the 2-5yr bucket.

Figure 34. Clear inverse relationship between duration and demand for the core in the last 3 months



Source: Citi Research

Figure 35. Demand for Spain has been concentrated in the short end, while appetite for Italy has been across the curve. Demand has coincided in the 2-5yr bucket.



Source: Citi Research

Conclusion of demand analysis

Conclusion of analysis of demand trends since the mood has improved, and what this could mean for next year.

Demand is obviously backward-looking, but it does give some insight into how fear and expectation is affecting where money is channeled. The positive change in mood that we have seen has been expressed in sustained demand for the periphery, reduction of core duration, and in Europe as a whole, much less discrimination between different maturities. If as we suspect, the happy status quo continues in the short term, with the troika managing to keep the unfit climbers roped together as they grumble and stumble on the narrow path along the arête[14], these demand patterns are likely to persist or evolve in a broadly similar direction. That points to support for Italy, the front end of Spain, and core long-end steepening.

[14] Whether they reach the summit of political and economic union is another matter. If they do it will take a long, long time. Perhaps the prospect of Touching The Void will keep them on the winding path and working together.

Bund vs Treasury Spreads in 2013

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Citi's forecasts indicate further decoupling between the US and the Eurozone in 2013. Markets are not pricing in that scenario. We explore opportunities to beat the forwards based on USD/EUR rate differentials in forward space.

Fundamentals & Policy Distortions

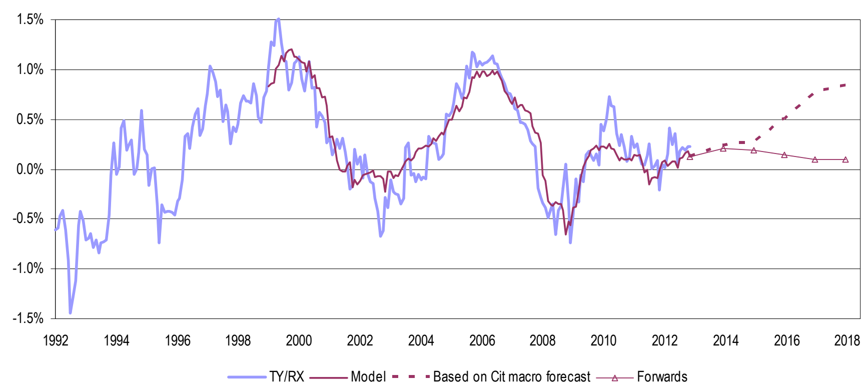
Monetary policy, inflation and economic activity drive USD/EUR spreads

Over the long-term, interest rates and bond yield are determined in equilibrium by macroeconomic variables. The spread between Bunds and US Treasuries is no difference: We estimate and forecast the 10y yield differential between benchmark Eurozone and US government yields as a function of relative inflation, business cycle differences and the orientation of ECB/FED monetary policy.

Citi's macro forecasts imply wider Treasury/Bund spreads…

Using macroeconomic projections published by Citi's economists (Global Economic Outlook and Strategy), we project a baseline scenario for the evolution of Treasury vs Bund spreads over the next 5 years (Figure 36).

Figure 36. TY/RX Model based on fundamentals



Source: Citi Research

…while forwards remain range bound

Based purely on macroeconomic projections, we should expect the yield differential to trade around current levels (25bp) in 2013/2014 and then widen towards 85/90bp in the subsequent three years. This compares with a range-bound trajectory as implied by the forwards market.

Policy Distortions

QE tends to distort the pure fundamental relationship between US and Euro yields

As recently highlighted (G10 Rates Weekly), significant differences in monetary policy as well as the prolonged zero interest rates environment impose a strong bias on market valuations. Therefore, TY/RX spreads have traded in a range-bound environment despite an evident divergence in growth and inflation trajectories between the US and the euro area.

ECB's non-standard measures somewhat balance the impact of FED's QE

On the other hand, FED's aggressive quantitative easing programs seem to be well matched by ECB's aggressive credit easing, i.e. the combination of long-term refinancing operation with full allotment, relaxation of eligible collateral rules and purchases of selected securities (EGB periphery and covered bonds). The significant safe-haven premium embedded in Bunds, resulting from intense periods of sovereign risk volatility in peripheral EGB markets, is also an important factor in delivering a rangy TY/RX spread even in light of FED's outright buying.

Trade Recommendation

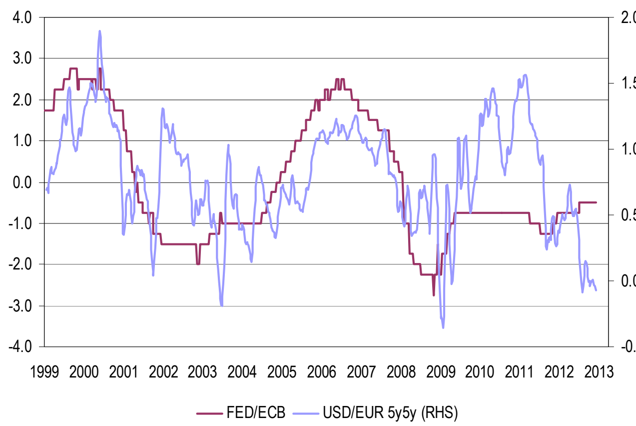
Receive EUR 5y5y, pay USD 5y5y

One way to express the underperformance of USD rates relative to EUR rates is to pay USD 5y5y vs receive EUR 5y5y around 12bp. The spread of forwards look quite misaligned compared to policy differentials (Figure 37), even more so if we used the Eonia or the ECB deposit rate as the true level of policy rates in the Eurozone.

Playing second-order risks

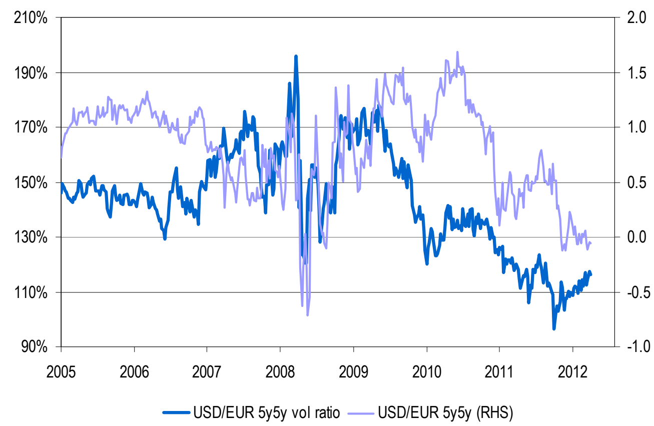
Furthermore, paying USD 5y5y also implies a second order curve risk (i.e. 5/10s steepening), which looks like the right kind of risk to have after a 60/65bp compression in the USD/EUR 5/10s box (currently around 10bp) from all time highs in Q2 2011. This makes sense under a scenario of jump in longer-term US inflation expectations, most likely related to direct and indirect monetary factors.

Figure 37. Forward differentials vs policy



Source: Citi Research

Figure 38. Perhaps via payers?



Source: Citi Research

The position incurs a mild cost of carry of approximately 8bp over the coming 12 months (USD/EUR 4y5y @4bp). The long-term average of USD/EUR 5y5y differentials is 80bp, which looks like a decent target level to us (stop loss should be not lower than -20bp, even under conservative scenarios).

Same trade via swaptions

We've also looked into the same USD/EUR 5y5y trade using options. The significant decline in the USD/EUR 5y5y vol ratio from 170% in 2009 to current 120% levels (Figure 38), suggests buying USD 5y5y payers OTM and selling EUR payers against it. The trade can be done around zero cost for USD 3.5% and EUR 3.25% strikes and the vol roll-down profile is almost flat.

2013 Gilt Outlook

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Economic backdrop: The UK economy is likely to disappoint again in 2013. Citi forecast growth of about 0.8% versus the 1.2% consensus. Our economists argue that *"the economy faces powerful headwinds from private deleveraging, poor credit availability, heavy fiscal drag, the EMU crisis and the bias among companies to allocate new investment overseas"* (see *GEOS*, 26 November 2012). Inflation is likely to be sticky in the near-term (tuition fees, food and energy), but then head lower. Further modest QE is likely over time.

Duration – carry is King

Trade theme: buy the dips in gilts

Duration – lower for longer: The fundamental economic backdrop points to a lengthy period of low gilt yields. It is difficult to see where any lasting bearish impetus would come from. Policy rates are likely to be on hold for several years and inflation risks are likely to be muted. There may also be further gilt buying from the BoE via modest QE. The ongoing EMU crisis should also continue to cap gilt yields, especially given our economists view that Grexit could occur in the next 12-18 months (60% probability) and that eventual sovereign debt restructuring is likely for several countries in the euro area (see *GEOS*, 26 November 2012).

What about fiscal and ratings risks? Fiscal risks are growing and there seems a reasonable chance that Moody's and S&P place the UK on Negative Watch and Negative Outlook respectively in 2013. Eventually, the UK may lose its AAA rating. However, we doubt that a ratings downgrade will have a lasting impact on gilt yields. Gilts are likely to continue to attract international flows thanks to its monetary policy independence and simply by being non-euro.

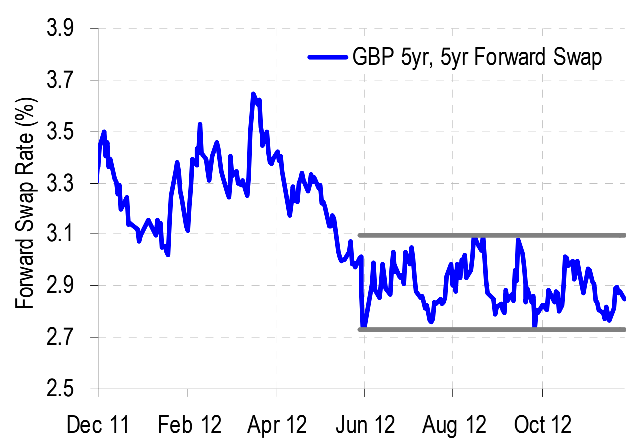
Trade theme: receive GBP 5yr, 5yr forward above 3%

Play the range: Gilt yields have averaged around 1.9% in the 10yr sector so far in 2012. Based on the fundamental outlook above, a similar average yield level is likely in 2013. In broad terms, we would be buyers of 10yr gilts around 2.1%-2.2% and sellers around 1.4%-1.5% (Figure 39). In sterling swaps, the 5yr, 5yr forward has been in a tight range since June (Figure 40). The range is likely to hold for the foreseeable future, in our view. If the range were to break, it would probably be more likely to break to the downside based on our 'lower for longer' view. With this in mind, we would look to fade any backup above 3% (especially given the attractive positive carry, see below).

Figure 39. Yields to remain range-bound at low levels

Source: Citi Research, Bloomberg.

Figure 40. Receive 5yr, 5yr GBP forward on any backup in yields

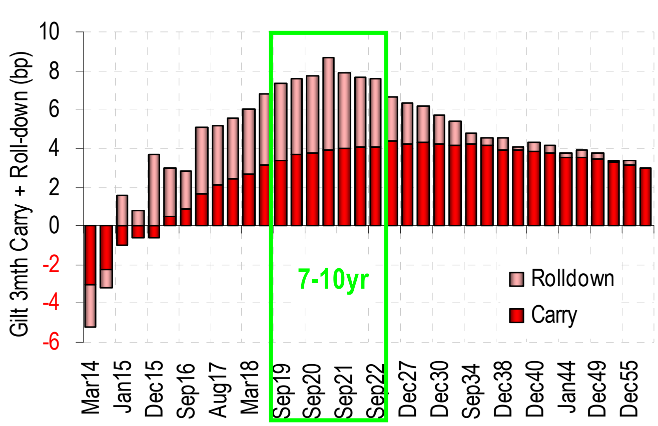


Source: Citi Research, Bloomberg.

Trade theme: the 7-10yr sector of both the gilt and swap curve offers the best carry

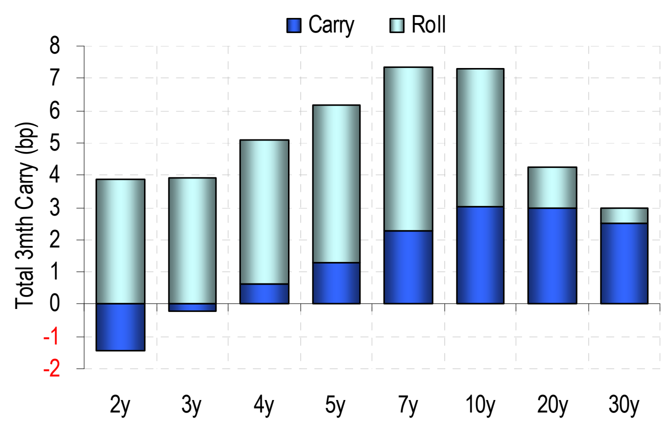
Carry is king: With yields likely to be range-bound at low levels, carry trades are likely to retain their popularity in 2013. The best total carry on the gilt curve (over a 3mth horizon) can currently be found in the 7-10yr sector, as shown by Figure 41. It is a similar story in sterling swaps. As Figure 42 shows, the 7-10yr sector offers the sweet spot it terms of maximizing carry and roll-down. One way of capturing the carry in the belly of the curve is by receiving the 5yr, 5yr forward swap rate shown above. This currently attracts 8.5bp carry over a 3mth horizon. This is down from a peak of 9.5bp in October, but still higher than the 6.5bp carry offered at the beginning of 2012.

Figure 41. The best carry is in the 7-10yr sector in both gilts…



Source: Citi Research

Figure 42. …and swaps



Source: Citi Research

Cross-market - gilts could still perform, with or without QE

Gilts are ending the year at cheaper levels: Gilts are ending the year at the cheaper-end of the 1yr range versus both Bunds and Treasuries. The recent cheapening largely reflects the pricing out of QE which the Bank of England held at £375bn in November. Without QE, the gilt market will face greater pressure from net cash-flows as a large chunk of issuance will no longer be offset. The decision to transfer APF coupon money back to the Treasury will help to lower issuance, but this will not fully make up for the lack of weekly buying from the Bank of England. The start of the year is likely to be particularly challenging for gilts given the prospect of heavy issuance coupled with adverse seasonals (see *European Rates Weekly* of 22 November). However, beyond that, gilts could perform well on a cross-market basis over the course of 2013, especially versus Treasuries:

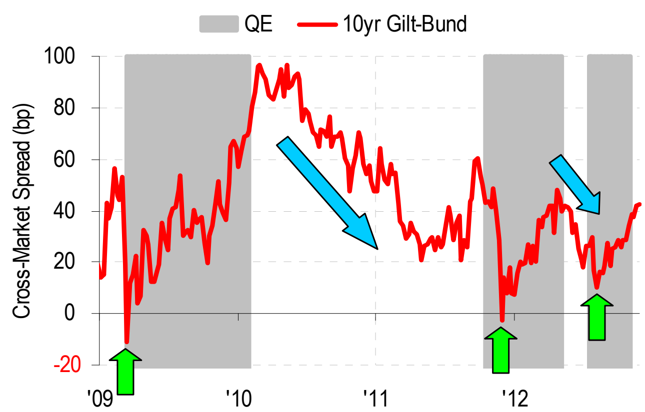
Trade theme: risk-reward favours gilts over Bunds

Gilts vs Bunds: The 10yr spread is likely to operate within a relatively tight range of around +10bp to +50bp, in our view. The current level is +40bp suggesting that the risk-reward currently favours long gilts vs Bunds, although better levels may present themselves in early 2013 (see above). A preference for gilts is supported by the Citi base case that more QE will be needed in 2013. Gilts tend to outperform Bunds sharply in the initial stages of QE as the market quickly prices it in (as highlighted by the arrows in Figure 43). The chart also shows that, over longer periods, gilts perversely perform better in non-QE periods than QE periods. This probably reflects market positioning and the impact of QE on broader asset prices. The implication is that gilts could benefit in the short-term if QE is restarted and over the longer-term if QE isn't restarted. The main risk to gilt outperformance vs Bunds is any flare up in the EMU crisis which would trigger flight-to-quality into Bunds. This risk will always be present, but the gilt-Bund spread is likely to be most vulnerable in the latter stages of 2013 given our economists Grexit view (see above).

Trade theme: gilts to outperform Treasuries significantly, but not until H2

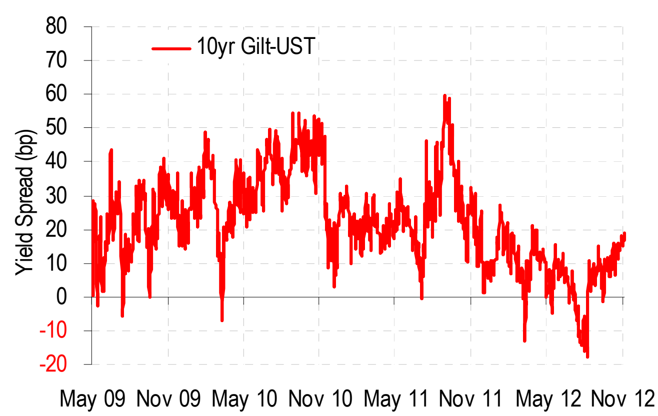
Gilts vs Treasuries: The 10yr spread is likely to remain relatively stable in the first half of the year, but with a bias towards gilt outperformance. However, the psychologically important 0bp is likely to prove hard to break on a sustained basis (Figure 44). This is likely to change in the second half of the year, in our view. Economic divergence coupled with an escalation in the EMU crisis is likely to see 10yr gilt yields eventually trade significantly through Treasuries, perhaps by as much as 70-100bp by the end of 2013.

Figure 43. Gilts perversely tend to outperform in non-QE periods



Source: Citi Research, Bloomberg.

Figure 44. The Gilt-Treasury spread is likely to remain at low levels



Source: Citi Research, Bloomberg.

Curve – direction and issuance likely to be key

Trade theme: curves and flies are likely to remain directional

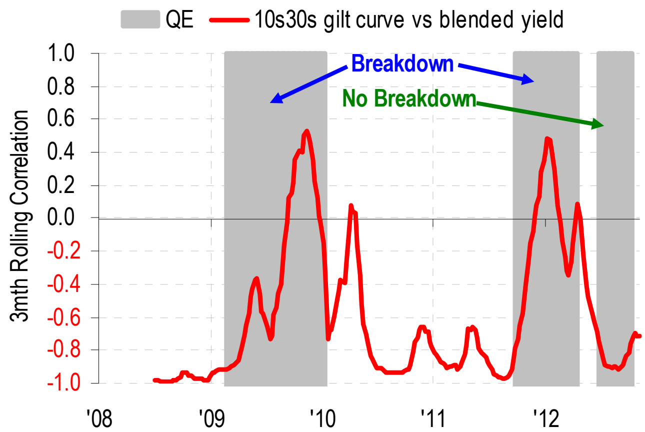
The high beta point is likely to remain in the belly of the curve: The front-end is likely to remain anchored by stable policy rates and 2s10s is likely to bear steepen and bull flatten. The long-end of the curve is also likely to remain highly directional; 10s30s is likely to bear flatten and bull steepen. Similarly, curve flies are likely to remain highly directional.

Impact of QE: Additional QE has the potential to disrupt the usual directionality in 10s30s, as it has over the last few years (Figure 45). However, the curve impact seemed to lessen ahead of and during QE3. If QE is restarted during 2013, it would probably take a bucket shift for it to have a major curve impact.

Issuance and 10s30s: Over the last five years, the 10s30s gilt curve has gone from a relatively flat curve, which was inverted up until late-2008, to a curve that stands out as relatively steep (Figure 8). This can partly be explained by issuance. The DMO have actively pursued a policy of lengthening the average maturity over the last few years. This has clear benefits in that it reduces refinancing risks and is looked upon favourably by the ratings agencies. However, in the current environment, it also acts to keep the curve steeper than otherwise. Issuance in Longs and Linkers (which is mainly skewed towards the very long-end) currently accounts for around 50% of the remit.

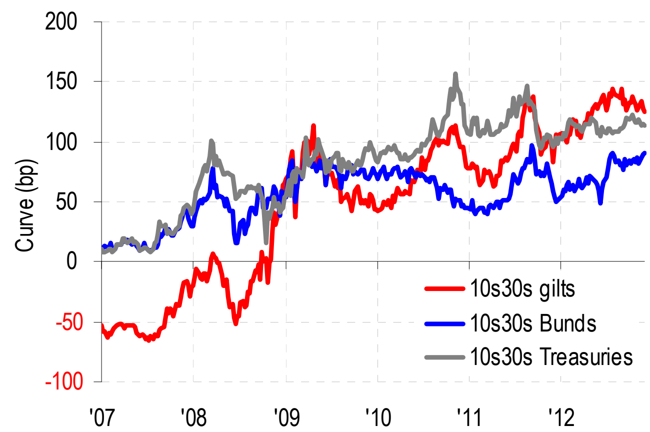
Long-end drivers: A significant flattening trend is only likely if yields move higher. However, the curve could lose some of its relative steepness if the issuance split is modified for FY2013/14. A reduction of issuance in Longs certainly seems justified given the relative cheapness of the long-end of the curve. This cheapness may become even more accentuated in the near-term following the announcement that a consultation will be held on modifying the discount rate used by pension funds. This will lessen the need for liability hedging in the long-end. Barring a move higher in yields, it is hard to see the curve flattening unless the supply-demand imbalance in the long-end is re-addressed.

Figure 45. QE can temporality break the directionality of the 10s30s



Source: Citi Research, Bloomberg.

Figure 46. The 10s30s gilt curve is steeper than Bunds and Treasuries



Source: Citi Research, Bloomberg.

Swap spreads – modest widening likely

Trade theme: look for 30yr gilts to outperform vs swaps

Widening bias: Swap spreads have tightened significantly in the second half of 2012, led by the front-end. This is largely reflective of the downward trend in Libor and tightening in the Libor-OIS spread. However, with Libor now sitting just above base rates at 0.52% and no prospect of a rate cut, front-end swap spreads look set to stabilize. There is scope for widening further out the curve, in our view. In particular, 30yr gilts are close to their cheapest level in a year.

Summary

Overview: Gilt market direction in 2013 is likely to be driven by a weak economy and the evolution of the EMU crisis. There will be plenty to play for within the range, but yields are likely to move broadly sideways. Carry will be king. For cross-market, curve and swap spreads, QE decisions and issuance are likely be highly influential.

A busy year for the Bank: The market has scaled back QE expectations in recent months. The APF coupon transfer (worth £11bn in FY2012-13, £37bn in FY2013-14 and around £13bn a year thereafter) is akin to QE, but without the buying flow. Our economics team still expects further modest QE in 2013. There will also be the first redemptions of gilts held within the APF worth £6.1bn in March and £1.5bn in September. Whether or not the cash is re-invested will reflect a monetary policy assessment at that time. The Bank will also be monitoring the impact of the Funding for Lending scheme (FLS) as it pursues unconventional policies beyond QE. And, of course, there will be a new Governor in July as King is replaced by Carney.

Favorite strategies: Buy the dips in gilts, receive GBP 5yr, 5yr forward above 3% (and enjoy the carry), risk-reward favours gilts over Bunds, gilts to outperform Treasuries in 2013 but not until H2, look for 30yr gilts to outperform vs swaps.

2013 UK Inflation Outlook

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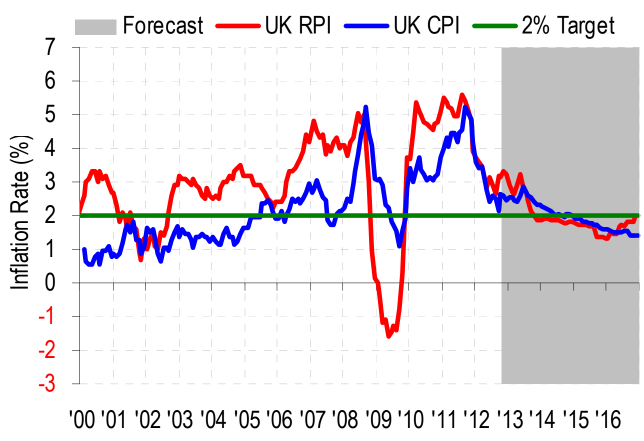
Economic backdrop: UK inflation is likely to be sticky in the near-term, due to tuition fees as well as food and energy prices, but then fall back towards target in 2014 (Figure 47). The near-term inflation overshoot is likely to be muted compared with the experience of the last few years. The sharp jump in inflation in October (RPI 3.2% from 2.6% in September) is not a sign of things to come, in our view. In light of the economic headwinds, the medium-term trend is likely to be disinflation.

CPAC uncertainty: Away from the fundamentals, there remains uncertainty over the way in which RPI will be calculated in the future. The Consumer Prices Advisory Committee (CPAC) consultation on the issue closed on 30 November, but there may not be any further guidance until January. Our base case (as reflected in the RPI profile) is that there is either a full removal, or near full removal, of the formula effect between RPI and CPI (currently worth 0.9%points). The outcome of the CPAC consultation will, of course, be pivotal for break-even direction in early 2013.

Trade theme: 10yr break-evens are likely to find support around 2.20%-2.25%

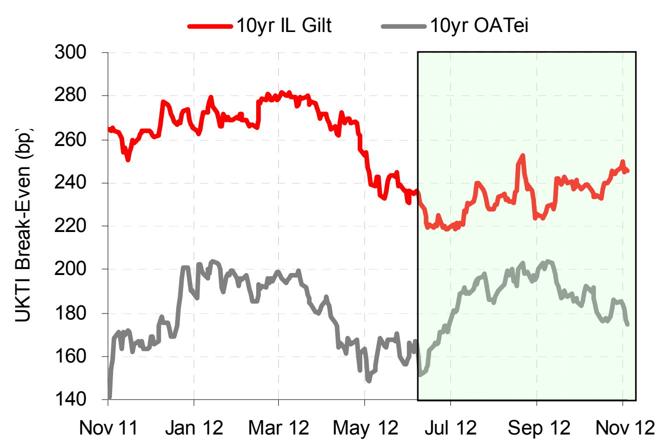
How will the market react? The least probable outcome, in our view, is that there in no change to the RPI calculation. In this event, break-evens would likely rally strongly, perhaps by 30-40bp in the first instance. The more probable outcome is that the formula effect is largely eliminated. This is likely to weigh on break-evens in early 2013 as the uncertainty is finally removed. However, the market does appear to have moved towards pricing in this scenario in recent months. Having fallen sharply, the 10yr break-even inflation rate has been finding support around the 2.20%-2.25% level. This seems fair, to us. Even if the formula effect is fully removed and RPI converges towards CPI (some differences will remain due to coverage and weights), long-dated break-evens should probably still trade at a premium to the 2% CPI target. UK break-evens should also continue to trade richer than euro break-evens, in our view, reflecting structural demand and a history of inflation overshoots.

Figure 47. UK inflation is likely to fallback over the medium-term



Source: Citi Research, Bloomberg.

Figure 48. UK vs euro break-evens in the 10yr sector



Source: Citi Research, Bloomberg.

Break-evens ending the year on a high: Since the October CPI/RPI release on 13 November, break-evens have widened sharply (10s by 13bp). October RPI printed at 3.2% YoY (consensus 2.9%) while CPI jumped to 2.6% YoY (consensus 2.2%). There has also been positive news in the form of the APF coupon transfer from the BoE to the Treasury. This is akin to QE, but will probably benefit both linkers and conventionals (via lower issuance) as opposed to regular QE which only benefits conventionals (as linkers are excluded from APF purchases). The resultant strong performance of UK break-evens can be seen vs euro break-evens (Figure 48), vs nominal yields (see green circle in Figure 50) and vs inflation swaps (not shown).

Trade theme: fade the recent rally in break-evens

Break-evens vulnerable: With CPAC looming, break-evens look vulnerable to us. This is especially true as we do not think that inflation surprises, such as in October, will become commonplace. Our economists expect RPI to peak in the next few months, probably at 3.3%, and then head lower in the latter stages of 2013.

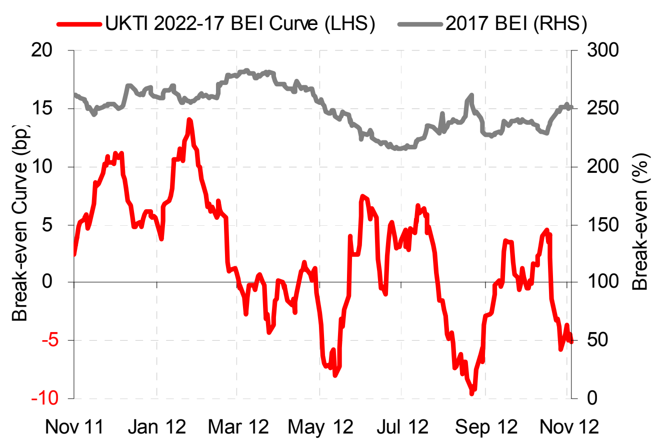
Trade theme: sell 5yr break-evens as a medium-term trade

Front-end break-evens look too rich: The recent break-even rally has been led by the front-end as the market re-priced the impact of tuition fees on the RPI fixings. The current level of break-evens looks rich vs our inflation outlook. The 2017s break-even is currently around 2.5%. This compares with our average forecast of 2% RPI between now and end-2016 (as far as our RPI profile currently extends). As the disinflationary outlook becomes more obvious in 2013, we expect front-end break-evens to correct lower and the break-even curve to steepen (Figure 49).

Trade theme: buy 10yr break-evens around 2.20%, sell around 2.70%

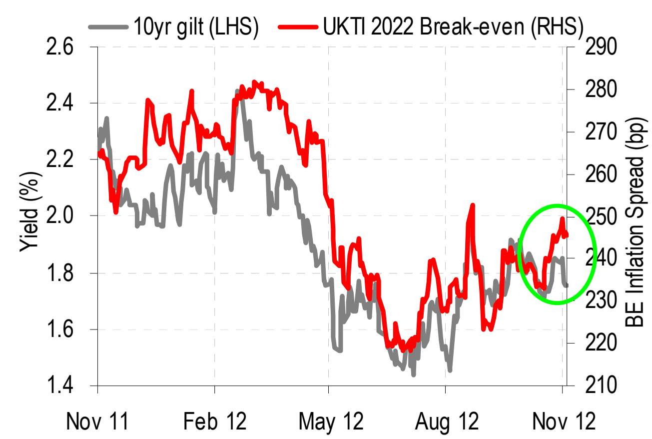
Strong directionality: A notable feature of UK break-evens over the last year has been the relatively strong directionality. In the 10yr sector, break-evens exhibit a much stronger one-year correlation with nominal yields (r = 0.89) than with equities (r = 0.05). This contrasts to 10yr euro break-evens where the correlation with equities (r = 0.75) is stronger than with nominal yields (r = 0.45). This helps to explain the diverging performance of UK and euro break-evens in recent months (Figure 48). More importantly, it highlights the significance of the outlook for nominal yields on the outlook for break-evens in 2013. In general, we expect 10yr gilt yields to range-trade in 2013. This suggests break-evens (and real yields) will broadly do the same. For 10yr break-evens, we envisage a range of around 2.20%-2.70% to be maintained (currently 2.50%).

Figure 49. The 5s10s break-even curve looks flat



Source: Citi Research, Bloomberg.

Figure 50. Strong directionality of UK break-evens



Source: Citi Research, Bloomberg.

Summary

Overview: The combination of underlying disinflationary trends and CPAC make us wary about the prospects for UK break-evens in 2013, especially in Q1. This is especially true following the recent rally which has taken 10yr break-evens to around 2.45%.

Favourite strategies: Sell 5yr break-evens or 5s10s break-even steepeners.

2013 Euro Inflation Outlook

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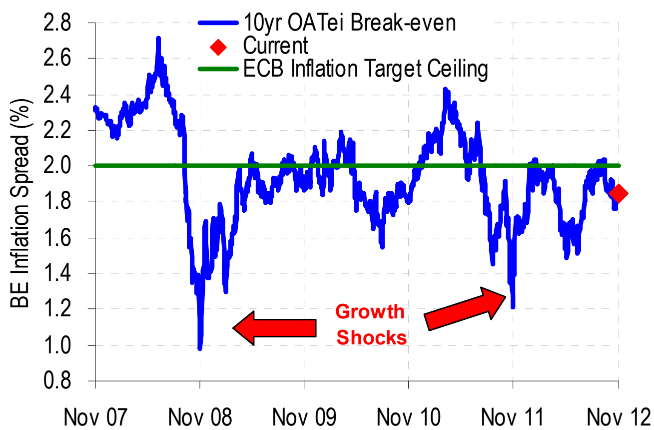
Economic backdrop: According to our economists, the euro area is likely to remain in recession for the next two years (see *GEOS*, 26 November 2012). Euro area inflation is likely to remain around the 2% target this year, but it is likely to become increasingly obvious that inflation will fall below target in future years. Citi forecasts 1.5% in 2014 falling to 1.2% in 2017.

Trade theme: sell 10yr euro break-evens above 2%

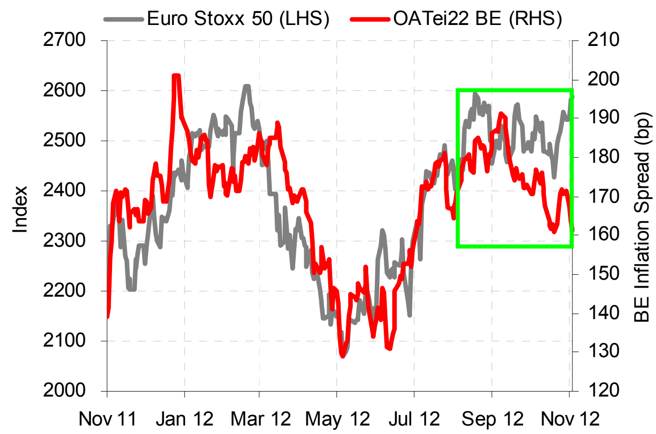
10yr break-evens likely to remain below 2%: Since the crisis began, 10yr euro break-evens have never traded above 2% for long (Figure 51). This contrasts to the pre-crisis era when 2-2.25% was the norm for 10yr break-evens. The benign inflation outlook described above coupled with recession, austerity and deleveraging suggests break-evens are likely to remain below 2% for the foreseeable future. That is not to say 10yr break-evens can't trade above 2% for short periods, but this would be an opportunity to establish narrowers in our view.

Figure 51. 10yr euro break-evens are likely to remain below 2%



Source: Citi Research, Bloomberg.

Figure 52. Break-evens continue to be influenced by risk appetite



Source: Citi Research, Bloomberg.

Correlation with risky assets: Euro break-evens continue to exhibit a strong correlation with equity markets. At the moment, break-evens look a little cheap to equities as shown by the green box in Figure 52. Moreover, our colleagues in equity strategy are bullish on the prospects for equities in 2013. This could present some upside potential for euro break-evens. However, break-evens will also be influenced by the direction of nominal yields and oil prices, both of which we expect to lack clear direction in 2013.

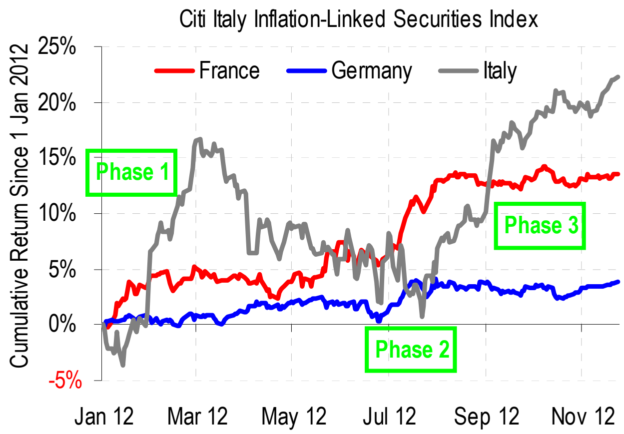
Downside risks from growth shocks: The greatest downside risk to break-evens in 2013 comes from a growth shock similar to 2008 and 2011 (Figure 51). This is especially true if accompanied by deteriorating market liquidity. For a full discussion, see *Rates market implications of a severe growth shock*, 25 October 2012.

BTPei ending the year on a high: Year-to-date, BTPei have returned an impressive return of 22%, but this masks what has been a very turbulent year as shown by the cumulative returns in Figure 53. The year can be split into three main phases. In phase 1, demand for BTPei was strong thanks to the 3yr LTROs and attractive asset-swap valuations. In phase 2, the EMU crisis escalated triggering downgrades, index events and a rise in real yields. In phase 3, the current phase, BTPei have performed well following Draghi's commitment to do "whatever it takes" and as break-evens recovered from historically cheap valuations.

Trade theme: reduce long positions in BTPei

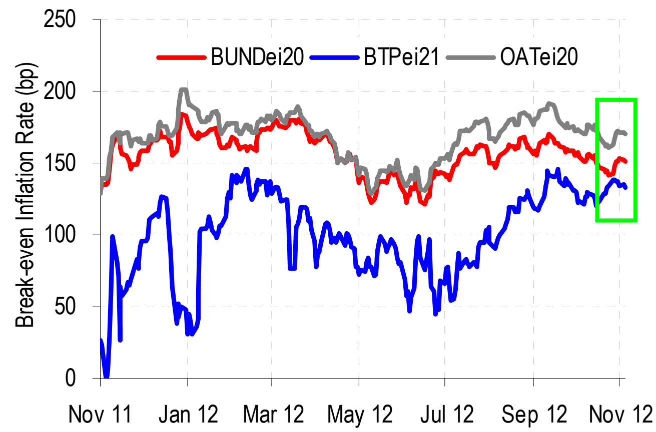
The strong performance of BTPei is unlikely to be repeated in 2013: Prospects for BTPei in 2013 depend on how much further BTPei break-evens can widen and how much more Italian yields can fall? On the former, the upside now looks limited. As Figure 54 shows, 10yr BTPei break-evens have converged to within 0-20bp of Bundei equivalents in the last few weeks. Assuming break-evens stabilise, BTPei real yields will become primarily driven by BTP yields. Here too, we expect further gains to be much more difficult in 2013. The 10yr BTP yield has fallen from a high of around 6.5% in the summer to 4.70% at the time of writing. The ECB's OMT programme will likely prevent a significant backup in periphery yields, but it also unlikely to drive them much lower from current levels. For 10yr BTP yields, we envisage an average of around 5.2% in 2013.

Figure 53. Cumulative returns of euro inflation markets in 2012



Source: Citi Research

Figure 54. BTPei break-evens have re-converged



Source: Citi Research, Bloomberg.

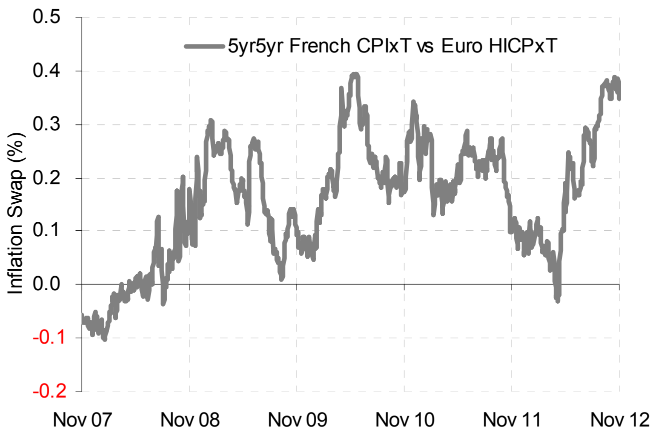
Trade theme: overweight Germany vs France and Italy

Overall euro linker performance is also likely to be down: The performance of the overall euro inflation index in 2013 will owe much to France (52% weight). The summer yield-grab into France has helped OATei/i return 13.6% year-to-date compared with 3.9% for Bundei (15% weight). However, French yields are likely to come under upward pressure in 2013 (see *European Rates Weekly* of 15 November). Citi forecast a 10yr OAT yield of around 2.70% for H2 2013 (currently around 2.10%). The double digit returns of 2012 are unlikely to be repeated in 2013. Yields are starting from much lower levels and economic risks remain heightened.

Trade theme: sell 5yr, 5yr forward French CPIxT swap vs euro HICPxT swap

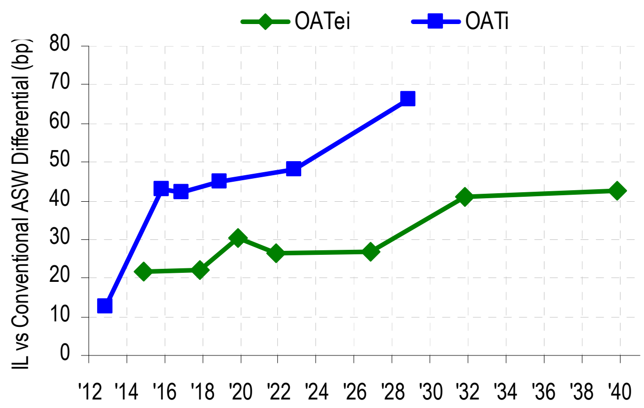
Sell French vs euro inflation: Massive inflows into Livret A and related savings products have already begun following the first of a staggered increase in the cap for the saving product. More inflows are likely in the coming months which will increase hedging flows into French inflation. However, this has been well anticipated by the market for some time now. French inflation swaps are already at levels well above what can be justified by the economic fundamentals. For long-term investors, who can stomach near-term volatility, selling French inflation vs euro inflation looks attractive (Figure 55). This is especially true given that there is a reasonable chance that supply responds to demand in 2013 and the AFT increase the supply of French inflation via greater issuance of BTAN/OATi. There may also be greater supply of French inflation via ongoing demand for BTAN/OATi asset-swaps which continue to look relatively cheap vs both conventionals and OATei (Figure 56). For more details, see *European Rates Weekly* of 22 November 2012.

Figure 55. French inflation swaps look historically rich vs euro



Source: Citi Research, Bloomberg.

Figure 56. OATi look attractive vs OATei on an asset-swap basis



Source: Citi Research

Summary

Overview: Returns are likely to underwhelm in 2013 compared with the double digits of 2012. Break-evens are likely to lack clear direction owing to the benign inflation outlook, although there are downside risks if market liquidity deteriorates. The overall performance of euro linkers will depend much more on broader yields trends and the evolution of the EMU crisis. This is especially true given France and Italy together account for 85% of the market. Essentially, the market is likely to be driven more by credit concerns than inflation.

Favourite strategies: Sell 10yr euro break-evens above 2%, overweight Germany vs France and Italy, sell 5yr, 5yr forward French CPIxT vs euro HICPxT.

Euro Money Markets

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We forecast the ECB to cut interest rates twice in 2013 (Global Economic Outlook and Strategy). In addition, there is a good chance of having a negative rate on deposits in mid 2013. Although the probability of a depo rate cut has clearly increased after the December meeting, markets do not yet seem convinced about negative deposit rates. We however see further refi rate cuts as a high probability scenario. Within this environment, we expect roll-down strategies to remain very popular trades and to consistently beat forwards-based expectations.

Beat the Forwards

Markets do not believe in a Japan-style scenario for the Eurozone. Apart from the next 9-10 months, the long-term Eonia curve is implying higher ECB rates (1y1y 15bp, 2y1y 40bp), producing an evident disconnect between BOJ's policy trajectory since the late 90s and current ECB market expectations (Figure 58).

Figure 57. ECB expectations for 2013

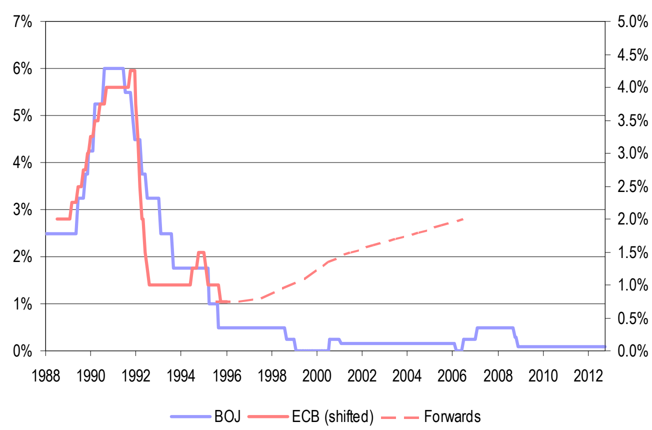
Meeting	Reserve Period		Eonia
06-Dec-12	12-Dec-12	15-Jan-13	0.08
10-Jan-13	16-Jan-13	12-Feb-13	0.06
07-Feb-13	13-Feb-13	12-Mar-13	0.04
07-Mar-13	13-Mar-13	09-Apr-13	0.04
04-Apr-13	10-Apr-13	07-May-13	0.03
02-May-13	08-May-13	11-Jun-13	0.03
06-Jun-13	12-Jun-13	09-Jul-13	0.03
04-Jul-13	10-Jul-13	06-Aug-13	0.05
01-Aug-13	07-Aug-13	10-Sep-13	0.05
05-Sep-13	11-Sep-13	08-Oct-13	0.06
02-Oct-13	09-Oct-13	12-Nov-13	0.05
07-Nov-13	13-Nov-13	10-Dec-13	0.07
05-Dec-13	11-Dec-13	14-Jan-14	0.08

Source: ECB, Citi Research

For next year, Citi's economics team expect two more rate cuts, bringing the refinancing rate down to 0.25% by the end of the year. Furthermore, the official forecast is for negative deposit rates by mid 2013 (-0.25%). Looking at the ECB curve (Figure 57), the event of negative depo rates is worth around 5bp until Jun-13 (3bp vs 8bp Dec-12 reserve). In our view, the market is reluctant to price in a high chance of negative depo rates for reasons that have to do not only with the sovereign bond market (the discussion about negative rates emerged in Jun/Jul, i.e. during a period of substantial volatility in peripheral bonds), but also with more technical issues (SMP/OMT sterilization and repayment options).

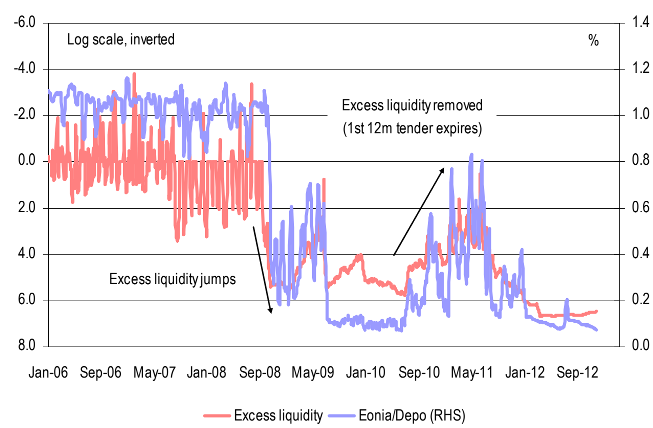
With regards to the LTRO's early repayment options, we conclude that investors' concerns about a large decline in excess liquidity and possible repercussions on Eonia fixings are unjustified (please see "LTRO: The Early Repayment Option"). Also, the ECB is without doubt aware of the implied tightening of monetary conditions in the event of a large unexpected decline in excess liquidity from the current level of EUR 620bn!

Figure 58. Forwards vs the Japanese experience



Source: Citi Research

Figure 59. Excess liquidity and deposit rates



Source: ECB, Citi Research

From a policy perspective, ECB's effort to kick-start economic activity via a mix of conventional and unconventional measures is (so far) proving to be ineffective. Repeated injections of long-term liquidity (1y and 3y LTRO programs), the SMP/CBPP together with the very low interest rate environment and tail-risk

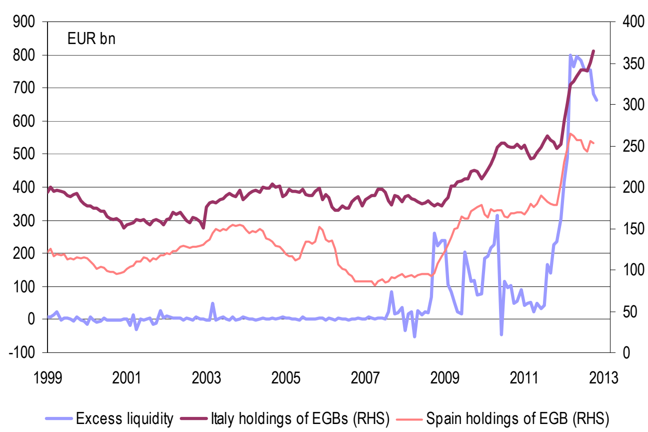
management through the OMT have been used by Eurozone's banks to load up on government bonds (Figure 60): Total MFI holdings of EGBs have increased by EUR 243bn during the 12 months ending in Oct-12 (+16%), with a particularly marked increase in Italy (EUR 110bn, +36%) and Spain (EUR 76bn, +35%).

More worrying is the fact that MFI have actually not deleveraged: Balance sheets have increased by roughly 9% during the three year period ending in Oct-12 (current 12 month average at +5%). There has been, however, an underlying process of "*qualitative deleveraging*" resulting from a combination of ample ECB liquidity and skewed regulatory framework (EGBs are zero-RWA).

Loan growth is flat over the past 12 months, while the loan-to-deposit ratio has dropped to 106% (from above 113% between 2003 and 2008, Figure 61). This suggests that the incremental ECB liquidity is not being fully transmitted to non-financial corporations and households. The process reminds us of Japan, where banks have financed carry trades on the JGB curve against the BOJ in a long-lasting attempt to qualitatively deleverage their balance sheets.

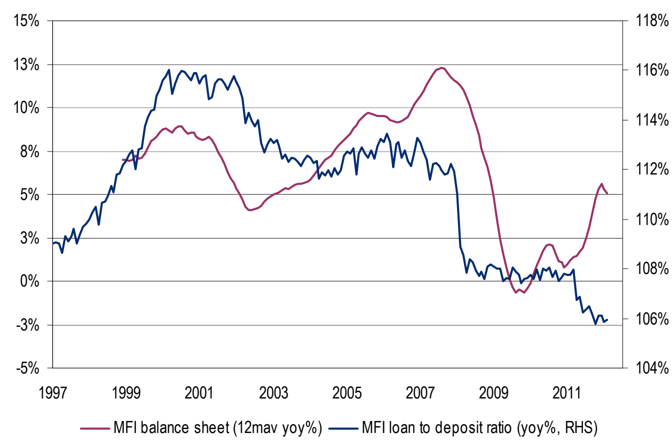
Ineffective transmission means that we're testing the limits of conventional monetary policy. In this context, unconventional measures have to be seen as necessary condition for monetary policy to affect the real economy. However, unconventional policy is by no means a sufficient condition, as we now from the Japanese experience. Rates could stay low for a very long period of time.

Figure 60. Leveraging on ECB's liquidity?



Source: ECB, Citi Research

Figure 61. Drop in loans-to-deposit ratios

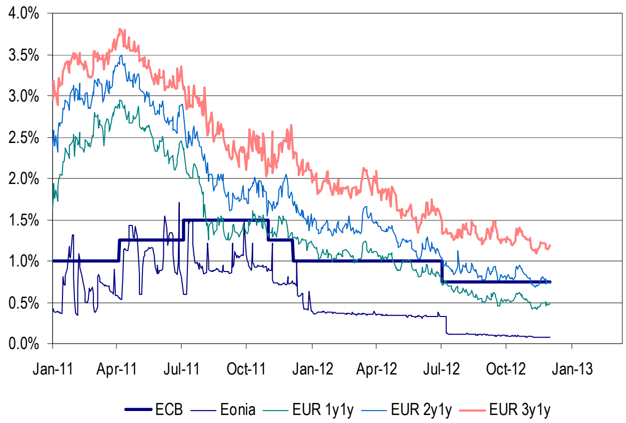


Source: ECB, Citi Research

Our investment mantra for 2013 is "carry". Risk factors for receiver positions at the front-end of the EUR curve should be mitigated by the following:

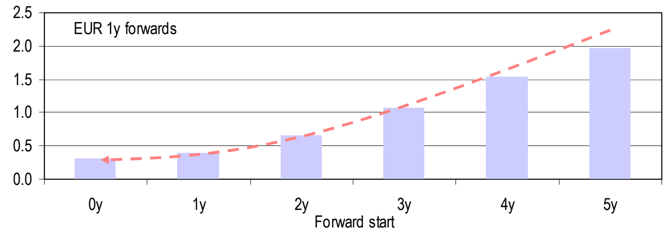
- Continued ample liquidity will prevent the kind of volatility in FRA/OIS spreads and Bor/Bor spreads that we have experienced intermittently from 2007 onwards;
- The ECB will respond with rate cuts to a deterioration in aggregate activity data as well as a decline in euro area inflation expectations;
- Substantial value in positioning against a realization of the current curve of 1y-forwards, which is still carry rich (Figure 62).

Figure 62. Less delta, more theta in 2013



Source: Citi Research

Figure 63. Carry analysis



Start	End	Swap/6s	Rolldown	BpVol	Risk Adj Rolldown
0y	1y	0.32			
1y	1y	0.39	7	35	0.21
2y	1y	0.66	27	46	0.59
3y	**1y**	**1.08**	**42**	**59**	**0.72**
4y	**1y**	**1.56**	**47**	**67**	**0.70**
5y	1y	1.98	43	70	0.61

Source: Citi Research

Trade Recommendation for 2013

We continue to recommend receiving EUR 3y1y (currently @1.16%), looking to capture not only the forecast rate cuts, but also an additional convergence towards a Japan-style scenario (JPY 1y1y dropped below 0.10% in 2003) as well as a substantial carry (Figure 63). Actually, the carry over a 2-years period from receiving 3y1y is now roughly 60% of the yield level, from 43% at the start of this year. The drop in forward rates during the course of this year (delta component) has outperformed the spread compression (forward swap roll-down). Hence, the implied carry cushion for receivers is now more interesting in percentage terms than at the start of 2012.

EUR Volatility: 3 themes for 2013

(1) Front-end forwards are too high

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Front-end rates to remain low: Citi expects the ECB to cut interest rates further in 2013: a 25bp cut to the refi rate in 1Q13, followed by a second refi rate cut which will probably come in combination with a cut of the deposit rate by 25bp (to -0.25%) in mid-2013[15]. Further rounds of LTROs to prevent liquidity shortages in the banking sector will probably occur in 2014 and no interest hikes are expected until 2016.

We expect the short-end forward yields to move lower

With this in mind, we would expect the current level of short-end forwards to move lower. As shown in Figure 64 forward yields are considerably higher than spot. Our preferred method to take advantage of loose policy rates in Europe and the prospect of further rate cuts and liquidity measures in the years to come is via carry trades (namely by buying ATM receivers). We prefer to avoid carry trades that are beyond 5yr points given the prospect of rate hikes in 2017.

The 1yr roll on the swap offsets the option cost for virtually all of our preferred segments

Roll down on the swap vs option cost: Figure 65 shows the 1year roll for selected points on the grid that we are comfortable with expressing bullish positions. Comparing this to the cost of ATMF receivers (Figure 66) shows that one a 1yr horizon the roll down on the swap offsets the option cost for virtually all segments (Figure 67). Thus, we recommend expressing bullish positions in any of these points.

Figure 64. Short-end forward yields vs spot (e.g. EUR 2y3yF – EUR 2y = 102bp)

		Tenor	
Start / Fwd-Spot	1y	2y	3y
18m	22	35	45
2y	37	54	66
3y	80	99	
4y	127		

Source: Citi Research

Figure 65. 1year roll on the swap curve (bp)

		Tenor	
Start / Rate Roll	1y	2y	3y
18m	20	28	34
2y	28	35	39
3y	42	45	
4y	48		

Source: Citi Research

Figure 66. Cost of ATMF receiver (bp)

		Tenor	
Start / Cost (bp)	1y	2y	3y
18m	20	23	26
2y	26	30	33
3y	41	44	
4y	54		

Source: Citi Research

Suggestions for choosing optimal points: The choice of which segment to express a bullish trade in the front-end is influenced by a number of factors such as an investors balance sheet constraint[16] or even an investors sensitivity to volatility slide[17]. The three figures below provide a snapshot of various screens that can be used to identify preferred points.

Figure 67. Ratio of 1yr swap roll to receiver cost

		Tenor	
Start / cost / roll (bps)	1y	2y	3y
18m	102%	119%	129%
2y	106%	117%	120%
3y	104%	103%	
4y	89%		

Source: Citi Research

Figure 68. Forward yield less spot yield less receiver cost (i.e. Figure 64 minus Figure 66)

		Tenor	
Start / Fwd - spot - cost	1y	2y	3y
18m	2	11	19
2y	11	24	33
3y	39	55	
4y	74		

Source: Citi Research

Figure 69. 1year vol slide (bpv)

		Tenor	
Start / vol roll	1y	2y	3y
18m	8	8	8
2y	10	10	9
3y	13	10	
4y	8		

Source: Citi Research

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16 E.g. although EUR 4y1y is 134bp above spot (Figure 64) the cost associated with purchasing an ATMF receiver (Figure 66) maybe too high in which case an EUR 3y2y receiver maybe more attractive

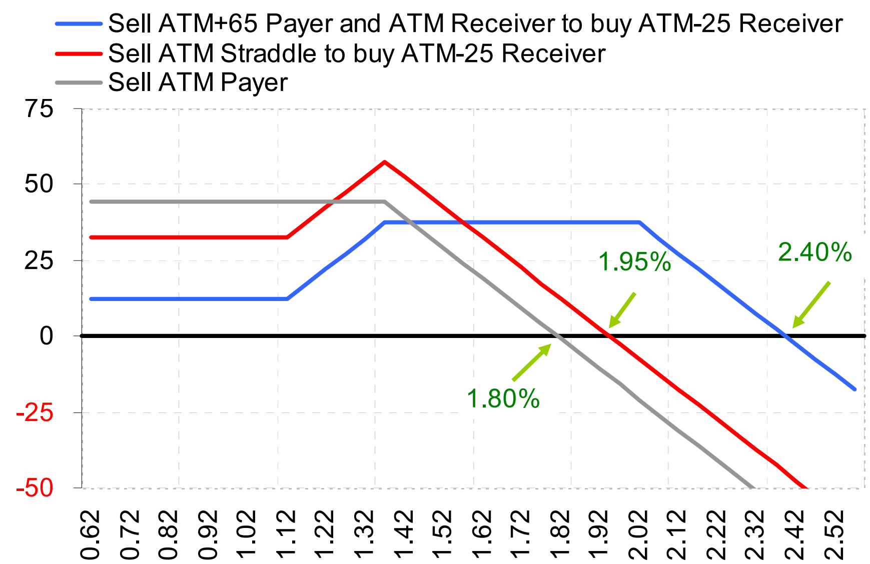
17 E.g. on a 1yr horizon the normalised implied volatility for 3y2y is 11bpv above the implied volatility for 2y2y - Figure 69.

Avoiding the initial premium outlay: "balance sheet sensitive" investors may have concerns over the initial cost of purchasing receivers, but have a strong conviction that forward yields are too high. A strategy that can exploit this would be to either sell a strangle (or straddle) and to buy an OTM receiver or to sell an ATM payer (Figure 70).

Strategies which do not incur an upfront cost

For example if you are bullish on EUR 3y2y then selling 1 x ATMF+65bp payer and 1 x ATMF receiver and using the proceeds to buy 1 x ATMF-25bp receiver offers a net premium take-in of approximately 37bp. The structure would lose money if the EUR 2yr rate is above 2.40% on expiry. This is a level that we are comfortable with given that no rate hikes are expected until 2016/17 and the maximum spread between 2yr euro swaps and the ECB refi rate has been 1.47% in the last 10yrs(!).

Figure 70. Payoff profile for selected EUR 3y2y structures at expiry



Source: Citi Research

(2) Conditional bull-steepeners

The macro view: As highlighted by our economics team in their most recent global economic outlook[18] publication there are a number of developments that are likely to occur in the next few years. During this period Citi expects the ECB to cut the refi rate by 50bps (to 0.25%) and the deposit rate by 25bps (to -0.25%). Aside from the policy rate outlook our economics team believes Greece will leave the euro area in early 2014 which is likely to result in further rounds of LTROs. Furthermore, sovereign debt restructuring in several periphery counties (such as Ireland in 2013, Portugal in 2015 and Italy & Spain before 2017) is envisaged in the next few years.

Ample scope for forward curve to bull-steepen

The forward curve is too flat: Taking into account our economic outlook for the next few years and the current level of forward rates, the EUR 5s20s curve slope is too flat, in our view. As shown in Figure 71 below the 2yr forward on EUR 5s20s is currently 93bp (this is 46bp flatter than EUR 5s20s spot).

Choosing the optimal expiry: Given Citi's expectation that "Grexit" is likely to occur in early 2014 which would result in multi-year LTROs (by the ECB) our preferred expiry on EUR 5s20s steepeners is 18months. Comparing the last three

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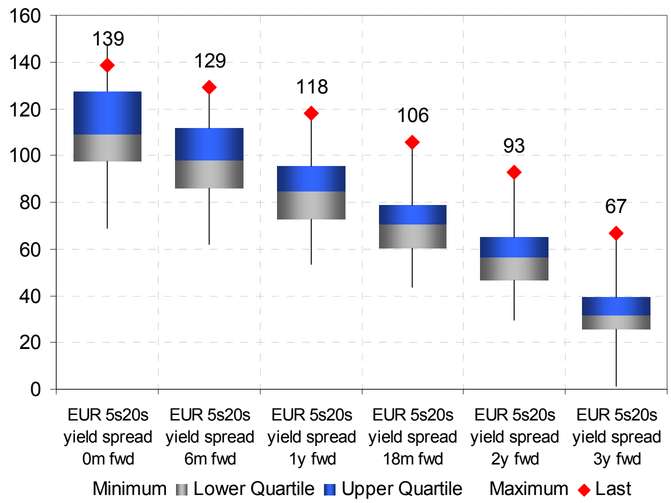
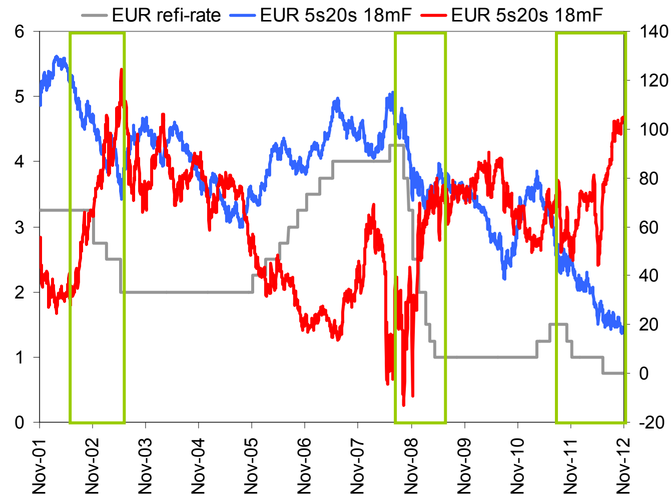
ECB rate cutting cycles to the slope of EUR 5s20s 18mF highlights the potential for the swap curve to bull-steepen during future rate cuts (and LTROs).

Figure 71. Current forward levels of EUR 5s20s along with a 3yr box whisker plot



Source: Citi Research

Figure 72. EUR 5s20s 18mF has bull-steepened during previous episodes of ECB rate cuts



Source: Citi Research

Entry level provides a healthy cushion against bull-flattening

A risk to this trade would be bull-flattening: We acknowledge that the absolute level of front-end yields is currently much lower than previous rate cutting cycles resulting in investors having concerns over the likelihood of bull-flattening. We disagree with these views and believe that the current level of EUR 5y 18mF (1.36%) provides ample room for the forward curve to bull-steepen (essentially moving to the spot curve). Furthermore, looking at the Japanese experience in 2008 shows that in the run up to the BoJ embarking on a rate cutting cycle JPY 5s20s was able to bull-steepen (even when JPY 5y 18mF was around 1.40% i.e. close to where EUR 5y 18mF is currently)[19].

Net premium intake: The richness of EUR18m20y bpv relative to 18m5y bpv offers a net premium take in of 4bp for conditional bull-steepeners[20]. Coupled with EUR 5s20s 18mF being 33bp flatter than spot we feel the current entry level provides a sufficient cushion to offset the risk of the curve bull-flattening.

(3) Calendar Spreads

Policy accommodation has crushed volatility

Quick recap of 2012: Since the start of the year, short-end EUR forwards have rallied sharply as central bank action has been highly accommodative - Figure 73. This has resulted in lower realised volatility and lower (normalised) implied volatility (Figure 74). The move has been most pronounced in shorter expiries where points such as 3m5y and 3m10y are over 30bpvol lower so far this year.

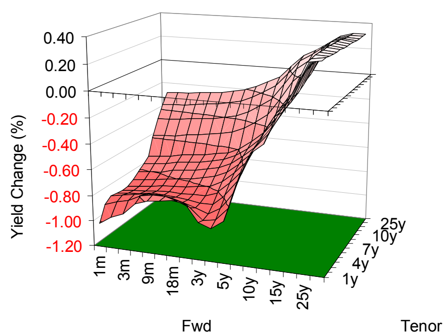
Calendar spreads have been driven higher

The sharp decline in EUR gamma has driven calendar spreads higher (the bpvol spread between short expiries and long expiries has widened considerably). For example, the spread between gamma and vega is almost at its widest level in 5years (Figure 75).

[19] Similarly the 2000-2003 experience, i.e. the period of QE and ZIRP that culminated in the all time low in JPY yields/rates in June 2003.

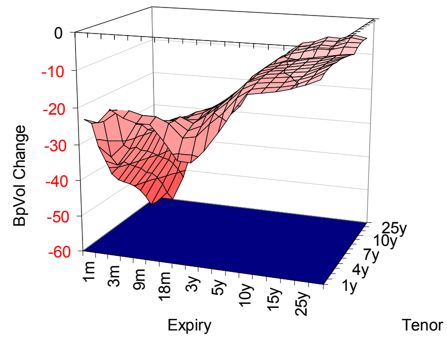
[20] Indicative mid-market levels at the time of writing

Figure 73. Change in EUR swaps since the start of the year by tenor and forward (%)



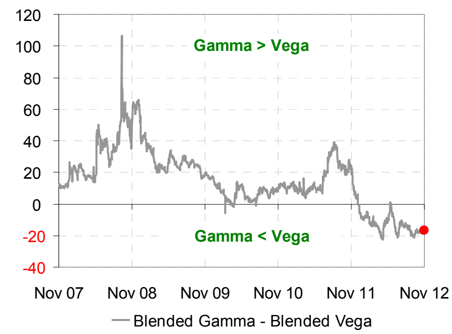
Source: Citi Research

Figure 74. EUR bpvol change since the start of the year (bpv)



Source: Citi Research

Figure 75. Blended gamma vs vega



Source: Citi Research

2013: Calendars are supported by the macro outlook

2013 and beyond: We expect the macro outlook to be supportive for calendars. More specifically, we think the upcoming event risks that we discussed earlier will put upward pressure on gamma and the low level of rates offers scope for vega to fall further.

Expressing calendars (long gamma vs vega) in expiries that are between 18months and 2yrs vs 4yrs to 5yrs

Expiry: Analysing the 6month bpvol slide for selected points on the grid shows expressing bullish vol positions in 9m10y against bearish vol positions on 5y10y (for example) can be expensive as the net slide on a 6month horizon is 9bpv against you. We therefore suggest expressing calendars (long gamma vs vega) in expiries that are between 18months and 2yrs vs 4yrs to 5yrs.

Tenor: As mentioned previously, the spread between gamma and vega is close to its widest levels in the last five years. Comparing calendar (bpvol) spreads for a selection of tenors enables us to identify points that are trading at relatively wider levels than others.

Use 10yr tenors for calendars and expiries such as 2y vs 5y

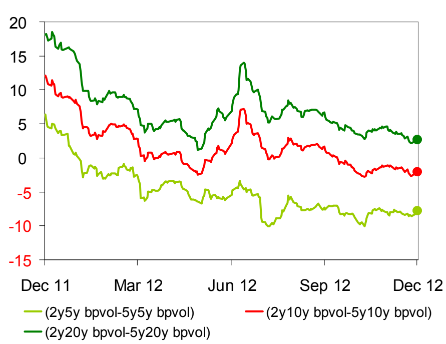
Using the data in Figure 77 and Figure 78 below we can see that the bpvol spread between 2y10y and 5y10y is currently at its widest levels for the last year whereas spreads 2y5y-5y5y and 2y20y-5y20y are slightly tighter than their 1yr wides. We therefore elect to express calendar trades in the 10yr tenor. Furthermore, low policy rates may prove to be headwind for long gamma positions in the 5yr tenor.

Figure 76. 6m bpvol change for selected points. For example 9m10y is 10bpv above 3m10y bpv.

		Tenor			
	Vol Roll	5y	7y	10y	20y
Start	9m	6	10	11	12
	1y	2	4	5	5
	18m	2	2	3	3
	2y	0	1	2	3
	3y	2	1	2	3
	4y	1	1	2	2
	5y	1	1	1	2
	7y	1	1	0	1
	10y	0	0	0	0
	12y	0	0	0	0

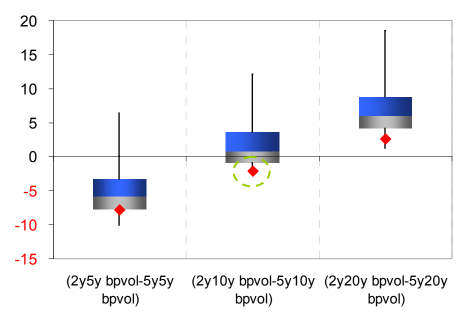
Source: Citi Research

Figure 77. Gamma is close to its cheapest levels vs vega but not all tenors are as extreme as each other



Source: Citi Research

Figure 78. Box whisker plot of the calendar spreads shown in Figure 77 (1year history)

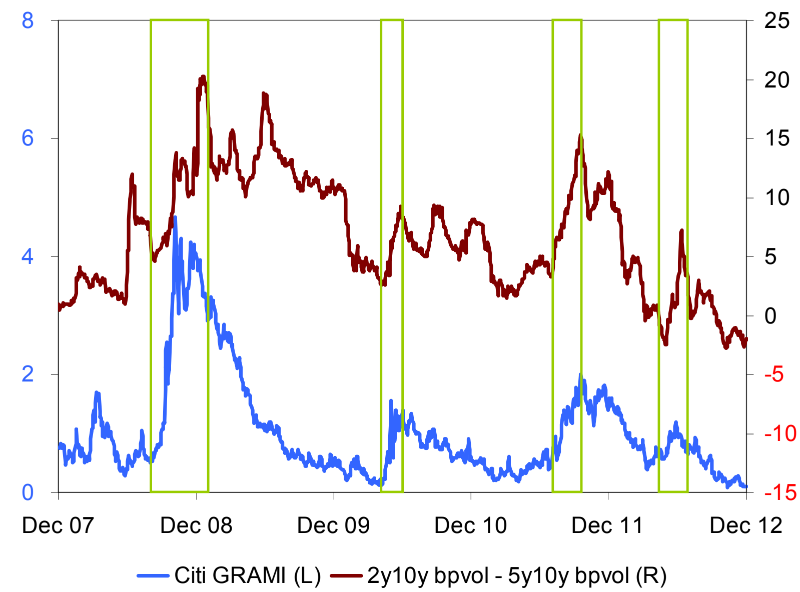


Source: Citi Research

Calendar spreads and risk indicators

Calendars vs risk-off: Comparing calendar spreads with risk indicators, such as Citi's Global Risk Aversion Macro index[21] (which spikes during periods of stress), highlights the scope for tighter vol spreads[22] (Figure 79). Thus, in summary, to gain exposure to the event risks that we have highlighted over the next few years, we recommend investors express calendar trades in the 10yr tenor such as selling 5y10y bpvol versus 2y10y bpvol.

Figure 79. EUR 2y10y bpv rises more than 5y10y when GRAMI spikes



Source: Citi Research

Summary

- **Bullish on front-end forward rates:** We expect front-end forward rates to move down towards spot during 2013. The low level of volatility coupled with elevated forward rates and attractive roll down enables investors to express bullish a bullish duration view using a variety of option strategies.
- **Conditional bull-steepeners:** The EUR forward curve has potential to bull-steepen over the coming year. Initiating EUR 5s20s bull-steepeners with an 18month expiry (or even a similar structure which also offers a net premium taken in) looks attractive at current levels.
- **Vol calendar spreads:** We expect calendar spreads to be supported by the macro environment – more specifically during previous. We recommend investors express calendar trades in the 10yr tenor such as selling 5y10y bpvol versus 2y10y bpvol.

[21] The Bloomberg ticker is GRAMI Index

[22] Comparing the calendar spread shown in Figure 79 to the VIX index points to the same conclusion.

2013 European SSA Outlook

Further performance likely, but wait for better levels

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The European SSA sector continues to attract considerable attention with rising issuance, a significant rally in 2012, healthy demand and the emergence of new issuers such as the ESM. The sector should continue to benefit from its high credit quality, its relatively low volatility and reasonable secondary market liquidity. The euro area outlook remains bleak and in times of market stress and uncertainty, core SSA issuers are likely to retain their safe haven status.

Demand is likely to remain firm

The SSA market will also be influenced by the twists and turns of the ongoing EMU debt crisis and spreads are likely to be wider than current levels for parts of 2013. Sovereign ratings and the emergence of the ESM are also prominent for the outlook. Overall, given the various fundamental concerns in the euro area and likely volatility in EMU spreads, we expect demand for AAA/AA SSA paper will remain healthy. Although performance might not be as strong as in 2012, we expect positive returns in 2013. However, we are likely to see better levels to add.

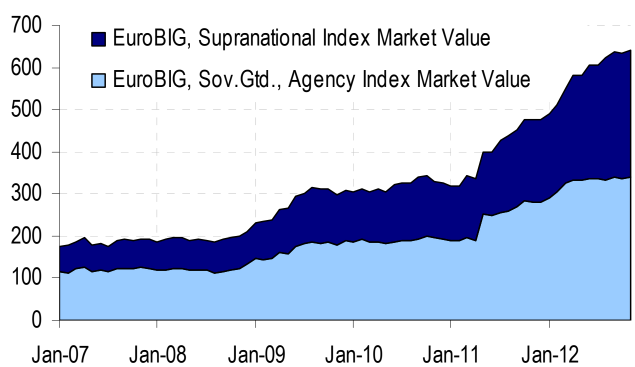
Together with trading the range and "buying on weakness", we recommend moving up in quality where the spread give up is minimal (such as KfW vs France) and continue to see relative value in core curves (such as EU vs EIB).

SSAs to remain providers of high quality supply in 2013

Size of the SSA market continues to undergo expansion and high quality supply helps to support liquidity

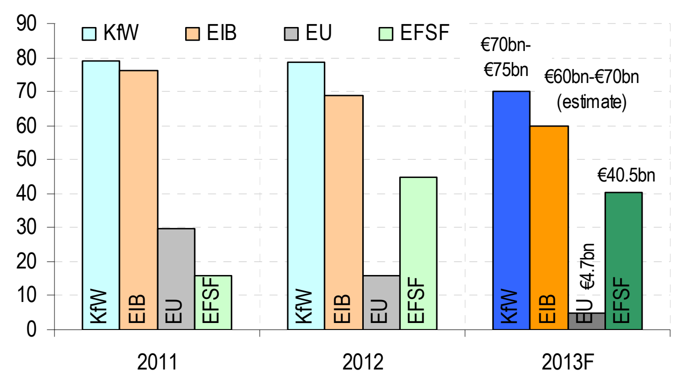
Market has expanded: The European SSA market continues to expand (in contrast to corporate credit markets) and we expect this to continue in 2013. The market value of Citi European Supra and Agency indices has risen considerably (Figure 80), particularly in the supranational space driven in part by (new) issuance from the EU and EFSF. In general, we expect the SSA market to continue being a key provider of high quality fixed income paper in 2013 (Figure 81).

Figure 80. Citi EuroBIG Supra and Agency Indices, Mkt Value (€bn)



Source: Citi Research, Yield Book.

Figure 81. Gross Supply of Select SSA Issuers (all currencies, €bn)



Source: Citi Research , KfW, EIB, EU, EFSF, DCM Analytics

Look for new issue premia as a way of enhancing returns

Supply: We expect slightly less supply compared to 2012, but issuance will still be high by historical standards. Specifically, KfW has announced a 2013 target range of €70bn-€75bn (compared with the €78.4bn completed in 2012). Similarly, we expect EIB to issue €60-€70bn and probably nearer €60bn given the prefunding in 2012. The EU has €4.7bn left to issue to complete EFSM programmes and the EFSF has indicated a long-term funding progamme of €40.5bn for 2013[23]. Full details of such issuers and their credit fundamentals and issuance patterns can be found in our *Euro SSA Strategy - An Introduction to Core European SSA Issuers*.

[23] EFSF Investor Presentation December 2012. This may change slightly as the EFSF exceeded its issuance target for 2012 with the €7bn Dec13s issue (which also adds to the maturity profile for 2013).

A new species of bond in 2013 – ESM supply?

The ESM is the latest issuer to enter the core European SSA landscape

A new entrant: Another key dynamic in 2013 is the prospect of issuance by the newly inaugurated European Stability Mechanism (ESM). This differs from the EFSF in that it has paid-in capital, it is permanent and it has seniority status in its lending operations, all of which is likely to have secondary market implications. Full details of the ESM's structural features can be found in *The ESM Becomes Operational.*

The ESM is currently involved in the package to recapitalize Spanish banks

Spanish bank recaps: On 5th December 2012, the ESM issued €35.9bn in unfunded bills and FRNs as part of the potential €100bn earmarked by the ESM for the Spanish bank recap programme agreed earlier in 2012. These securities will be transferred to the FROB for banks to repo as part of this package. This does not constitute formal financial assistance for sovereign level finances akin to the Troika programmes of Greece, Ireland and Portugal, nor does it enable OMT activation. That requires a country to request ESM aid for sovereign level support.

The prospect of ESM bond issuance in 2013 largely depends on whether financial assistance is sought

ESM sovereign support: Sovereign level ESM assistance is strictly conditional and can take many forms, such as credit lines and the purchasing of bonds in the primary and secondary market. Tradable ESM bonds will, therefore, only need be issued to fund programmes should a sovereign seek financial aid. Citi's base case is for Spain (and then Italy) to seek such sovereign-level support (probably an ECCL) some time in 2013 (*Prospects for Economies and Financial Markets in 2013 and Beyond*). Should bond buying be part of the overall programme, we expect the ECB to do the heavily lifting via the OMT initiative, which could limit ESM supply.

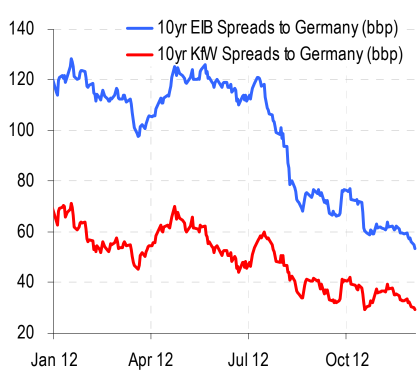
SSA spread 2013 outlook and market drivers

Rally has been impressive

Market drivers: The recent performance of core SSA spreads is impressive (Figure 82), especially in the context of supply. We expect spreads to grind tighter in the remaining weeks of 2012, especially given very limited supply pressures. The experience of 2012 is one reason why we think supply need not be an impediment to overall performance. While it might govern short term moves, and perhaps even drive some curve segments, other factors will also be important in assessing the SSA spread outlook, such as levels of demand (including the ESM), the ratings outlook and the evolution of the wider EMU debt crisis. In general, we expect the 10yr sector to remain the high beta point on the curve (with the front-end relatively anchored). Spread curves are, therefore, likely to remain directional, bull steepening in rallies and bear flattening in sell offs (Figure 83, Figure 84).

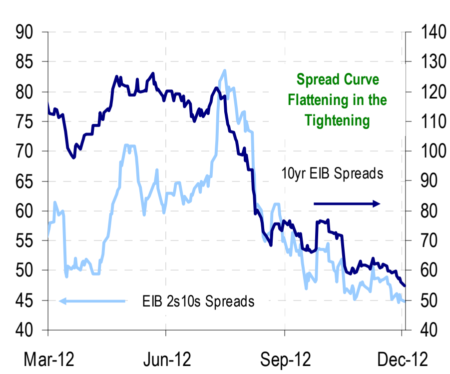
To the extent we see further spread tightening, we would expect a flatter spread curve to governments

Figure 82. 10yr Spreads to Germany (bp)



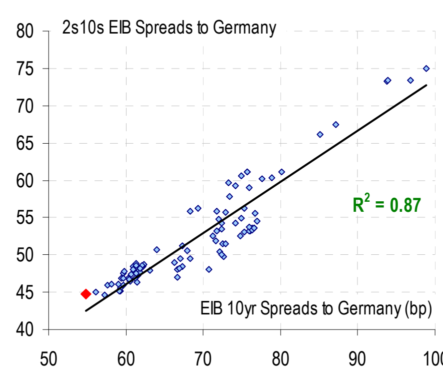
Source: Citi Research

Figure 83. EIB 2s10s Spreads vs 10yr Spreads (Spreads to Germany, bp)



Source: Citi

Figure 84. Bull Flattening, 2s10s Spreads vs 10yr Spreads, 4m History (bp)



Source: Citi Research

Demand likely to remain healthy

Demand to remain healthy: We believe that demand for high quality SSA paper will remain healthy in 2013 and the growth in international investor interest is encouraging. In general, tight spreads do not necessarily mean that selling pressure will emerge given the wider macro environment. What it does mean is that it will likely alter the risk-reward assessment for the marginal buyer (although the scarcity of other assets with "SSA like characteristics" is to the benefit of the sector).

Yields likely to remain low but trade the range

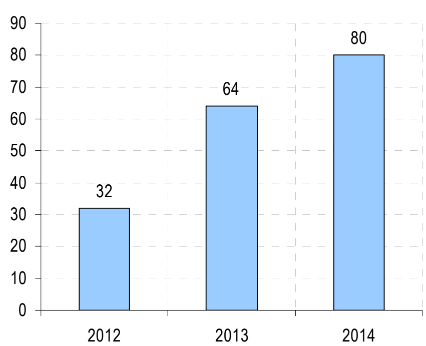
Low volatility and safe haven status: Given Citi's fundamental outlook, our base case is for SSA spreads to remain low and range-bound in 2013 (but there will almost certainly be periods where spreads are wider than current levels). Spreads will likely be guided by supply and the ongoing theme of "risk-on / risk off" driven by the euro area debt crisis. In times of stress, SSAs' haven status will attract demand. Overall for 2013, the European SSA sector will remain a high quality fixed income asset class with relatively low spread volatility. We expect positive returns can be generated by relative value trading strategies and by buying on weakness.

The ESM as a buyer – a fund investing in SSAs

ESM Investment Fund purchases is a market support

ESM Investments: One new support for the SSA sector, especially the front-end, is the process whereby the ESM itself invests its paid-in capital in high quality EMU sovereigns and SSAs. To date, the ESM has €32bn of such paid-in capital and in 2013 another €32bn will be available (with a further €16bn in 2014 to achieve €80bn in total, Figure 86). According to ESM Investor Policy criteria "*For diversification purposes, at least 30%...shall be invested either in supranational institutions or outside the Euro area*" complying with the Eligible Assets Lists (Figure 85)

Figure 86. ESM Cumulative Paid-in Capital Schedule (€bn)



Source: Citi Research, ESM

Figure 85. ESM General Eligible Asset List and Criteria

Issuing Entities	Investment Instruments	Rating Criteria
Central Banks Sovereigns / DMOs Euro area government related agencies Supranationals	Debt Securities (including bonds, bills, covered bonds, CP, certificates of deposit) Deposits (secured and unsecured)	Minimum rating for all debt securities: equal or higher than at least AA

Source: ESM Investment Policy.

We believe buying by the ESM in this way will be supportive for the SSA market, especially spreads in the front end of curves. Further details on this topic can be found in our recent piece, *The ESM as an Investor*.

Fundamental outlook – rating stability

We do not expect significant ratings pressure in 2013

EMU sovereign credit ratings attracted considerable attention in 2012. This is hardly surprising given the multiple notch downgrades of Spain and Italy, the selective defaults of Greece and the one notch downgrades of France and Austria. Despite this, the ratings of core SSA issuers remained relatively resilient: the EU, EIB and KfW all remain AAA/Aaa. The only issuers affected were the EFSF and ESM, but even then, ratings were moved just one notch lower with limited market impact.

High credit quality and relatively strong fundamentals will remain supportive for the SSA market

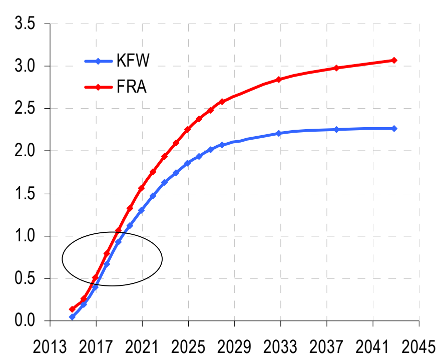
Ratings pressure on such issuers intensifies when core, large guaranteeing sovereigns such as Germany, the Netherlands and France face downgrade risk. Citi does not expect such sovereigns to be downgraded in the near-term (next 2-3 quarters in our *Sovereign Ratings* Outlook) and indeed expects a relatively benign outlook for sovereign ratings in 2013 (especially when compared to 2012). This should consequently provide a degree of stability to SSA ratings in the year ahead.

Trading strategy: move up in quality

Prefer KfW vs France and look for switches where the yield give up is minimal

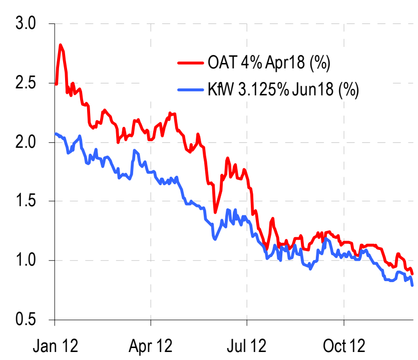
With many spreads at tights, we recommend moving up in quality by switching out of France (AA+/Aa1) and into KfW (AAA/Aaa). More broadly, in our article on France in 2013 (page 21), we argue that OATs are likely to stabilise at a new equilibrium relative to Bunds over the course of 2013. This has many drivers including the likelihood of less supportive flow components (when compared with 2012). To the extent that we expect spreads between France and Germany generally to widen (forecasts can be found in the recent *Global Economic Outlook and Strategy*) we advocate moving up in quality in the SSA space by looking at minimal spread give-up switches between France and KfW. France's curve has progressively moved towards KfW's (Figure 87) and many yield differentials are now in single digits (Figure 88, Figure 89). Although it may be hard to argue for value in KfW on an absolute basis, we would prefer being long German agencies on a relative basis vs France over 2013.

Figure 87. KFW and France Yield Curves (%)



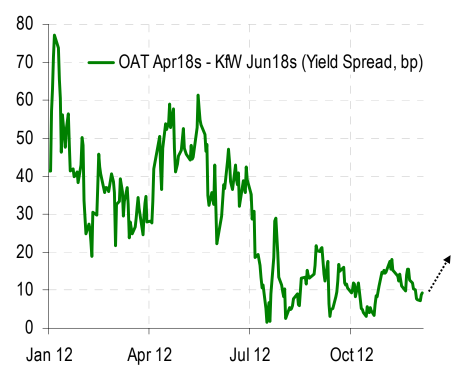
Source: Citi Research

Figure 88. 5yr KfW and France (%)



Source: Citi Research

Figure 89. 5yr KfW vs France (Yield Spread, bp)



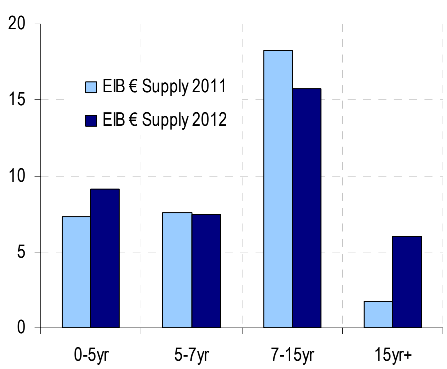
Source: Citi Research

Trading strategy: supply dynamics and EIB & EU's curves

Prefer the front end of the EU's curve relative to EIB given supply dynamics

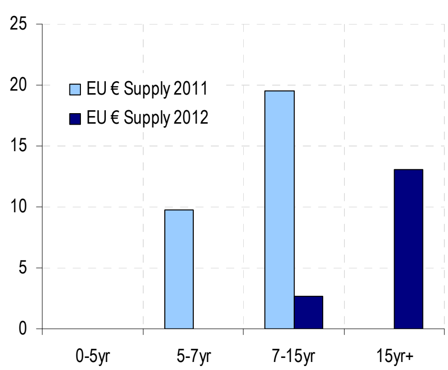
EIB has issued around €7bn-€9bn in the 0-5yr sector over recent years, around 20-25% of its total € supply (Figure 90). The EU on the other hand is expected to issue much less than in previous years (€4.7bn in 2013 compared with €16bn in 2012) and importantly does not issue sub-5yr maturities (Figure 91). All things being equal, we would expect this to put pressure on the spread between the EU and EIB in the front end, which is already at historically tight levels (Figure 92)

Figure 90. EIB Gross EUR Issuance (€bn)



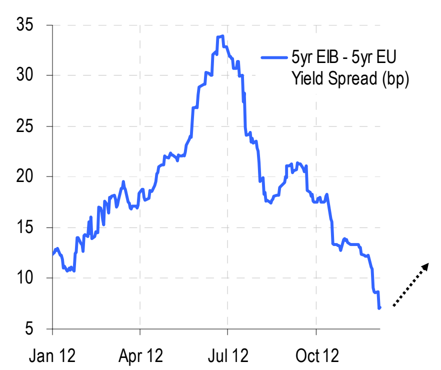
Source: Citi Research, DCM Analytics, EIB

Figure 91. EU Gross EUR Issuance (€bn)



Source: Citi Research, DCM Analytics, EU

Figure 92. 5yr EIB vs EU (Yield Spread, bp)



Source: Citi Research; Based on Citi's Fitted Curves

European SSA 2013 Summary

Supply: We expect the European SSA sector to remain a provider of high quality supply in 2013 with issuance levels broadly similar to that of 2012. The prospect of ESM supply is a key focus for investors.

Market Supports: We generally expect spreads to remain low and in a range. Demand is expected to remain healthy although the “risk-on / risk-off” theme driven by the twists and turns of the euro area debt crisis mean that spreads are likely to be wider for periods of 2013 than current valuations. Overall, we expect the core SSA market to be supported by its high credit quality, relatively low volatility and safe haven status.

Trading Themes: We recommend trading the range and buying on dips. Spread curves are likely to remain directional, bull flattening in rallies and bear steepening in sell offs. Our key themes for 2013 include moving up in quality where the spread give up is minimal and trading the relative value between core issues such as the EU and EIB.

Appendix – Global Supply Forecasts

Figure 93. UK, US and EMU-11 Gross Supply – Citi forecasts

2012 / 2013 Cashflow Tables

	Gross Supply (£bn cash)							A	B	C = A - B	D	E	F = C - D - E
	Auctions				Syndications								
UK	Shorts	Mediums	Longs	Linkers	Long	Linker	Mini Tender	Gross Supply	Coupons	Net Supply	Redemptions	Buybacks	NCR
Apr-12	4.5	4.1	2.4	1.5	5.1			18		17		17	
May-12	4.9	3.8	2.7	1.4		4.7	1.7	19	1	19		3	16
Jun-12	4.8	3.5	1.9	1.4				12	8	4	26		-22
Jul-12	4.6	3.9	4.6	1.2		4.0		18	3	16		11	5
Aug-12	5.0		2.1	1.4			1.7	10	1	9		12	-3
Sep-12	5.0	3.8	2.3	1.6		3.8		16	11	5		12	-7
Oct-12	4.5	3.8	2.2	1.8	4.2		1.7	18		18		15	3
Nov-12	4.5	3.6	2.5	1.2		3.1		15	1	14			14
Dec-12	0.0	2.7	0.0	1.2	0.0	0.0	0.0	4	7	-3	0	0	-3
Jan-13	4.2	2.7	1.5	1.2	4.2			14	2	11			11
Feb-13	4.2	2.7		1.2		3.8	1.3	13	1	12			12
Mar-13	4.2		1.5	1.2				7	11	-4	35		-39
Total	50.4	34.5	23.7	16.3	13.5	19.5	6.3	164	46	119	60	70	-12

	Gross Supply ($bn nominal)							A	B	C	D = A - B - C	E	F = D - E
US	2yr	3yr	5yr	7yr	10yr	30yr	TIPS	Gross Supply	Coupons	Fed Purchases	Net Supply	Redemptions	NCR
Dec-12	35	32	35	29	21	13	14	179	7	0	172	92	79
Jan-13	35	32	35	29	21	13	16	181	10		171	93	78
Feb-13	35	32	35	29	24	16	10	181	23		158	118	40
Mar-13	35	32	35	29	21	13	14	179	8		171	98	74
Apr-13	34	31	35	29	21	13	16	179	5		174	117	57
May-13	34	31	35	29	24	16	14	183	25		158	118	40
Jun-13	34	31	35	29	21	13	8	171	3		168	94	74
Jul-13	33	30	34	29	21	13	16	176	11		165	119	46
Aug-13	33	30	34	29	24	16	14	180	25		155	129	26
Sep-13	33	30	34	29	21	13	14	174	2		172	96	76
Oct-13	30	28	32	29	21	13	8	161	8		153	94	59
Nov-13	30	28	32	29	24	16	14	173	20		153	125	27
Dec-13	30	28	32	29	21	13	14	167	6		161	96	65
Total	431	395	443	377	285	181	172	2284	153		2131	1391	741

Gross issuance forecasts for 2012 to 2013
(for fixed rate governmnent bonds and index-linked notes)

Gross Supply	2012	2013
EMU-11 (€bn) - excluding GRC, IRE and PRT	824	680

Gross Supply	2012	2013
US ($bn)	2284	2035

Gross Supply *	11/12	12/13
UK (£bn)	179	164

UK supply forecasts on financial year basis (cash amt)

Gross Supply (€bn)	2012	2013	Tickers used in our supply estimates
Germany	184	183	Schatz, Bobl, Bund, Bundei, Boblei
France	201	188	OAT,BTAN,BTANi,OATi,OATei
Italy*	205	182	BTP, BTPei, CCT, CTZ
Spain**	99	90-107*	SPGB
Netherlands	60	59	DSL
Belgium	43	37	OLO
Austria	21	21	RAGB
Finland	11	10	RFGB
Ireland	5	10	IRLD
Total	829	788	

*excluding CCT and CTZ we forecast €164bn of issuance in 2013

**The provisional 2013 estimate for gross issuance by the Spanish Treasury is €90bn. Citi's budget deficit forecast is €17bn higher than baseline assumption used by the Spanish Treasury. However, this does not necessarily translate into €17bn of more bond issuance as the funding requirement can be met by private placements, state lottery funds and credit lines by banks to regional governments.

Source: DMOs, Citi estimates, Bloomberg

EMU 2013 Issuance Forecasts

Figure 94. 2013 Euro Government Bond Supply – Citi Forecasts (Euro in Billions)

GERMANY	Gross Supply	Coupons	Net Supply	Redemptions	NCR	Cumulative NCR
Jan	16	12	4	24	-20	-20
Feb	17	1	16		16	-4
Mar	11	0	11	18	-7	-11
Apr	18	3	15	28	-13	-24
May	17		17		17	-7
Jun	16	1	15	17	-2	-9
Jul	17	12	5	22	-17	-26
Aug	13		13		13	-13
Sep	20	1	19	17	2	-11
Oct	17	2	15	16	-1	-12
Nov	17		17		17	5
Dec	5	0	5	15	-10	-5
Total	183	31	152	157	-5	

ITALY*	Gross Supply	Coupons	Net Supply	Redemptions	NCR	Cumulative NCR
Jan	18	1	17		17	17
Feb	17	9	7	21	-14	3
Mar	16	8	9		9	12
Apr	15	1	13	29	-16	-4
May	15	5	10		10	6
Jun	15	2	13	17	-4	2
Jul	14	1	12	14	-2	0
Aug	11	9	2	25	-22	-23
Sep	18	8	10	11	-0	-23
Oct	17	1	16		16	-7
Nov	17	5	12	18	-6	-13
Dec	11	2	9	20	-11	-24
Total	182	52	130	155	-24	

FRANCE	Gross Supply	Coupons	Net Supply	Redemptions	NCR	Cumulative NCR
Jan	19	2	17	18	-1	-1
Feb	19	1	18		18	17
Mar	18		18		18	35
Apr	18	17	2	22	-20	15
May	19		19		19	34
Jun	18		18		18	52
Jul	18	6	12	33	-22	30
Aug						30
Sep	18	0	18	11	7	37
Oct	25	15	10	22	-12	26
Nov	11		11		11	37
Dec	5		5		5	42
Total	188	41	147	106	42	

SPAIN**	Gross Supply	Coupons	Net Supply	Redemptions	NCR	Cumulative NCR
Jan	15	7	7	14	-7	-7
Feb	12		12		12	5
Mar	9		9		9	13
Apr	6	4	1	15	-13	0
May	6		6		6	6
Jun	6		6		6	11
Jul	7	8	-1	15	-16	-4
Aug	4		4		4	0
Sep	9		9		9	8
Oct	9	4	5	16	-11	-2
Nov	9		9		9	7
Dec	8		8		8	14
Total	98	23	75	60	14	

NETHERLANDS	Gross Supply	Coupons	Net Supply	Redemptions	NCR	Cumulative NCR
Jan	6	4	2	16	-14	-14
Feb	9		9		9	-5
Mar	7		7		7	2
Apr	5	0	5		5	8
May	6		6		6	14
Jun	5		5		5	19
Jul	9	6	3	16	-13	6
Aug						6
Sep	4		4		4	10
Oct	3		3		3	13
Nov	4		4		4	18
Dec						18
Total	59	10	49	32	18	

BELGIUM	Gross Supply	Coupons	Net Supply	Redemptions	NCR	Cumulative NCR
Jan	4		4		4	4
Feb	4		4		4	8
Mar	6	7	-1	13	-13	-6
Apr	4		4		4	-2
May	3		3		3	1
Jun	3	0	3		3	4
Jul	3		3		3	7
Aug						7
Sep	5	5	0	16	-15	-9
Oct	3		3		3	-6
Nov	3		3		3	-3
Dec						-3
Total	37	12	25	28	-3	

AUSTRIA	Gross Supply	Coupons	Net Supply	Redemptions	NCR	Cumulative NCR
Jan	6	1	5		5	5
Feb	1	0	0		0	5
Mar	1	1	-0		-0	5
Apr	2	0	1		1	6
May	1		1		1	8
Jun	5	0	5		5	13
Jul		2	-2		-2	11
Aug	1		1		1	11
Sep	1	1	0		0	11
Oct	1	1	0	13	-13	-1
Nov	1	0	1		1	0
Dec	1		1		1	1
Total	21	7	14	13	1	

FINLAND	Gross Supply	Coupons	Net Supply	Redemptions	NCR	Cumulative NCR
Jan	1		1		1	1
Feb	3		3		3	4
Mar						4
Apr	1	1	0		0	5
May						5
Jun	1		1		1	6
Jul		1	-1	6	-7	-1
Aug						-1
Sep	2	1	2		2	0
Oct						0
Nov	1		1		1	1
Dec						1
Total	10	2	7	6	1	

*we estimate €164bn of issuance excluding CCT and CTZ

**The provisional 2013 estimate for gross issuance by the Spanish Treasury is €90bn. Citi's budget deficit forecast is €17bn higher than baseline assumption used by the Spanish Treasury. However, this does not necessarily translate into €17bn of more bond issuance as the funding requirement can be met by private placements, state lottery funds and credit lines by banks to regional

Source: DMOs, Citi Research

Summary of Recent Publications

Date	Publication	Topic	Page	Region
05-Dec-12	NOTE	Euro Rates Strategy: Greece - Modeling the Buy-Back Auction	-	EUR
03-Dec-12	NOTE	EMU Flow Analysis: Few Signs of Concern Evident in Demand Trends	-	EUR
29-Nov-12	NOTE	Weekly Supply Monitor: Euro, US and UK supply outlook	-	Global
29-Nov-12	European Weekly	EMU Directionality: Go with the flow	8	EUR
		EUR 3y1y: most popular trade in the world?	10	EUR
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27-Nov-12	NOTE	European Flow Analysis: Clear increase in appetite for France	-	EUR
23-Nov-12	NOTE	European Month-end Index Projections	-	EUR
22-Nov-12	NOTE	Weekly Supply Monitor: Euro, US and UK supply outlook	-	Global
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